



# Capital Account Liberalization Debates

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**ABSTRACT:** The case for capital account liberalization has been the centre of outgoing debate. This paper discusses both the short term and longer term flows (FDI). This paper is divided into 5 sections. Section 1 presents the claims of neoclassical economists who believe that the case for free trade is the same as the case for capital account liberalization. They further point out that such liberalization increases social welfare and promotes efficiency. Section 2 provides the critique of the classical view as several assumptions made in traditional theory may not hold in real life. Section 3 provides the empirical evidence to claim that free capital flows lead to instability and culminate into a crisis. Section 4 explores the effects of FDI on countries and concludes that unrestricted flows may not always benefit nations. Section 5 analyses empirically the effect of FDI on inequality, long term and short-term economic growth.

**KEYWORDS:** capital account liberalization, FDI, Neoclassical economics

## INTRODUCTION

According to Singh (2003), the Neoclassical theorists maintain that a country's consumption or production paths are smoothed by free movement of external capital. They claim that free trade and free movement of capital across countries are analogous. The case for free trade is based on the First Theorem of Welfare Economics which states that any point of competitive equilibrium is also a point of pareto optimum when there is non-satiation and no externalities involved. The Second Welfare Theorem states that in presence of all-around convexity, any pareto efficient point can be achieved as a competitive equilibrium with the help of lump-sum transfers (Singh, 2003).

Many of the assumptions mentioned above required satisfying both welfare theorems may not be met in real life. According to Chakravarty and Singh (1998) free trade may not be the best option when there is increasing returns to scale. "at a theoretical level, learning over time is a relevant paradigm for developmental gains from trade than the neoclassical story that emphasizes the exploitation of arbitrage opportunities (Chakravarty and Singh, 1998, p. 195). Singh (2003) emphasizes that although there are certain loopholes in case for free trade but still "selective trade or economic openness have substantial benefits" (Singh, 2003, p. 195) which can be realized only when there is full employment and appropriate domestic policies.

Now the theoretical case for capital account liberalization is analyzed. As pointed out by Singh (2003), Fisher (1997) favors capital account liberalization. Singh (2003) points out that Fisher (1997) states that the benefits of capital account liberalization are greater than the costs involved. Countries must develop their financial system well in order to prepare themselves for such liberalization and for ensuring smooth and orderly process of capital account liberalization, amendment of IMF's Articles of Agreement is required. He suggests that economic efficiency will be enhanced by such liberalization. The world savings will be allocated in most productive manner it would promote diversification of portfolios and help to reduce the risk (Gupta & Mittal, 2020; Mittal, 2015). Such liberalization would lead to increasing social welfare, development of the financial system of the country and better allocation of resources. This liberalization could increase the welfare by transferring resources from developed nations with older population and very low interest to newly industrialized countries with younger population as well as higher rate of return (Singh, 2003).

## UNRESTRICTED CAPITAL ACCOUNT

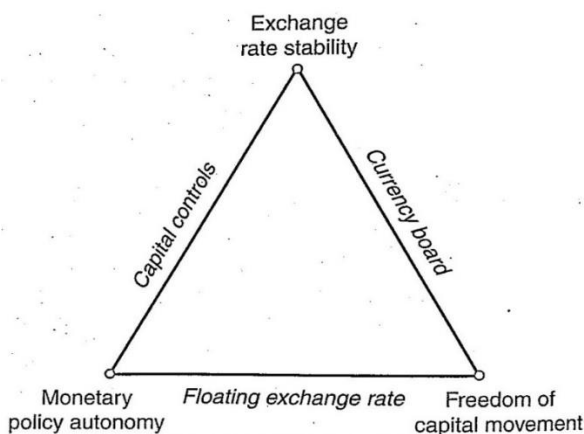
This section explores the fact that the case for unrestricted capital account liberalization is not supported theoretically as well. According to Singh (2003), the fact that capital account liberalization has risks is supported by orthodox economists as well.

Bhagwati (1998) supports free trade but is against capital account liberalization. This assumption of full employment and macroeconomic stability which are required for fully realizing benefits of such liberalization may not hold in real world. Singh (2003) observes that Rakshit (2001) suggest that certain assumptions like “(a) resources are fully employed everywhere (b) capital flows themselves do not stand in the way of attaining full employment or macroeconomic stability; and (c) the transfer of capital from one country to another is governed by long-term returns on investment in different countries” (Singh, 2003,p. 196) to prove beneficial. Even these assumptions may not be fulfilled in real world.

As highlighted by Singh (2003), Stiglitz (2000) believes that the case for free trade is different from that of free movement of capital across countries. Capital flows may be characterized by moral hazard, asymmetric information or even by adverse selection. Tradition economists believe that the process of price formation is based on utility maximization and rational expectations and leads to formation of efficient prices. Keynes recognized the role of speculation in price determination by describing the case of beauty contest where the entrants have to choose the most beautiful face and if their choice matched with the majority the person would win a prize. Now the people do not choose the person they think is beautiful but base their judgment on what others believe as beautiful, same is the case in financial markets where agents’ judgment of prices is not based on this fundamental value but is based on what others perceive its value to be. Rational investors may always behave rationally is not true especially when there are noise traders. There may be multiple equilibria in financial markets due to coordination failures (Singh, 2003)

Here it would be beneficial to talk about the impossible trinity” Krugman and Obstfeld (2009) explain the macroeconomic policy trilemma that, the stability in exchange rates independent monetary policy and free movement of capital, all three of them cannot be achieved simultaneously.

Figure 1

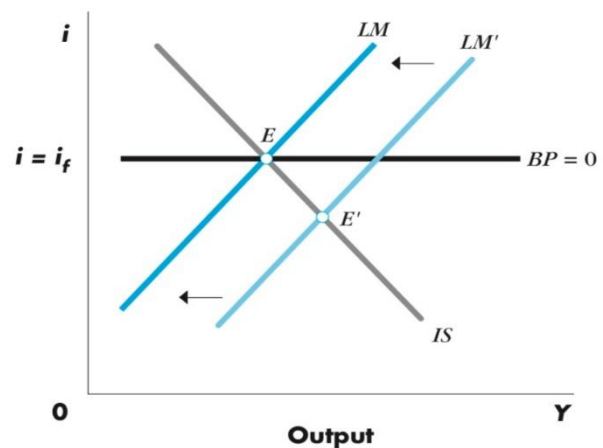


Source: Krugman and Obstfeld, 2009, p. 650

They further claim that in the last two decades of 20<sup>th</sup> century, capital mobility has increased which made adjustable peg regimes vulnerable to speculation hence developing countries are driven towards of one of the other sides of the triangle.

Dornbush et al. (2004) explain the impossible trinity via the Mundell- Fleming model. In Figure 2, the BOP = 0 is a horizontal line, because of perfect capital mobility. Only at  $i=i_f$ , BOP equilibrium exists. Consider a monetary expansion the LM curve shifts down and towards right the economy moves from E to E'. At E' there is a deficit and the pressure on the currency to depreciate hence, the Federal Reserve intervenes by selling foreign money and receiving domestic money. The supply of domestic money falls so LM' shifts back to LM. Hence, commitment to maintain fixed exchange rate makes the money stock endogenous (Dornbush et al, 2004).

Figure 2



Source: Dornbusch et al., 2004, p.285

According to Kregel (1998), the separation of ownership and control of capital is one of the key problems in financial markets. Contract packages generate huge amounts of commission incomes and fee, this becomes the key aim of banks and financial intermediaries.

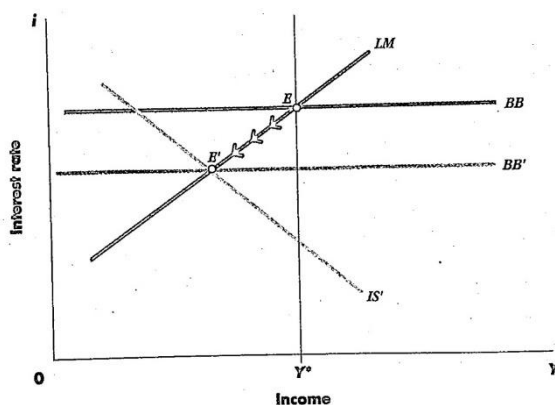
According to Harmes (1998) neo-classical economists point out that the activities of arbitrageurs overpower the behavior of non-rational investors and make process efficiently determined. Many economists stress on collective nature of capital allocation process. The first approach suggests that there are institutions which operate in financial markets and individuals base their decision on their decisions. The other approach is related to behavioral finance which recognizes the presence of ‘noise’ traders and explains various ‘judgement biases’ which lead investors to follow the herd. Investors allocate their capital based on ‘pseudo-signals’ as referred by Shleifer and Summers and do what the gurus of market suggest.

Harmes (1998) points out various reasons which explain as to why the activities of noise traders dominate those of arbitrageurs. The first reason is the mispricing by noise traders in case of 'indexing' will have larger effect on market. The second reason is that capital inflows will cause the price of the asset to increase and create incentives for arbitrageurs to follow herd which moves prices away from fundamentals. This is called 'rational' speculative bubble formation. The third reason is that the arbitrageurs' activities to bring process close to fundamentals fail when there are overvalued assets. The behavior of institutional investors is different from that of individual investors because of growing competition within the industry (Harmes, 1998).

Garber (1998) points out that the very nature of derivatives reduces as well as increases market risks associated with capital flows. Diversification of risks facilitated by derivatives encourages investors to take more risks. He claims that "Derivatives can be used to leverage financial safety nets in efforts to double up lost financial bets" (Garber, 1998, p. 2)

Dornbush et al. (2004) explain as to how a speculative attack on currency can lead to macroeconomic stability in case of fixed exchange rates. Suppose initial equilibrium is at E and market develops the expectation of home currency appreciation. Now even with low domestic rate of return, domestic assets are attractive hence, BB schedule shifts downward to  $BB'$  and point E is a point of surplus with large capital inflows, this causes exchange rates to appreciate. The speculative attack can lead to a large loss in competitiveness and finally falling output and employment.

Figure 3



Source: Dornbusch et al., 2004, p. 524

Singh (2003) highlights post Keynesian economists claim that crisis arise due to uncertainty and can't be avoided even with transparency or availability of more information. He points out that certain theoretical reasons themselves explain as to why capital account liberalization may lead to crisis. Self fulfilling expectations can explain a part of the story. Such

markets are characterized by "over borrowing syndrome", "credit constraints" and "even moral hazard" (Singh, 2003, p. 201). He concludes that capital flows are volatile and pro cyclical in nature.

### FREE CAPITAL FLOWS AND INSTABILITY

This section provides empirical evidence to support the proposition that free capital flows are a cause of instability. Singh (2003) reveals that Martin et al (2002) empirically prove that after liberalization there is a negative correlation between probability of financial crisis and per capita income, whereas such correlation is weaker before liberalization. Singh (2003) reveals the proposition that the capital flows are pro cyclical in nature is supported by study of Williamson and Drabek (1998). They put forward capital suddenly withdrew from Chile when there was a fall in copper prices. Singh (2003) points out that Ramey and Ramey (1995) note that volatility of GDP growth is negatively related to long term economic growth and positively to volatility of capital flows. Singh (2003) observes that Kamisky and Reinhard (1999) found that there are close links between banking crises and currency crises and financial liberalization preceded the banking crisis. Singh (2003) observes that Demiguckunt and Detragiache (1998) conclude that there are close links between banking crises and financial liberalization. Theoretically it is claimed that long term economic growth may overpower the instability caused by financial liberalization, 2008). As cited in Singh (2003), Singh (1997) considers advanced countries and concludes that GDP growth was greater in "golden age" than in liberal regime (Singh, 2003, p. 204).

Kregel (1998) points out that swaps contracts played a major role in Asian crisis. According to Calvo et al. (1996) in Latin America capital inflows during 1920s and 1978-81 were succeeded by economic crisis.

### EFFECTS OF LONGER TERM CAPITAL FLOWS

This section briefly explores effects of longer term capital flows (eg. FDI). According to Singh (2003), long term flows are believed to be less volatile by Stiglitz and other proponents. Stiglitz supports FDI flows as he believes that they improve human capital with access to new technology and resources.

Singh (2003) claims that unregulated FDI may not always be the best option especially when developing nations are concerned. FDI flows may not always be stable with growth of the derivatives and also because retained profits form a larger part of the FDI and such profits are volatile. FDI surges can cause appreciation of exchange rates, foreign exchange liabilities are created by FDI, which produce liquidity crisis.

Lall (1993) claims that technical know-how and appropriate skills are necessary precondition for reaping the benefits of technological transfers. Developing nation usually lack the required absorptive skills and capacity building and social investment in

education. "Provisions of linkages and development of institutions to undertake activities beyond the scope of individual firms becomes a vital part of capability development." (Lall, 1993, p. 100). According to him the decision of whether to create a technology internally or import it is a complex one and depends on costs and longer term dynamic benefits involved. At lower stages of development "inflow of foreign technology and skills via FDI will generally be more complementary than competitive to indigenous capability." (Lall, 1993, p. 102). At higher stages of development the choice becomes difficult as then "competitive aspect of technology import and indigenous technological effort has to be taken into account." (Lall, 1993, p.103).

### CROSS-NATIONAL EFFORTS OF FDI

Bornschier et al. (1978) evaluate various cross-national empirical studies of efforts of FDI. They conclude that income inequality rises with FDI, although it is possible that foreign investors are more attracted to countries with unequal income. So the direction of the causality of the relationship also constitutes a field of study. FDI and foreign aid increases economic growth for a short period of time and stocks of FDI reduce the long term economic growth rate as in the short run demand for land, labor etc. by foreign investors rises, while in the long run exports of profit and structural distortions reduce economic growth rate, this relationship depends on the level of development of a country. The effect of foreign capital is negative within both richer and poorer developing countries it is significantly more negative in richer countries than in poorer countries.

Singh (2003) highlights that even in short run the FDI is very volatile. He claims that the government needs to "monitor and regulate the amount and timing of FDI" (Singh, 2003, p. 209). He further refers to a study by Aitken and Harrison (1999) they found that the productivity of domestic plants in Venezuela was negatively affected by the multinational investment. Hence, "unfettered FDI would not be Pareto optimal for all developing nations." (Singh, 2003, p. 212). Countries having absorptive capacity may benefit from unrestricted FDI but regulation could benefit others (Singh, 2003).

### CONCLUDING REMARKS

This paper concludes that the effects of capital account liberalization in real life may not be same to what is suggested by traditional economic theory. The fact that unrestricted capital account liberalization may lead to crisis is supported not only theoretically but also empirically. Even orthodox economists like Bhagwati do not favor free movement of capital. Also, the case of unrestricted FDI is neither supported theoretically nor empirically.

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