Volume Title: International Capital Flows

Volume Author/Editor: Martin Feldstein, editor

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-24103-3

Volume URL: http://www.nber.org/books/feld99-2

Publication Date: January 1999

Chapter Title: Introduction: International Capital Flows

Chapter Author: Martin S. Feldstein

Chapter URL: http://www.nber.org/chapters/c9795

Chapter pages in book: (p. 1 - 4)

International Capital Flows: Introduction

Martin Feldstein

Changes in world politics and in technology have led to an explosive growth of international capital flows in recent years, particularly to the emerging market countries and to the nations of eastern and central Europe and the former Soviet Union. The private market in debt finance, in equity capital, and in direct foreign investment has become overwhelmingly larger than current and past official capital flows. These capital flows bring the recipient countries substantial gains by augmenting local saving and by improving both technology and incentives. But as the experience in Latin America in the early 1980s and in Asia in the late 1990s has shown, capital flows can also bring serious problems.

The political changes that contributed to the surge in capital flows deserve emphasis here because they have been largely ignored by economists and are not discussed elsewhere in this volume. The end of the cold war and the collapse of the Soviet Union opened opportunities for investment in a large group of countries that needed capital, management, and technology. The shifting political climate in China also made investment in that country more attractive.

Political change also accounts for the rise in investment in many of the developing countries of Latin America and Asia. Country after country abandoned Marxist ideology and no longer treated capitalist countries as political or ideological enemies. In this environment, they welcomed foreign direct investment from the industrial countries as well as minority equity investments. They privatized state-owned industries and allowed foreigners to invest in these companies. The change in the political climate in these countries also made them more attractive to foreign investors who felt more secure about lending, making equity investments, and locating operating businesses.

Modern technology has changed the management of financial transactions in ways that have expanded international capital flows. Developments in computing and communication capability have made it possible to create precisely defined international index funds at very low cost. Even individual investors can expand their portfolios to include representative equities or bonds from a variety of countries or regions without having to choose particular companies or even particular countries. Through mutual funds that sell such index funds, investors can invest abroad in relatively small amounts.

The relevant technological advances involve more than just computing and communication. It is also financial technology that has encouraged and increased the international flow of investment. Derivative markets allow investors to separate cross-border equity or interest rate risk from cross-border currency risk by hedging the currencies associated with equity or bond positions. This hedging may help to explain an important but still inadequately understood feature of the international capital market: the contrast between the very large volume of gross flows and the very small volume of net flows. Despite the trillions of dollars of gross flows, most national saving remains in the country where it originates.[1]

The most obvious contribution of international capital flows to host countries is to augment the supply of domestic saving in countries with unusually rich investment opportunities. The high marginal product of capital means that capital-importing countries can benefit even when the interest rates and the equity yields to the foreign providers of capital are high.

Despite this contribution, it is important to note that the magnitude of the capital inflows is still small relative to the volume of domestic saving. Most of the investment in plant and equipment and in real estate in every country is financed by domestic saving. This reflects the limited size of current account deficits and associated capital inflows that the international capital market will support. For example, a country in which business investment and housing construction is equal to 20 percent of GDP will have to finance 85 percent of that investment with local saving if its current account deficit is not to exceed 3 percent of GDP.

Direct foreign investment means much more than additions to the stock of capital. It brings with it better technology, modern management, and expanded access to global markets. Portfolio equity investments also help in a different way by exposing local companies to the scrutiny of the international capital markets, requiring greater accounting transparency and more effective corporate governance.

International capital flows also bring advantages to the investors. The companies that bring direct foreign investment acquire market access, lower cost inputs, and opportunities for profitable introduction of more efficient production methods. Portfolio investors typically enjoy higher yields than they would in the industrial countries from which the capital comes as well as an opportunity for risk diversification that can lower the overall risk of the investors' portfolios. The potential benefits of international diversification appear to be so

1. This point was first emphasized in Feldstein and Horioka (1980). See also the discussion in Feldstein (1994).

large that financial economists are puzzled by the limited extent to which individual and institutional investors have availed themselves of this opportunity. One explanation for this puzzle may be that investors do not accept the historical risk experience as a good guide to future risk. Concern about the political risks of debt defaults or of tax changes that expropriate equity investments may drive investors to seek the comfort of the low-diversification herd instead of the opportunity of an optimal investment strategy. The recent experience in several Asian countries has involved changes in currency and equity values that greatly exceed the historical experience described by the variances of currency values and equity prices that are used in optimal portfolio models. When historical estimates of risk are adjusted to reflect this recent experience, investors may well be vindicated in their refusal to accept the implications of portfolio theory based on previous historical measures of risk.

The experience of the past two decades has shown that with international capital flows can come substantial risks to both the providers and the recipients of those funds. During the 1970s, the banks of the United States and other industrial countries recycled OPEC surpluses and their own national savings to eager borrowers abroad, particularly in Latin America. Low real interest rates and high commodity prices encouraged borrowers to accept more credit and expand their activities. But when the U.S. Federal Reserve finally acted decisively to reduce spiraling double-digit inflation, real dollar interest rates rose sharply, reducing economic activity and lowering commodity prices and demand. The debtor countries of Latin America, led by Mexico in the summer of 1982, found they could not get the increased credit they needed to pay the high interest rates and to offset the shortfall of export earnings. The result was a debt moratorium that engulfed nearly all of the Latin American countries.

During the rest of the decade, the borrower countries went through a painful transition as they lowered domestic consumption in order to reduce their dependence on imported capital, to pay the high interest rates on their growing debts, and to compensate for the decline in exports. The creditor banks that had lent to the Latin American countries were also hard hit during this period as the loan write-downs impaired bank capital, causing bank regulators to require dividend suspensions and other changes in the banks' activity. Further defaults by the borrower countries could have made major commercial banks technically insolvent and led to their being closed by the regulators.

The Asian problems that began in Thailand in the summer of 1997 are still unfolding. Although a full analysis of the factors that precipitated the widespread series of currency crises remains to be done, it is clear that its fixed exchange rate regime and chronic current account deficit increased the likelihood of a crisis in Thailand. Other local factors that may have contributed to these currency crises include weak financial sectors, rapid increases in real estate prices, and inadequate quantities of foreign reserves. The devaluation of the Chinese yuan and the sharp fall in the yen-dollar exchange rate added to the risks since Thailand and others in the region compete with Chinese producers and had pegged their currency values to the dollar when the yen is a more relevant currency because of local trade patterns. The spread of the crisis from Thailand to Indonesia, Malaysia, South Korea, and other countries reflected a mix of fundamental factors (e.g., devaluation by one country increased the potential trade deficits of the others) and psychological contagion among investors who preferred to abandon the region during a period of stress and uncertainty.

The events in Asia have raised a number of important questions that deserve careful attention. How can emerging market countries act to reduce the risk of future currency and financial crises? When such crises occur, how can they be managed to reduce the adverse effects on the domestic economies? And how can industrial countries revise their own policies to reduce the risk of future crises in international capital markets?

These are questions to which the NBER will return in a future research project. I hope that the current volume is both interesting in itself and useful as a background for that future research.

References

Feldstein, M. 1994. Tax policy and international capital flows. *Weltwirtschaftsliches Archiv* 4:675–97.

Feldstein, M., and C. Horioka. 1980. Domestic saving and international capital flows. *Economic Journal* 90 (358): 314–29.