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Chapter Author(s): Michael P. Dooley

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Comment Michael P. Dooley

This paper provides a valuable review and evaluation of private capital flows into formerly planned economies. It is particularly useful because it provides a factual basis for comparing these countries' experiences with those of other emerging markets. The paper was completed before the crisis in Russia but cautions readers that Russia and the other formerly planned economies are vulnerable to a reversal of capital inflows.

Perhaps the most striking aspect of this paper is the recognition that recorded private capital inflows to Russia and some of the other countries studied were completely and simultaneously matched by unrecorded private capital outflows. A simple comparison of current account balances, official lending, and reserve accumulation leads to this conclusion.

This, in turn, poses a difficult problem for the econometric work reported and its interpretation. The main result is that reform and reserve accumulation seem to predict recorded capital inflows. But why would these same factors tend to generate unrecorded private capital outflows? The answer probably lies in a more structural story about the incentives faced by residents and nonresidents and governments that lead to cross-hauling of financial claims and liabilities.

In a relatively simple model with a representative private sector investor and a government, we can see how official capital outflows in the form of reserve accumulation might be systematically matched by private capital inflows. The familiar story is that sterilized exchange market intervention designed to resist currency appreciation generates a pattern of interest rate differentials and exchange rate expectations that induce private investors to arbitrage excess returns in the home markets. As the authors point out, this seems to play some role in the pattern of capital inflows observed in several of the countries studied.

But on top of this model we must also consider at least two sets of

Michael P. Dooley is professor of economics at the University of California, Santa Cruz, and a research associate of the National Bureau of Economic Research.

private investors that have different incentives or constraints in allocating their financial portfolios. One possibility is that an extreme case of home bias was being reversed as these markets opened to international capital flows. Residents of Russia and the other countries studied were not permitted to hold foreign assets in the old regime and may have been willing to accept relatively low expected returns on foreign assets. At the same time, nonresidents may have seen Russian assets as a valuable addition to their portfolio since these returns may have been independent of their existing portfolios. This is a welfare improving story that is certainly consistent with the observation that reform seems to have been an important determinant of private capital inflows *and* outflows.

The problem with this interpretation is in understanding why the inflows should be so easily observed in balance of payments data while the outflows are entirely absent from the data. While many interpretations are possible, a plausible answer is that some residents had good reasons to want their wealth in a form that the government could not tax. This can lead to a volatile situation. In this case there are two types of private investors because recorded capital inflows are insured by the government, usually through the banking system, while unrecorded capital outflows cannot be taxed by the government. In this case private capital inflows and outflows generate private gains from trade but the welfare implications are quite different. In general such a pattern of capital flows will generate costly crises when governments' capacity to insure is exhausted, outcomes now clear with the benefit of hindsight.