Coping With Capital Flight

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"Money won't manage itself." In light of the chaos prevailing in currency markets, government officials and economic ministers are forced to consider anew the famous admonition of English central banker Charles Bagehot. Since September 1997 the Indonesian rupiah has depreciated 72 percent against the U.S. dollar, the Malaysian ringgit has lost 22 percent of its value against the dollar, and the South Korean currency (the won) has lost 33 percent. In two of the cases cited above (Indonesia and Malaysia), a collapse of the domestic stock market precipitated a "flight to the dollar." South Korea, a nation that restricts foreign ownership of domestic business firms, found itself victimized by the activities of professional foreign exchange speculators (known in the trade as FXers), who bet en masse against the won earlier this year.

These developments were foreshadowed by the Mexican crisis of 1995. President Zedillo's decision to devalue the peso in December 1994 (so as to make Mexican-made goods more price competitive) provoked a "run" on the bolsa (the Mexican equivalent of the New York Stock exchange). As the peso went into free fall against the dollar, U.S. Treasury Secretary Robert Rubin scrambled to put together a bailout package so that a Mexican default on its external debt could be forestalled.

So life goes in the Brave New World of global finance and "connectivity." Liquid securities markets evolved in places like Singapore, Brazil, Turkey, and Thailand so that these "emerging" economies could gain access to badly-needed money capital. Trouble is, the very feature of well-organized securities markets that makes them so appealing to wealth-holders (namely, that they render the decision to purchase a stake in particular business enterprise readily reversible) is at the same time an important source of economic instability.

Leaders in emerging market countries face a Catch 22 as they spur the global money mandarins to take positions in securities denominated in the local currency. The money won't come unless the key players have the assurance that they can pick up and leave at any time. Hence, officials in emerging market countries frequently eschew "capital controls"—that is, restrictions on the liquidation of domestic shares and the conversion of proceeds into dollars, marks, pounds, or other currencies. But by protecting the interests of investors, emerging market nations make themselves vulnerable to a scourge known as capital flight.

Capital flight occurs when there is a general push by investors to exit both the stock market and the local currency. The Dow Jones Industrial Average was off its July 24
high by as much as 23 percent in early September. But the value of the dollar hardly budged, and domestic interest rates actually fell. As fund managers and others liquidated holdings of GE, Citicorp, and Intel, they purchased dollar-denominated assets such as Treasury bills. The story was much different in Mexico, Indonesia, and elsewhere. The sale of peso or ringgit-denominated financial assets generated a concomitant surge in the demand for dollars as wealth-holders fled to the world investment community’s safest haven.

The options available to countervail the effects of an exodus from domestic financial markets are unappealing, to put it mildly. Allow your currency to float, and you diminish the capacity of firms and households to purchase imported goods. The situation is made worse if domestic firms have substantial external debt denominated in dollars (as was the case of South Korea). Stabilizing the currency means depleting precious foreign reserves. Some countries have attempted to reverse the capital flow by steeply elevating domestic interest rates (the short-term bank rate in Indonesia was at 57 percent on September 1). A loan package from the International Monetary Fund (IMF) would help, but must be purchased at the expense of lost economic and political autonomy.

The meltdown of emerging nation stock markets (and associated capital flight) was on the one hand an efflux of fundamental economic and institutional problems (such as those described by Roger Roderick in this space in June) plaguing the recently industrialized world. The global investment community was registering its dissatisfaction with financial reporting systems, exposure of banks to commercial real estate, and rampant cronyism. However, many economists wonder if the magnitude of the quake in Asian financial markets was out of proportion to the objective factors listed above.

Some of the best brains are presently exploring ways the world financial system might be reformed so that emerging nations can get access to capital, but at the same time be protected from the fickleness and caprice of the world’s asset management elite. Let’s hope they succeed.