A Chile Wind in an Anarchic World

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A relaxation of domestic capital restrictions in industrialized countries and a commitment to a liberal economic model by most members of the international community have provided the means for capital to flow in and out of countries at an astonishing speed. In addition to promoting opportunities for efficient global saving and arbitrage across markets, the liberalization of financial controls has decreased economic stability throughout the world economy. While some individuals have prospered in this environment, the debt crises of the 1980s and the 1990s in Latin America and East Asia attest to the perils of free-flowing capital.

In modern times, destabilizing forces, such as global conflict, are often constrained by the dominant power of a hegemon and/or an institution designed to serve a similar function. However, in the field of global finance, most economies have abolished capital controls and become more exposed to the destabilizing effects of mobile capital while the United States, which most closely approximates a global hegemon, has become more reluctant to fulfill a leadership or coordinating role to prevent or mitigate the effects of capital volatility. Further, and to the probable dismay of regime theorists, the International Monetary Fund (IMF) to date is not adequately equipped to replace the United States as the *de facto* guardian of the world's financial system.

In light of the problems that unfettered entry and exit of global capital across borders created in Latin America and East Asia, the management of the global financial system takes on increasing importance. Unfettered access to markets fosters increased investment that is critical for economic growth and development. However, open access to markets also allows for destabilizing speculation. Given the dearth of regulation at the global level, it is reasonable to ask whether developing countries themselves could regulate capital flows in a beneficial way.

This paper examines the current "non-system of international monetary affairs," as well as the decisions of developing countries, Latin American countries in particular, to liberalize capital markets.[1] It questions the prudence of these decisions for these countries and whether feasible alternatives to a liberalized capital market exist. Using the case of Chile, it concludes that limited controls on the inflow of foreign capital, in addition to other sound fiscal and monetary tools, may serve as a viable way to control global capital without significantly discouraging it.

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The Problem of International Capital Flows

Currency crises are not new nor are they uncommon.[2] In fact, most of the currency crises of the past were minor, and many were actually beneficial in that output grew rapidly in the year after the crisis.[3] The financial crises of the last two decades, however, have been far more costly. In part, this may be attributed to the relaxation of capital restrictions in industrial countries (e.g., reduction of taxes on financial transactions and regulatory restrictions on financial intermediaries), the expansion of "offshore" financial markets, and the introduction of new technologies that speed up capital flows and stimulate the development of innovative financial products.[4] In the early 1970s, for example, the United States dropped its controls on capital movements, and many other states promptly followed its lead.[5] As a result of these developments, the speed and level of capital flows has risen dramatically, and the amount of capital invested in short-term debt has increased.

Unfortunately, the resources of governments, particularly those of developing countries, are no match for the scale and the frequently short-term nature of these new private capital flows. As Bosworth has written, investors today are seeking to allocate a stock of wealth globally among national assets that are increasingly substitutable. When news or the pressure of events causes investors to reallocate their assets, the resulting short-term demands on a country's foreign exchange reserves far exceed anything envisioned in the days of limited capital mobility.[6]

This new environment underscores the challenges presented by a world of mobile capital even for countries with strong economic structures.[7] The Latin American financial crises of the last two decades and the more recent East Asian financial debacle attest to the perils of this free flowing system. At the same time, the international community lacks a dominant power to control it. As Gilpin has written, "[t]he absence of a regime governing international finance is surely one of the most extraordinary features of the world economy at the close of the century."[8]

Decline of a Hegemon

For the past century, successive dominant powers with strong interest in maintaining a liberal economic system have maintained, for the most part, the international economy.[9] As Keohane has written, "[h]egemonic leadership can help to create a pattern of order."[10] The hegemon provides the other states in the international system with leadership in return for the deference of other states and the assurance that the system will function smoothly. In the late nineteenth century, for example, Great Britain used its influence to promote liberal ideals and an international free trading system. It served as an example of economic success and encouraged other countries to negotiate tariff reductions and to open their markets to the rest of the world.[11]

The British also provided stability to the international financial system.[12] The Bank of England coordinated the actions of the other central banks in the international community, ensuring the smooth functioning of the international gold standard. This coordination, referred to as the "follow-the-leader" convention, prevented banks from undertaking actions unaccompanied by other banks.[13] For example, the British leadership guaranteed that one bank did not unilaterally reduce its discount rate, as this would instigate reserve losses and threaten the country's currency convertibility.[14] While Great Britain's protection was certainly not as steadfast for developing countries as it was for the industrialized countries, Britain and other industrialized countries freely accepted the commodity exports of developing countries, which helped them to service their external debts and adjust to balance of payments shocks.[15]

After World War II, the United States took the lead in promoting a liberal international economic order. Although institutions such as the International Monetary Fund (IMF) were created at that time to promote liberal economic principles and assist with the management of the global economy, the participation and leadership of the United States were fundamental to the success of these institutions. According to Eichengreen and Kenen, one of the main factors lending strength and flexibility of the postwar institutions was the capacity and willingness of the United States to make the side payments needed to get the other countries to cooperate and continue their support of the new institutions.[16]

In the last few decades, however, the United States' role as hegemon in the international financial system has changed. "During the early postwar era of the unquestioned dollar hegemony, the United States accounted for about 50 percent of the world GNP; in the mid-1990s, the United States accounted for only about 25 percent of the world GNP."[17] Fluctuations in the value of the dollar have been costly to dollar-denominated asset holders, raising the question of the United States' ability to coordinate and stabilize the international financial system. Additionally, the increasing size of the U.S. foreign debt has shaken global confidence in the dollar. Although the dollar remains important, its use as a reserve currency has declined relative to levels of the past. For example, "between 1984 and 1993, the percentage of total official foreign exchange reserves held in dollars dropped from about 70 percent to 60 percent."[18]

While in absolute terms the United States remains a powerful military and economic state, hegemony requires a state that is "powerful enough to maintain the essential rules of governing interstate relations and willing to do so."[19] The United States reaction to the latest financial crises suggests that its willingness to act as the preponderant leader in the realm of international finance has begun to fluctuate. In the early 1980s, for example, the United States took the lead in formulating debt restructuring programs for Latin America. "Within two days of the Mexican financial crisis of 1982, the United States had organized a $1 billion loan to rescue the Mexican economy."[20] In the Mexican crisis of 1994, however, the United States did not provide financial assistance without lengthy domestic debate. In describing the United States in the more recent East Asian debacle, Gilpin writes that, "the United States remained aloof from the region's financial crisis."[21] Although the United States did finally agree to contribute money to the IMF's Asian financial rescue package, it first attempted to find other countries to foot the bill.

Further, neither the Europeans nor the Japanese appear able or willing to assume the role of leader of, or lender to, the global monetary system. As Gilpin has written, the European currency, the Euro, would likely play an increasingly important role as a reserve and transaction currency, but it is unlikely to unseat the dollar.[22] Given the increasing reluctance on the part of the United States to act as a global lender to the international financial system, it is reasonable to question whether this position is assured for the future.

Can the Existing Institutions Fill the Role Alone?

The regime theory of international relations suggests that a hegemon or one country serving as the preponderant power may not be necessary to maintain stability in the international system.[23] Rather, an institution could be created to undertake the responsibilities of the preponderant leader. In many ways, the IMF has already laid the groundwork for playing this role. Additionally, many scholars and policymakers have outlined plans for the IMF to officially serve as the "lender of last resort," intervening in countries in the event of financial crises with financial support in order to contain the crises and limit their damage. Proponents of this role for the IMF claim that the provision of capital to countries experiencing speculative attacks can prevent the countries from declaring bankruptcy and can provide them with sufficient time to balance accounts and ward off the speculators.[24] Many problems remain, however, before the IMF could assume this role, including low IMF funding levels (i.e., lack of sufficient funds to rescue countries in crises), and the inability of the IMF to coordinate and greatly influence sovereign states or regulate assets in the hands of a diffuse group of private investors. Additionally, the presence of a "lender of last resort" creates a moral hazard problem in which investors, knowing the IMF will rescue the country in crisis, behave in a manner that is even more speculative and destabilizing than they would have behaved in the absence of the IMF.

Additionally, large and complex international bureaucracies such as the IMF are not quick to adapt standard operating procedures. The problems created by international capital flows change with each new crisis, and the global leader of monetary affairs must be able to adapt to these changes. Procedures established after learning the lessons of an old crisis may not be sufficient to guard against a new one. For example, the developing country debt crises of the 1980s, with their vast amounts of public debt, are significantly different from either of the developing country financial crises of the 1990s, which have entailed mostly private debt (i.e., private lenders and private borrowers with little government direction).[25] While an examination of the Latin American debt crises of the 1980s may lead to a conclusion that developing country governments should change the way they borrow capital, these changes alone would not have helped significantly in preventing the crises of the 1990s.

Further, even if the correct policies can be formulated, the nature of the most recent crises (private borrowers rather than public ones) makes the issue of regulation by an institution more complicated. It is easy to advise governments on prudent steps to avoid a crisis; it is difficult to guide a diffuse group of private entrepreneurs who do not view it as their responsibility to prevent the state from collapsing.

Financial Liberalization: the Challenge Facing Developing States

The management of the global financial system takes on increasing importance in light of the constraints that unfettered capital flows impose on developing countries with respect to growth and development. On the one hand, foreign capital inflows in the form of direct investment provide technological know-how and access to markets. At the micro level, greater amounts of external capital inflows lower the cost of capital for creditworthy firms. At the macro level, foreign capital inflows can complement domestic savings, providing developing countries with funds for research and entrepreneurial activity, which promote even higher levels of investment and long-term macroeconomic growth.[26] On the other hand, in an age of mobile financial flows, this money holds developing countries hostage to volatile foreign exchange and capital markets.[27] Outflows of foreign capital, particularly if they lead to currency and financial crises, can result in decreases in output, investment, employment, growth, and increases in poverty.[28] Given this tradeoff, why did Latin American countries decide to liberalize?

In the 1970s, Western banks lent vast sums of money to developing countries, especially Latin American countries, in an effort to recycle the surplus of oil-exporting country petrodollar deposits. In the early 1980s, anti-inflationary policies in the United States caused real interest rates to rise, and a recession in industrialized countries caused prices on commodities, the primary export products of developing countries, to fall. These macroeconomic forces caused the value of many Latin American national currencies to depreciate against the U.S. dollar. As most of their debt was denominated in dollars, the amount of debt measured in local currencies rose substantially.[29] International banks responded to the deteriorating situation by cutting back new lending to most Latin American countries, making their loan repayments much more difficult. In 1982, Mexico announced that it would not be able to continue servicing its large external debt, triggering an international debt crisis.[30]

By 1985, the recession had ended, interest rates had come down, and most Latin American currencies had stopped depreciating against the dollar. However, it had become clear that the countries would still be unable to meet their debt payment obligations.[31] In order to solve these balance of payments problems (and concurrent with other IMF structural reforms and United States debt rescheduling efforts), Latin American countries searched for new sources of capital. Liberalization of capital markets was considered the best strategy for attracting this new capital. Specifically, countries presumed that if they maintained or increased financial openness in the face of a crisis, foreign investors would perceive the move as an assurance that investments could be liquidated at will (an attraction) and that fiscal and monetary discipline would be maintained (another attraction).[32]

Toward the end of the 1980s, Latin American countries reaped the fruits of their efforts as private capital flows to the region increased dramatically. Unfortunately, the benefits of these increasing flows were accompanied by costs. Notwithstanding the macroeconomic factors that contribute to the sense of investor risk in Latin America (e.g., high levels of foreign debt, excessive monetary growth, overvalued currencies, inflation, and class conflict), the ability of capital to turn on a dime has led many scholars to qualify the conditions under which capital account liberalization is considered an optimal policy for these countries.[33]

Evaluation of Capital Flows

Several guides help to unravel whether capital flows are serving mainly to generate growth and development in Latin America or whether they are just placing the countries at risk. The first involves the question of absorption. If capital is to contribute to long-term development, it should be reflected as an increase in the investment rate. With the exception of Chile, however, an increase in the investment rate has not been visible in Latin America.[34]

Countries must also evaluate the consequences of exchange rate appreciation or rising inflation. On the one hand, large inflows of capital without government intervention in the foreign exchange market tend to cause the exchange rate to appreciate in value.[35] An overvalued exchange rate is likely to be a severe problem for Latin American countries, given that they are simultaneously trying to promote export growth, achieve targets of current account deficit reduction, and attract even higher rates of investment. On the other hand, large capital inflows accompanied by government intervention in the foreign exchange market increase the domestic money supply and tend to spur inflation, a recurring problem for Latin American countries.[36]

Given the negative consequences of mobile capital and the absence of a global leader to buffer the negative effects, is a liberalized capital market the optimal policy choice for all countries? Do alternatives exist to a liberalized capital market?

Capital Controls

Historically, developing countries maintained controls on both foreign activity in the state and domestic activity outside the state.[37] The benefit of controls on capital flows is their ability to discourage short-term investment. Additionally, capital controls are thought to encourage long-term investment to the extent that money flowing into the country remains for a longer period of time. However, they are risky. If capital controls are not structured properly, they could serve to discourage foreign investment altogether, particularly if the investors perceive that the controls will limit their ability to repatriate profits. Further, capital controls are difficult to employ efficiently because they create opportunities for evasion and corruption.

As Paul Krugman has written, governments should heed four guiding principles when implementing capital controls. First, the actual implementation of controls should aim to disrupt business as little as possible. Second, they should be maintained temporarily. Third, currency controls do the most damage when they are used to defend an overvalued currency. Fourth, controls should serve as an aid to reform, not as an alternative. Controls should only be used in countries where strong fiscal, monetary and exchange-rate policies are already in place.[38]

A Look at the Case of Chile

Economic policy measures undertaken in Chile serve as interesting examples of ways in which measures to discourage short-term capital played a significant role in the overall successful management of capital flows in and out of the country.[39] In fact, Chilean Central Bank measures to discourage short-term capital inflows, along with prudent macroeconomic management, are widely seen as a reason for Chile's survival as one of only a few countries in Latin America to be relatively unaffected by the "tequila effects" of Mexico's financial crisis of 1994. It is also thought to be the reason behind Chile's ability to withstand the aftershocks wrought by the East Asian financial crisis of 1997.[40] Specifically, the Government of Chile promoted three main policies to couple a liberalized goods market and export-led growth with restrictions on the destabilizing short-term flows wreaking havoc in other markets.

First, the Chilean Central Bank imposed a non-interest bearing reserve requirement on all financial inflows, excluding foreign direct investment (FDI). Essentially, this reserve requirement acted as a tax on short-term borrowing from abroad. Investors had to leave a deposit on their investments before the funds could be put to use; after a specified time period, the deposit was returned to investors, although earned interest was lost. This policy discouraged the short-term flows of hedge funds and portfolio investors by increasing the cost of these flows, while continuing to foster long-term flows. While FDI had to remain in Chile for a one-year period, there were no restrictions on profit remittances.

Second, the Chilean government implemented a sliding exchange rate band centered on a reference price linked to a basket of three currencies (U.S. dollar, deutsche mark, and yen). Given the instability of international exchange rates, this measure was intended to make interest rate arbitrage between the dollar (to which it was formerly pegged) and the Chilean peso less profitable, introducing greater exchange-rate uncertainty for speculative capital flows. This mechanism, like the reserve requirement, increased the cost for short-term investors.

Third, the Chilean Central Bank intervened in the foreign exchange markets (i.e., engaged in sterilization efforts) to mitigate the monetary effects of the international reserve accumulation. This practice slowed the appreciation of the real exchange rate and allowed the continuation of export growth. Indeed, central bank intervention was the method by which the currency spot rate was kept relatively stable.

As stated previously, it appears that the Chilean policies were successful. They prevented an even larger surge of foreign capital from entering the country and kept real exchange rate appreciation within bounds. Additionally, the policies caused the rate of short-term capital inflows to fall. According to Agosin, the policies also appear to be partly responsible for the country's positive growth performance. In the 1990s, for example, a large portion of investment into Chile was foreign direct investment (about 60 percent), rather than other types of capital investment.[41]

It must be noted that the efficacy of the Chilean strategy has decreased since late 1995 and capital inflows into the country have increased, as investors have discovered ways to circumvent the controls. Additionally, in response to downward pressure on Chile's currency due to the volatile international situation, existing restrictions on capital flows were gradually eased from June 1998 until their eventual removal in September 1998. This weakening of the efficacy of Chilean capital controls and the eventual decision to remove them only strengthens the argument that any type of monetary control must be maintained for a limited time. Additionally, surges in capital inflows must be addressed with a mix of policy tools rather than with a single instrument.

Controls Not the Only Answer

Chile serves as an example because it has not only successfully implemented short-term capital controls, but also successfully altered policies to ensure that its market remained stable, even as controls began to lose their effectiveness. Specifically, two policies (in addition to short-term controls) contributed to the success in managing capital flows in Chile. First, fiscal policy has been very conservative. Chile is one of the few Latin American countries to have maintained a fiscal surplus during the 1990s (one to two percent of GDP). As a result of this surplus, the Chilean government has almost no domestic debt. This conservative monetary policy has eased the task of monetary authorities because it has lowered the current account deficit, slowing exchange rate appreciation.

Second, Chile has implemented strict new banking regulations (monitoring the quality of bank assets and imposing strict limits on lending to firms) to prevent capital inflow from causing a commercial bank spending spree (and a consumption boom) and to ease the task of keeping the exchange rate within bounds. As a result of the combination of Chilean policies, saving, investment, and growth have improved in the country since 1989.[42]

Would the Chilean fiscal and monetary policies be transferable to other countries in the region? Like Chile, many other countries in the region have undertaken structural adjustment programs and have strengthened their fiscal, monetary, and exchange rate structures. The Chilean experience would be applicable to other Latin American countries; however, in regulating capital and adapting the Chilean model to their specific needs, the countries should seek instruments that are as non-discretionary as possible. Non-discretionary and (semi) automatic instruments have the advantage of minimizing corruption and evasion — a significant problem for Latin American countries.

Conclusion

Technology has provided a means for unfettered international capital to flow in and out of countries at an astonishing (and destabilizing) speed. At the same time, there is no global leader (country or institution) in charge of monetary affairs to protect and maintain both the system as a whole and the individual countries within it. In this "non-system of international monetary affairs," developing countries have experienced severe debt crises and financial turmoil. In light of the lack of a central authority in this area, perhaps developing countries should take matters into their own hands.

The challenge for developing countries, however, is to reconcile their need for foreign capital for development and the desire to avoid short-term, destabilizing speculative capital flows. The policies pursued in Chile serve as an example for other Latin American countries to follow. However, the secret to the Chilean success was its implementation of short-term controls on capital inflows along with reforms to achieve fiscal surpluses, transparency, and improved bank regulation.

Notes

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