

INTERNATIONAL CAPITAL FLOWS: DISCUSSION

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I welcome the contribution that Sebastian Edwards's sharp, lucid paper has made to the literature and to deepening our understanding of the Chilean case, because the Chilean case is critical. It is the key model that is inevitably cited as *the* example of experience with disincentives to short-term capital inflows. If you will excuse a terminological quibble, I do not think Chile has capital controls. I think it has price disincentives, like taxation. It is like taxing something that is causing you a problem. It is quite different from a rigid quota. But with that qualification, the current conventional wisdom is, and I think it is basically right, that the East Asian crisis was very much driven by short-term flows, and it makes sense to look at possible ways of dealing with these crises and to have as one option such disincentives.

My general position, of course, is that capital flows contribute to international growth and efficiency, just in the way that free flows of trade do. You can draw the same welfare triangles for capital that you can for trade. You can make the same arguments about dynamic side effects for capital that you can for trade. That being said, let me first go briefly through the areas where I agree with Edwards, and then the areas where I have questions.

First of all, I agree on the sequencing: first, trade; second, bank strengthening; third, capital flows. Korea had, as a major source of its problems, the fact that it did not do the domestic bank strengthening before the capital liberalization. Moreover, it liberalized the wrong thing: It liberalized the short-term instead of the long-term flows. Korea discriminated against direct investment and against foreign bonds. Of

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course, the macro policies are more important than capital liberalization or controls—I agree in these areas. Usually it is a fixed exchange rate with a mismatched fiscal and monetary policy that causes a high interest rate, and therefore interest arbitrage, that gets the country into trouble. But I do not agree that you should totally rule out short-term disincentives in cases of global capital market exuberance and large inflows.

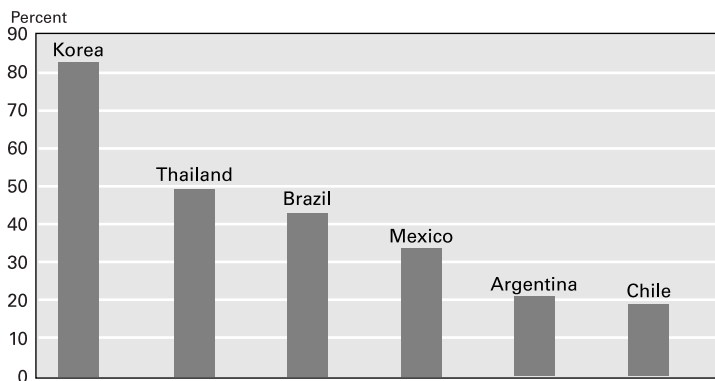
If we look at the experience of the East Asia crisis, it is unambiguous that a run-up in short-term capital was a critical factor in triggering the problem, especially in the case of Korea, where short-term debt went from \$40 billion to almost \$100 billion. As a result of this experience, the rating agencies, for example, now acknowledge that short-term liquidity vulnerability can make a country illiquid, just as it can get a company into trouble, even if the relative weight of its overall debt is modest.

What about the specific findings of Edwards's paper? First of all, in 1977 to 1981, Chile did in fact sharply increase the maturity of its debt. That experience casts some doubt on the subsequent conclusion that you really cannot do much about it. Implicit in the later part of the paper is the message that Chile managed to have a crisis in the early 1980s, even with its capital controls. Well, of course it had a crisis, with a severely overvalued exchange rate and an extremely large current account deficit. When you get a loss of confidence, you do not have to deal so much with the short-term outflow if you do not have short-term debt, but you do have to finance the ongoing current account deficit. Chile had convertibility and a fixed exchange rate, which made it easy for capital flight to occur. That being said, no one would argue that short-term capital flow controls are infallible.

That was the second finding. Third finding: Chile's short-term debt fell from 19 percent of the total in 1990 to 5 percent in 1997. Again, that does suggest some impact. If you look at the conventionally defined short-term debt for Chile, it is indeed much lower relative to imports or other economic bases than is the case in the other crisis economies and some of the comparable Latin economies. Ah! but here, Edwards's paper makes a strong argument; it says the data are no good. What he does is look at the residual maturities for the next year, and those data say there is a little bit of difference, the short-term portion accounts for 50 percent of the bank debt for Chile, but 65 percent for Korea. That is some difference, but it is no big deal. The implication: The disincentives do not work.

Well, I was struck by those figures so I tried to put together the Institute's figures on a broader base that does not simply look at the bank debt, but instead takes the entirety of the short-term debt and adds the entirety of the amortization coming due on long-term debt in the coming year, and divides that sum by the entirety of external debt. In other words, I took short-term debt plus the amortization on the long-term debt coming due, for all classes of debt, which is the counterpart to his BIS

Figure 1
Short-Term Debt plus Amortization Due on Long-Term Debt
as a Percent of Total External Debt, 1996, Selected Countries



Source: Institute of International Finance, Inc.

residual maturity for banks. I am using a broader set of debt here, but basically the same concept, and dividing by the entirety of external debt. As you can see in Figure 1, in Korea the resulting share was over 80 percent under this extended concept of short-term liabilities; in Chile, it was the lowest at under 20 percent. So, I do not buy into the argument that the new set of data should make us conclude that Chile's disincentives were totally ineffective.

It is also the case, of course, that we have to look at overall debt, and if you have disincentives on short-term debt, that will have some effect in suppressing overall debt. Chile had a total debt-to-exports ratio in 1996 of 125 percent, compared with 350 percent for Argentina and Brazil. Similarly, if you have a disincentive to short-term debt flows, that will tend to push the balance toward long-term direct investment. In 1994 to 1996, the relationship of Chile's direct investment flows to its debt flows was about one to one, whereas in Argentina it was about 60 percent. Again, the basic point is that one should not be focusing too narrowly on the particular bank data that Edwards presents.

Let me turn to the part of the paper that essentially tries to argue that the controls are not effective because they do not affect total debt, the exchange rate, or interest rates. The bottom line here for me is that this is interesting but irrelevant. It is not relevant to the policy debate on architecture, which seeks to avoid a situation where a tremendous amount of capital can exit at a moment's notice. The architecture debate

is not asking whether Chile can have an independent monetary policy; it is not asking whether Chile can affect its exchange rate. These issues are part of a somewhat parochial debate. The Chileans obviously have focused on this part of the debate, but it is a minor part of the architecture argument.

I would submit that in the context of the architecture discussion, it may even be desirable to have this finding, right? The basic issue is the degree of substitutability between short-term debt and long-term debt. If that substitutability is infinite, you should not be surprised by the fact that you cannot suppress the total amount of debt, and you should be delighted from the vulnerability standpoint that these disincentives can, dollar for dollar, shift your short-term debt to long-term debt.

As to the specific tests, I think there is some difficulty in this question of which two different periods to consider. The domestic interest rate is equal to the international interest rate plus little k , which is the rate of taxation on short-term capital, plus the big R , which is country risk. When the world is awash with money, the government slaps on little k , so that keeps the interest rate high domestically by this identity; but when there is a market collapse, that raises the big R because everybody thinks that all emerging markets are basket cases. Result: You do not see any change in domestic interest rates by this identity. The fact is that the impact of the little k in the identity should be one for one on the interest rate. To my mind, this relationship has more force than the particular test, and it suggests that the real question is whether in fact the government was able to achieve the little k that it thought it was imposing, or whether the little k , the effective tax rate, was zero in actuality.

In sum, Edwards's paper seems to attempt to discard Chile as a useful model of short-term disincentives. But I would submit its main tests, particularly regarding the increase in the interest rate, or the increase in the exchange rate, are not germane—or the data, especially on the ratio of short-term lending to total bank debt alone, may be misleading.

Let me return to the broader debate, briefly. The first issue that follows from this discussion is how you manage short-term debt, beyond avoiding combinations of fixed exchange rates and high domestic interest rates, which usually reflect a policy mismatch. Dealing with the distortions is like dealing with pollution. Before you start taxing fossil fuels, you should remove the subsidies to coal consumption. Let direct investment come in, let long-term bonds come in. Here I have Chile's tax incentives in mind as an example, because I do think that they still belong on the policy options menu, probably in a temporary form and reserved only for that day, if it ever returns, when the world is awash with liquidity and the money is headed toward the emerging market economies, which is not the case right now.

Finally, I have a question on the Basle risk weights for short-term

credits. That announcement has been made now; the old rates are being eliminated and replaced by weights based on rating agency types of assessments. I think that change does raise a question of whether there will be consequences for interbank liquidity, including in industrial countries. It does raise a question about short-term trade credit. It also raises a question about whether that is a sufficient place to end in the journey toward reformulation of capital requirements more generally.