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**Money and Development: Recommendations
for capital inflow dependent countries**

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htw.

Application of Thirlwall's law to Asian and African countries

"The ... explanation of the poor performance of African countries must be found, primarily, in the low magnitudes of their dynamic Harrod foreign trade multipliers... These income elasticities ... are the direct product of the characteristics of the goods produced. ... [P]rimary products such as those produced and exported by African countries, tend to have an income elasticity of demand of less than unity (Engel's Law), ... Thus, it is only logical to find that most African countries have a low dynamic Harrod foreign trade multiplier, given their excessive dependency on exports of primary commodities and imports of manufactured goods. This, as the results of this paper show, would constrain their growth to low rates that can only be surpassed if these countries are able to finance ever increasing external deficits."

Source: Hussain (1999: 128)

Motivation & research aim

Given that developing countries cannot easily change their export structure nor change the rules of the game for trade and capital flows:

- **What to recommend to countries that depend on capital inflows?**
- Stylized empirical findings & implications
- Assumption: capital flows determine current account

Outline

- (Reminder on capital flows, current account, external wealth, external illiquidity versus insolvency)
- Stylized facts on current account balances in LDCs
- The role of current account deficits in traditional theoretical approaches & empirical findings
- Empirical findings for the effects of capital inflows from past currency crises
- How to support export-driven growth?
- Recommendations for capital dependent LDCs

Reminder: Capital flows, current account, and external wealth

- Current account deficits have to be financed by net capital inflows
- Net balances might even understate dependence on capital inflows (Kaltenbrunner)
- A current account deficit implies an accumulation of foreign liabilities, net external wealth decreases.
- Net External Wealth = Rest-of-the-world (ROW) assets owned by home country – home assets owned by ROW

Reminder:

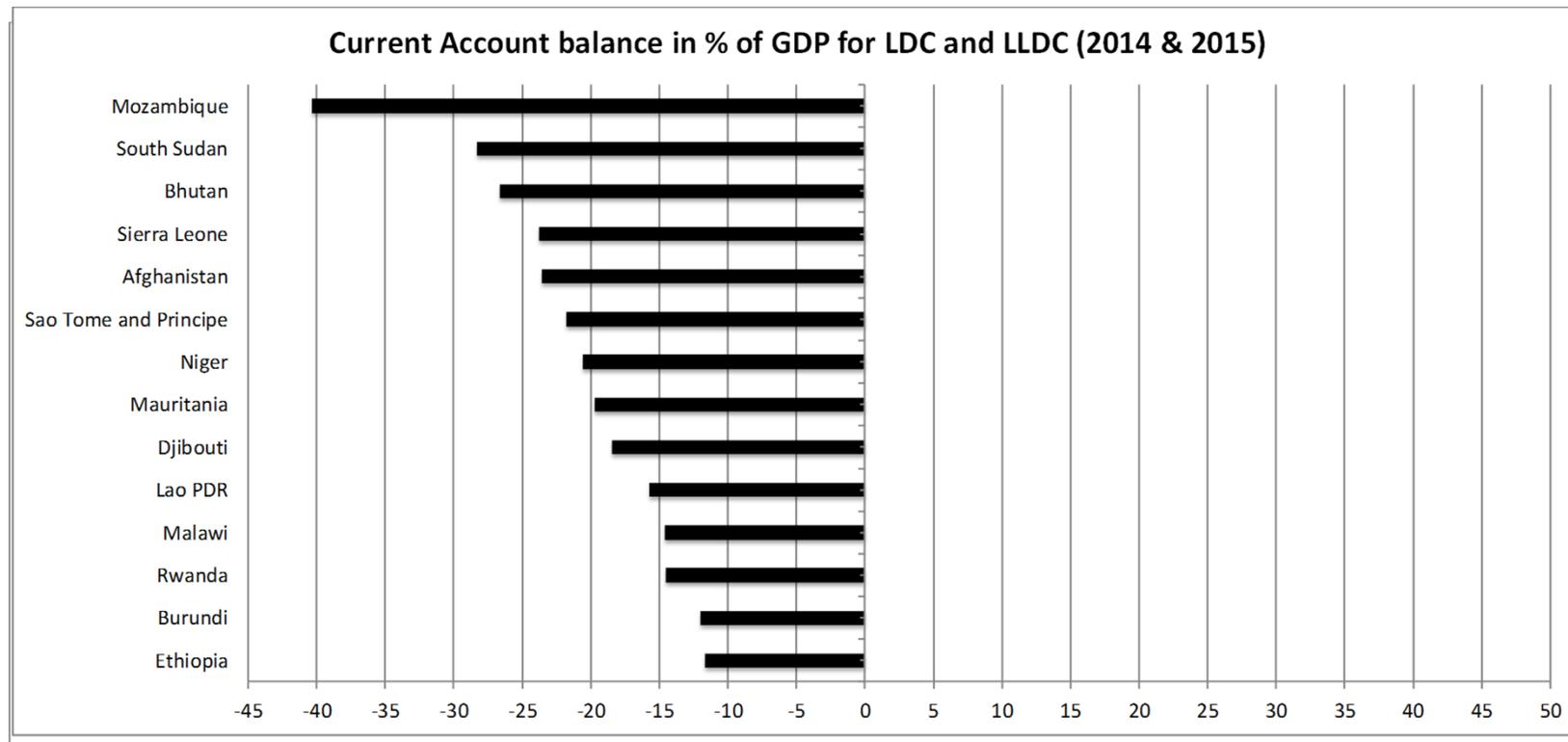
External illiquidity versus external insolvency

- **Liquidity** problem:
not enough foreign currency to pay for foreign currency
denominated imports and liabilities
=> depreciation, currency crisis
- **Solvency** problem:
=> assets not covering liabilities, over-indebtedness

Stylized facts on current account balances in developing countries

- Most developed countries have a small current account surplus/deficit, except the US
- US has a persistent current account deficit (around 5% of GDP until financial crisis, now <3% of GDP)
- OPEC countries normally have a surplus
- A few developing countries have small deficit, a few strong surplus, especially in Asia
- Most low income countries run high deficits, up to 40% of GDP, mostly financed by aid and remittances

Stylized facts (cont'd) : Current account balance in % of GDP of LCDs and LLDCs



Data source: World Bank Database, March 2019, own presentation

Stylized facts (cont'd)

- Huge current account deficits reflect aid dependency (grants, concessional loans)
- Countries with very high deficits will not receive private (commercial) capital inflows
- Capital inflows are in most cases hard currency
- Changes in the 2000s
 - Remittances plus FDI in relation to ODA in Sub-Saharan Africa: only 19% in 1990, but 167% in 2013!
 - Sovereign Bonds issuance of Sub-Saharan African countries in the mid 2000s!

The role of current account deficits in LDCs in traditional theoretical approaches

- **Inter-temporal consumption smoothing**
 - in case of negative shocks
- **Gains from efficient investment**
 - Idea of a “savings gap” in LDC that needs to be closed by foreign savings to finance investment
 - This will increase the capital stock, increase labour productivity, and allow for catching-up to developed countries’ p.c. income levels

See: Feenstra/Taylor 2014, ch. 17

The role of current account deficits: Example for efficient investment

- Open economy can borrow to finance investment, without having to reduce consumption today

		Period							Present Value
		0	1	2	3	4	5	...	($r^* = 0.05$)
Output <i>GDP</i>	<i>Q</i>	100	105	105	105	105	105	...	2,200
Expenditure <i>GNE</i>	<i>C</i>	104	104	104	104	104	104	...	2,184
		<i>I</i>	16	0	0	0	0	0	...
Trade balance	<i>TB</i>	-20	+1	+1	+1	+1	+1	...	0
Net factor income from abroad									
from abroad	<i>NFIA</i>	0	-1	-1	-1	-1	-1	...	—
Current account	<i>CA</i>	-20	0	0	0	0	0	...	—
External wealth	<i>W</i>	-20	-20	-20	-20	-20	-20	...	—

Source: Feenstra/Taylor 2014, ch. 17

The role of current account deficits in LDCs

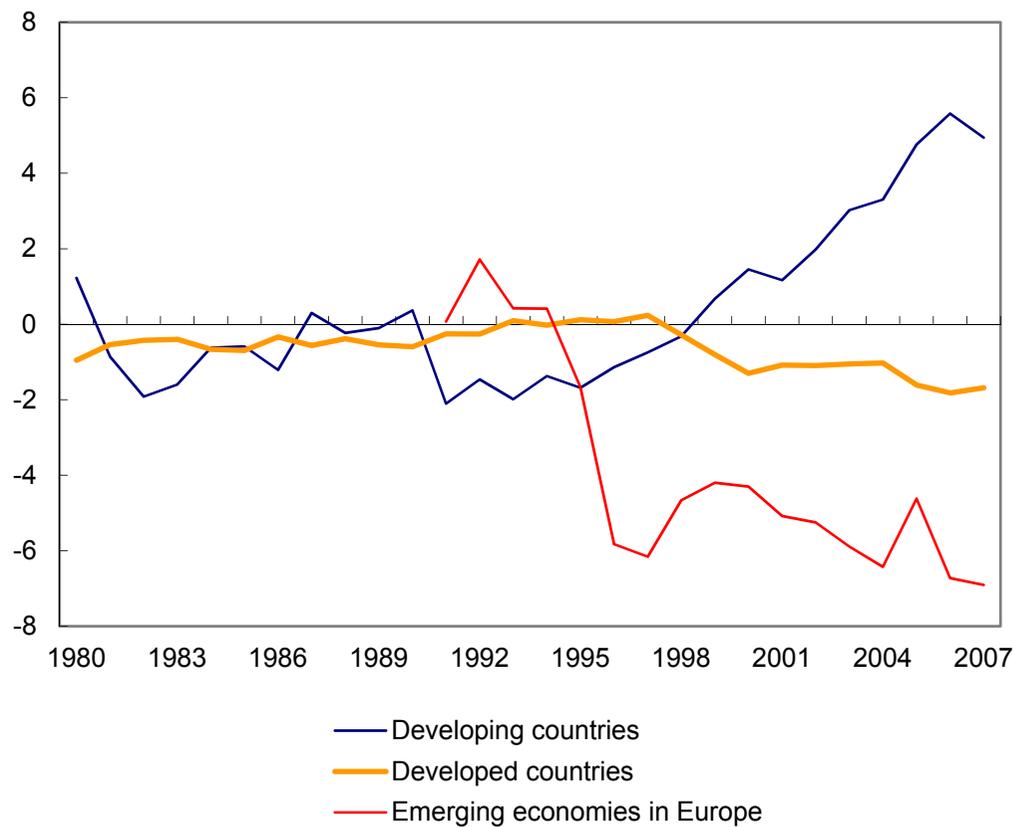
Empirical findings

Contrasting empirical observations:

- **Consumption volatility is higher than output volatility** (exceptions: very open countries)
 - Less developed financial markets; lack of access
 - Sudden stops in inflows in case of negative shocks
- **“Lucas Paradox”**: **Capital is flowing uphill, from poor to rich countries**
 - Lower “technical & social efficiency” in LDC may lead to lower productivity effects
 - High risk premia for investment in LDC

The role of current account deficits in LDCs in Empirical findings (cont'd)

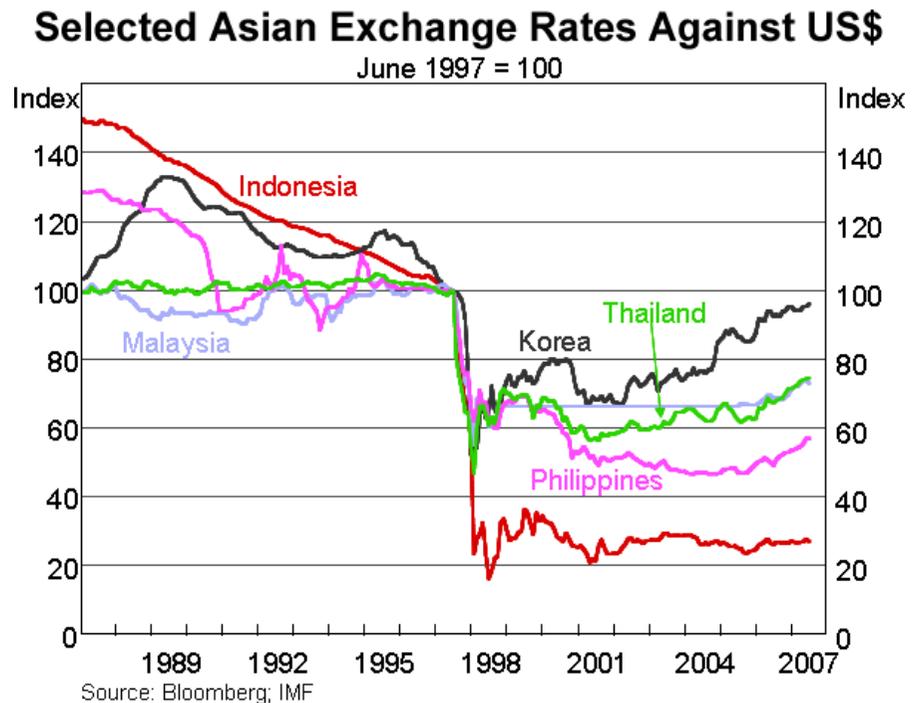
Current Account Balance in % of GDP



Capital seems to be flowing "uphill"

Empirical findings for the effects of net capital inflows from past crises

- Latin American debt crisis in the 1980s
- “Tequila” crisis in 1994/5: from Mexico to neighbouring countries in LA
- Asian crisis in 1997/8: from Thailand to neighbouring countries)



Empirical findings for the effects of net capital inflows from past crises

- (Who is the borrower matters)
- Rule of thumb approach
- Types of inflow matters
- Usage of capital inflows matters
- Currency mismatch matters
- Role of key currency developments

Findings: (Who is the borrower matters)

- “Lawson doctrine”: current account deficit caused by private economy is tenable, but not if caused by government
- Assumption: government is “unproductive”
- Private sector commercial debt seen as “sound”, otherwise creditor and debtor wouldn’t contract
- Implicitly: Ignoring information asymmetry, asymmetric risk distribution etc.; speculation ignored; hedging assumed
- Untenable after Asian/Argentinean crisis

Findings: Rule of thumb approach

- Rule of thumb: deficit should not exceed 5% of GDP!
- Sometimes used as a pragmatic and cautious approach in “emerging” economies
- Sometimes based on consideration of sustainability of external debt, e.g. constant debt service/GDP, $iD/Y = \text{constant}$

Findings: Types of inflows matter

Types of private external finance (excluding grants):

- FDI
- Portfolio inflows (stocks, bonds),
- Bank loans,
- other private capital flows
- [Remittances]

Findings:

Types of inflows matter (cont'd)

- FDI is considered best, as a long-lasting interest in investing in the country is assumed
- Short-term portfolio inflows are seen as the most risky

Problems with this idea:

- Current account deficits = decrease in foreign wealth
- FDI may lead to higher imports
- ... without necessarily increasing overall productivity, employment, exports...

Findings: Usage of capital inflows matters!

Idea:

- Not the magnitude of the deficit is considered a problem but how the capital inflows to finance it are used (for C or G or M or I)?
- If external finance is used in a „productive“ way, it will enhance growth and repayment capacity

Findings: Usage of capital inflows matters

Problems with this idea:

- What is “productive”?
- How to channel inflows into productive activities?
- Key is: Net exports must rise, i.e. more exports and/or import substitution
- How to achieve this?
 - ⇔ Asian crisis: crises in countries with high investment
 - ⇔ ODA may be earmarked to be spent on imports, ...

Findings:

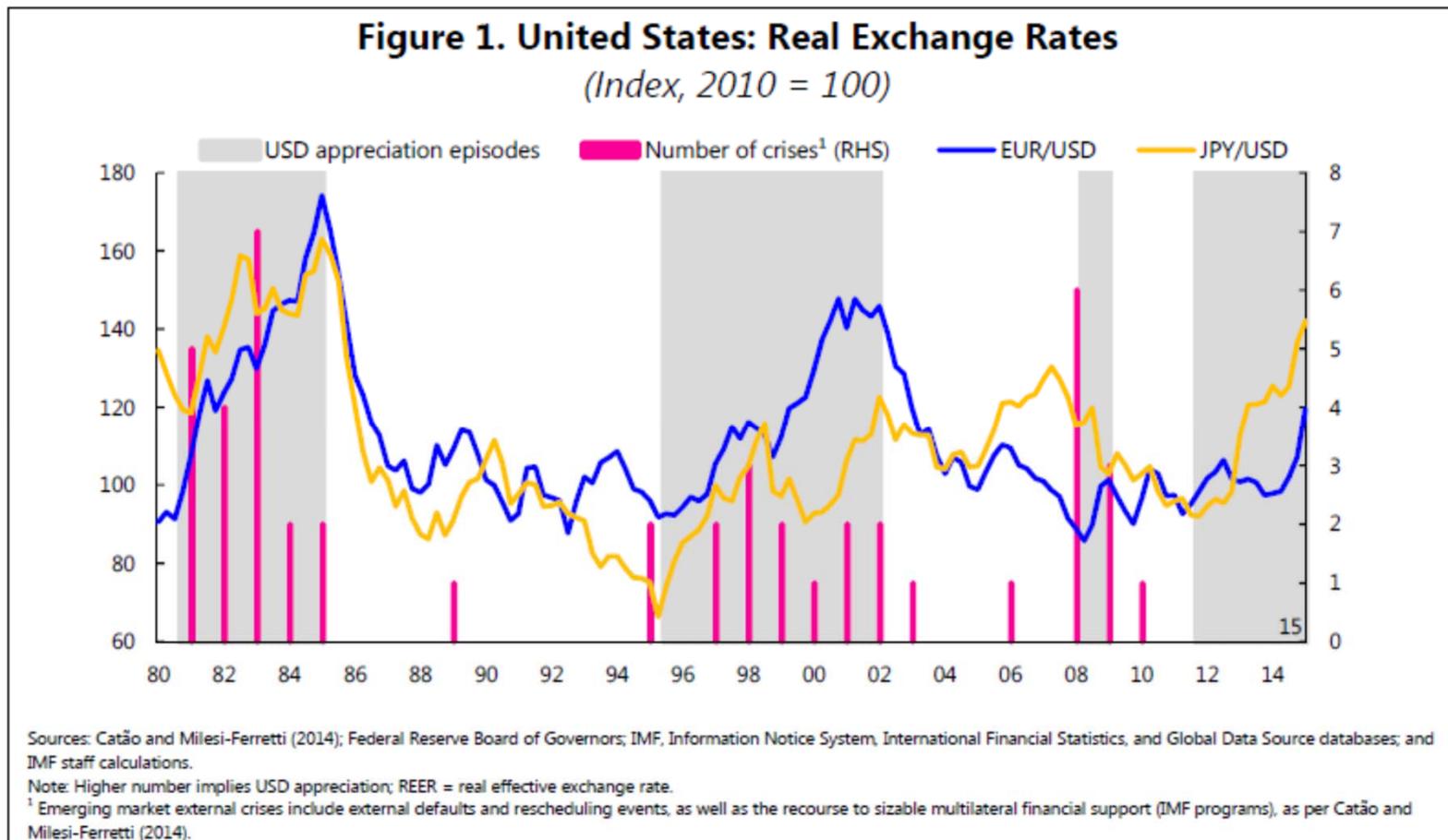
Currency mismatch matters

- Borrowing in foreign key currency (USD), revenues in domestic currencies further twin crises (currency crisis coupled with banking crisis)
- Similarly negative effects if the mismatch is in the banking sector, household or corporate sector

Problem:

- How to avoid the incentives to borrow in foreign key currencies with lower interest rates?
- Discussed: role of fixed exchange rate regimes

Findings: Role of key currency (USD) developments



Findings:

Role of key currency developments (cont'd)

- Limited role of domestic “fundamentals” in case of global swings of capital flows
- Dominance of key currency developments
(Kaltenbrunner, Griffith-Jones, Goda/Priewe 2019...)
- Even if LDC avoid currency mismatch, they cannot influence the currency mismatch of international financial investors and thereby shocks to their economies
(Kaltenbrunner/Painceira 2015)

Findings:

Role of key currency developments (cont'd)

- Role for domestic capital inflow controls (Ostry et al. 2010, IMF staff position notes)
- Incentives for foreign reserves buffers, export-surplus strategies at the domestic level
- Increasing arguments for new international capital flow arrangements (e.g. Griffith-Jones 1999 for a new financial architecture, Ocampo 2010 on taxing forex transactions, Davidson on modern versions of Keynes' plan for a reform of the global monetary system, criticism by Blecker 2009 in JPKE)

How to support export-driven growth: Real undervaluation strategy

- Decreasing deficit in current account or even (increasing) surplus is considered favorable for growth
- Implies real undervaluation of exchange rate (assume for simplicity: balanced CA reflects “correct” real exchange rate)
- Undervaluation boosts net exports, reinforces competitiveness of the economy => export-led growth
- Strengthens expected quality of currency
- Requires fixed/managed exchange rate; other countries must run deficits

How to support export-driven growth: Real undervaluation strategy

- Undervaluation strategy for the real (!) exchange rate
- Nominal exchange rate less relevant for growth (see Rose 2011)
- Yet, undervaluation strategy should be coupled with
 - Strategic industrial policy for less commodity dependence, increasing value added of exports
 - Freeing monetary policy from internal constraints (nominal wage anchor for price developments)
 - Subordination of fiscal and other policies

How to support export-driven growth: Real undervaluation strategy

Examples:

- Germany & Japan in the 1950s and 1960s under Bretton Woods;
- China since 2000s, and selected Asian countries
- Argentina during 2002-2008 (Palazzo/Rapetti 2017)
- Germany since 1995? (Dullien/Joebges/Palazzo)

Recommendations I:

Avoid current account deficit that...

- ... is not sustainable, i.e. too high (unless it is only a short-term deficit)
- ... will raise country risk premium and induce expectation of depreciation, perhaps speculation for depreciation (in case of capital mobility)
- ... is financed with short-term debt
- ... is financed with in foreign currency denominated debt
- ... is used for C or for inflating asset prices ("hot money")

Recommendations II:

Allow for net capital inflows if...

- ... there is a long-standing lack of foreign exchange (“foreign exchange gap”) that cannot be lowered by real depreciation of the exchange rate.
- ... real depreciation is workable but increases poverty or impedes growth (necessary imports cannot be financed any more ...)
- Yet, current account deficit should then be financed by grants or long-term preferential loans
- ... and aid should be used for increasing export capacity.

Recommendations III:

Strive for a current account surplus, if...

- ... this is growth enhancing! => export-led growth can be favorable, at least temporarily!
- But: Avoid too strong dependence on exports to the "North".
- Surplus countries' currency tends to be strengthened (expected appreciation) => "real undervaluation" strategy necessary.

Recommendations IV:

Can the exchange rate balance the CA?

- Exchange rate cannot do it alone
- Flexible exchange rate does not guarantee balanced current account (can even increase imbalances if capital account is open!)
- Current account balance depends on: real effective exchange rate; growth differentials; domestic interest rate compared to ROW; changes in sectoral composition of economy; capital flows; restrictions on capital mobility/trade

Discussion:

- Assume the current account deficit is caused by a government budget deficit to pay teachers' salaries, financed with concessional* loans from World Bank, maturity 10 years. Does this deficit pose a problem for the country?

**concessional loan: loan with an original grant element of 25 percent or more.*

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Thank you for your attention!