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Capital Account Liberalization: Lessons For the Chile Singapore Trade Agreements

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Subcomittee on Domestic and International Monetary Policy, Trade and Technology
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Introduction

Chairman King, Ranking Member Maloney and distinguished members of the committee, my name is Peter Blair Henry. I am Associate Professor of Economics at the Stanford University Graduate School of Business. I am also a Faculty Research Fellow of the National Bureau of Economic Research, and my research is funded by the National Science Foundation's Early CAREER Development Program. I have written extensively on the economic effects of capital account liberalization. Thank you for the opportunity to discuss the implications of my research for the financial services component of the recent U.S. trade agreements with Chile and Singapore.

1. What Is My Position On the Importance Of Free Trade in Goods?

Free trade in goods, also known as trade liberalization, is the lynchpin of globalization. All countries can benefit from free trade, because free trade allows countries to export those goods for which they are low-cost producers and import those goods for which they are high-cost producers. This kind of Specialization brings two specific benefits. First, countries get to consume goods for a lower price than would be possible if, instead of importing the goods, the countries produced them at home. Second, specializing in the production of goods at which they are more efficient raises countries' gross domestic product.

Trade liberalization is not costless. Liberalizing trade may cause unemployment by driving inefficient producers out of business. In principle, however, the overall gains in gross domestic product that result from free trade are sufficiently large to pay for the cost of retraining workers in redundant industries. In other words, all members of society can be made better off from trade liberalization, when it is judiciously applied.

Therefore, the United States should take the lead in promoting worldwide free trade by continuing to open its borders to foreign goods and encouraging other countries to follow suit. The recent trade agreements with Chile and Singapore provide a small step in the right direction.

2. What is My Position on the Importance of Free Trade in Capital?

Capital account liberalization was once seen as an inevitable step along the path to economic development for poor countries. Liberalizing the capital account, it was said, would permit financial resources to flow from capital-abundant countries, where expected returns were low, to capital-scarce countries, where expected returns were high. The flow of resources into the liberalizing countries would reduce their cost of capital, increase investment, and raise output.[1] The principal policy question was not whether to liberalize the capital account, but when — before or after undertaking macroeconomic reforms such as inflation stabilization and trade liberalization.[2] Or so the story went.

In recent years intellectual opinion has moved against capital account liberalization. Financial crises in Asia, Russia and Latin America have shifted the focus of the conversation from when countries should liberalize to if they should do so at all. Opponents of the process argue that capital account liberalization invites speculative hot money flows, increases the likelihood of financial crises, and brings no discernible economic benefits. Some economists have gone so far as to suggest that open capital

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[1] See the following articles and the references therein: Stanley Fischer, "Capital Account Liberalization and the Role of the IMF," *Princeton Essays in International Finance* 207, 1998, pp. 1-10; Lawrence H. Summers "International Financial Crises: Causes, Prevention, and Cures," *American Economic Review*, May 2000, pp. 1-16.

[2] See Ronald I McKinnon, *The Order of Economic Liberalization*. Johns Hopkins University Press, Baltimore, 1991.

markets may even be detrimental to economic development.[3] But I believe that there is a serious flaw with such reasoning. This flaw stems from the fact that those who oppose capital account liberalization have failed to define exactly what they mean.

Why is it important to define precisely what one means by the term capital account liberalization? The reason is that there are many different types of capital account liberalization. Recent research demonstrates that the answer to the question: "Is capital account liberalization helpful or harmful?" depends critically on the type of liberalization undertaken. While liberalization of debt flows has often led to great difficulty, liberalization of portfolio equity flows has been associated with booming stock markets, greater capital investment, and faster economic growth.

In its broadest form, capital account liberalization can be any decision by a country's government that allows capital to flow more freely in and (or) out of that country. Allowing domestic businesses to take out loans from foreign banks, allowing foreigners to purchase domestic debt instruments, and allowing foreigners to invest in the domestic stock market are three examples. At a minimum, we need to distinguish between two categories of liberalization: those that involve debt and those that involve equity. While this is obviously an oversimplification, it is useful for driving home the following point. Debt financing and equity financing are different. While this point may seem obvious, it seems to have gotten lost in the heated policy debate over whether developing countries should have open capital markets. The rest of this report will

[3] See the following articles and the references therein: Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, May/June 1998, pp. 7-12; Dani Rodrik, "Who Needs Capital Account Convertibility?". *Princeton Essays in International Finance* 207, 1998, pp. 55-65; Joseph Stiglitz, *Globalization and Its Discontents.* W.W. Norton, New York, (2002).

demonstrate that the liberalization of debt flows has had very different consequences than the liberalization of equity flows.

A. Debt Market Liberalizations

Let's start with the case of the liberalization of external debt flows. A number of economists have documented that excessive short term borrowing (loans with a maturity of less than a year) in dollars from foreign banks by Asian banks, companies, and governments played a central role in the onset of the crisis. In essence, the mismatch between the term structure of Asian borrowers' assets (long term) and their dollar-denominated external liabilities (short-term) placed these countries in an extremely vulnerable position. Any bad news that made their lenders reluctant to extend new loans was bound to create an immediate liquidity problem. Importantly, a bunching of long-term debt maturity profiles will have the same effect as an over-reliance on short-term debt. Beyond the Asian Crisis, in general it appears that excessive short term borrowing in dollars played a central role in precipitating the onset of almost every emerging market financial crisis during the 1990s.

Thus, a key lesson is that once external debt flows have been liberalized it is of utmost importance that the magnitude and maturity profile of the country's external debt liabilities are compatible with the magnitude and maturity profile of its assets. That the liberalization of external debt financing can quickly generate liquidity problems for a country is a well-known phenomenon that dates back at least as far as Chile in the late 1970s.

B. Equity Market Liberalizations

While there are numerous studies, which show that premature liberalization of dollar-denominated debt flows in the capital account has deleterious effects, there has been a relative dearth of evidence on the effects of equity market liberalizations. In order to address this deficiency, I conducted three studies.[4] All three studies suggest that countries derive substantial economic benefits from allowing foreigners to purchase shares in their stock markets.

Identifying stock market liberalization dates is the first step in determining whether stock market liberalization has any discernible economic effects. Since markets are forward-looking, the most important question is when does the market first learn of a credible, impending liberalization? In principle, identifying a liberalization date simply involves finding the date on which the government declares that foreigners may purchase domestic shares. In practice, the liberalization process is not so transparent. In many cases, there is no obvious government declaration or policy decree that one can point to.

When there is no salient liberalization decree, I infer the first date on which foreigners could hold domestic shares from the first date on which a closed-end country fund was established. Table 1 presents a list of the 18 countries in the sample, the date of their first stock market liberalization, and the means by which they liberalized. For example, the table shows that the modal means of liberalization occurred through the establishment of a closed-end country fund.

[4] For more details on these studies, as well as other references see: Peter Blair Henry "Capital Account Liberalization, The Cost of Capital, and Economic Growth" *American Economic Review*, May 2003; "Stock Market Liberalization, Economic Reform, and Emerging Market Equity Prices" *Journal of Finance*, April 2000, pp. 529-564; "Do Stock Market Liberalizations Cause Investment Booms?" *Journal of Financial Economics*, October 2000, 301-334.

The establishment of a country fund in particular, and stock market liberalizations in general, may seem like a narrow way to define capital account liberalization, but it is precisely the narrowness of stock market liberalizations that make them more useful for two specific reasons. First, focusing on stock markets alone helps us distinguish between the consequences of debt versus equity market liberalization. Second, studies that use broad liberalization indicators focus on cross-sectional data, examining the long-run correlation between average openness and average investment.[5] Examining the correlation between average openness and investment tells us whether investment rates are permanently higher in countries with capital accounts that are more open. The problem with this approach is that economic theory makes no such prediction.

What the theory does predict is that capital-poor countries will experience a temporary increase in investment when they liberalize. Hence, the relevant issue is not whether countries with open capital accounts have higher investment rates, but whether investment increases in the immediate aftermath of liberalizations. The most transparent way of testing the prediction is to compare investment rates during liberalization episodes with investment rates during non-liberalization periods. Because they constitute a radical shift in the degree of capital account openness, stock market liberalizations provide ideal natural experiments for confronting the theory with data.

The first study I conducted found that, on average, opening up to foreign shareholders led to a 38 increase in the real dollar value of the liberalizing countries' stock markets. Since stock market liberalization does not alter the functioning of these companies in any way— remember, the only thing that liberalization changes is the

[5] See for example, Rodrik (1998).

ownership of the shares of the companies listed on a country's stock exchange— is the increase in share prices evidence that capital account liberalization drives domestic stock prices away from the fundamentals and leads to stock market bubbles? Not necessarily.

The price of a stock depends on the expected future dividends to be paid by that stock and the discount rate shareholders apply to those expected future dividends. The discount rate has two components, the interest rate and the equity premium. Stock market liberalization leads to lower interest rates through the inflow of foreign funds. Stock market liberalization also reduces the equity premium, because emerging market stocks provide diversification benefits for investors in countries like the U.S. In other words, stock market liberalization leads to a lower cost of equity capital. In short, there are sound fundamental reasons for share prices to increase when the stock market is liberalized and we seem to observe this in reality.

Exactly who benefits from the increase in share prices and the decline in the cost of capital? Clearly, domestic shareholders benefit: those who sell their shares realize capital gains and those who continue to hold their shares see the value of their portfolios increase. Although foreign shareholders do not benefit from the increase in prices— indeed, they must now pay more to get into these markets— they are better off because their portfolios are more diversified than was possible prior to the stock market liberalization. For less obvious reasons, domestic residents who do not own shares will also benefit from stock market liberalization.

Remember that when a country's stock market increases in value, the country experiences a fall in the cost of capital. For a given capital-raising requirement, a higher stock price means that fewer shares need to be issued. Figure 1 illustrates the fall in the

cost of capital that occurs when developing countries liberalize the stock market. The figure plots the average aggregate dividend yield across the liberalizing countries in event time (year [0] is the year of liberalization). The average dividend yield falls by roughly 240 basis points—from an average level of 5.0 percent in the 5 years prior to liberalization to an average of 2.6 percent in the five years following liberalization.

While the immediate effect of liberalization is higher share prices and a lower cost of capital, that is not the end of the story. The lower cost of capital will encourage firms to build new factories and install new machines. The reason for increased investment is straightforward. Since stock market liberalization reduces the overall cost of capital, some investment projects that were not profitable before the stock market liberalization are profitable after liberalization.

The higher investment that should result from stock market liberalization is particularly important for emerging economies, because more investment should lead to faster economic growth and higher wages for workers. Thus, stock market liberalization should generate substantial economic benefits, even for those individuals who did not own shares before the liberalization and therefore do not reap the capital gains associated with the increase in share prices.

It sounds plausible that a lower cost of capital should lead to increased investment, but what is the reality? Figure 2 demonstrates that, on average, countries experience an increase in investment when they liberalize the stock market. The growth rate of the capital stock rises by 1.1 percentage points in the aftermath of liberalizations— from an average of 5.4 percent per year in the pre-liberalization period to an average of 6.5 percent in the post-liberalization period.

While liberalization leads to a sharp increase in investment on average, it is also important to know whether this is a uniform effect— do all countries experience higher investment, or is it just a select few that drive the results? In order to address this question, I looked at the results on a country-by-country basis. In one study I conducted, only two of the countries in the sample did not experience abnormally high rates of investment in the first year after liberalization. In the second year after liberalization, only one of the countries did not experience abnormally high rates of investment.

Increased investment should raise productivity and economic growth. Figure 3 shows that the growth rate of output per worker rises by 2.3 percentage points in the aftermath of liberalization— from an average of 1.4 percent per year in the pre-liberalization period to an average of 3.7 percent per year in the post-liberalization period.

Stock market liberalizations are usually accompanied by other economic reforms. Therefore, it is important to ask whether these economic reforms would have caused large increases in stock prices, investment and growth, even if there had not been any stock market liberalizations. The financial and economic effects of stock market liberalization remain statistically and economically significant, after controlling for contemporaneous reforms.

C. Do Equity Market Liberalizations Cause Crises?

Is equity market liberalization a good idea for emerging economies? It is hard to quibble with higher stock prices, investment, and economic growth. There is, however, one potential criticism of equity market liberalization, which needs to be addressed: *The*

opening of equity markets to foreign investors may have led to an initial stock market boom, but it also contributed to the collapse of emerging stock market values during the recent crises in Asia and Latin America.

In evaluating this criticism it is important to remember that these countries liberalized their stock markets in the late 1980s and early 1990s. Given that these stock market liberalizations took place more than 5 years before the crises (and as much as 10 years before in some cases), the argument that this policy change is responsible for the stock market collapse seems untenable.

The proximate cause of the fall in stock markets during the crises was the revelation that these countries' banking systems had been poorly managed. As news of imprudent lending and corporate insolvencies surfaced, economic prospects dimmed and stock prices responded accordingly. There is no law, economic, or otherwise, that says stock market gains are irreversible. In fact, it would be more worrying if stock markets in emerging economies did not respond negatively to bad economic news, as do stock markets in developed countries like the United States. In other words, the collapse of stock prices during recent emerging market crises was due to poor short-term economic prospects; the fact that foreigners were active participants in these markets is immaterial.

3. Lessons for The Language in This and Future Agreements on Capital Controls

The evidence I have outlined in this report can be distilled into two key lessons for the capital controls portion of the Chile Singapore free trade agreements. First, the liberalization of dollar denominated debt flows should proceed slowly and cautiously. This agreement, as well as all future agreements, should refrain from any language that

inadvertently pushes countries into prematurely liberalizing dollar-denominated foreign borrowing. The second lesson is that all the evidence we have indicates that countries derive substantial economic benefits from opening their stock markets to foreign investors; there is no reason to think that Chile and Singapore will be any different in this regard.

Table 1. Country Stock Market Liberalization Dates

Country	Year of Liberalization	Means of Liberalization
Argentina	1989	Policy Decree
Brazil	1988	Country Fund
Chile	1987	Country Fund
Colombia	1991	Policy Decree
India	1986	Country Fund
Indonesia	1989	Policy Decree
Jordan	1995	Policy Decree
Korea	1987	Country Fund
Malaysia	1987	Country Fund
Mexico	1989	Policy Decree
Nigeria	1995	Policy Decree
Pakistan	1991	Policy Decree
Philippines	1986	Country Fund
Taiwan	1986	Country Fund
Thailand	1987	Country Fund
Turkey	1989	Policy Decree
Venezuela	1990	Policy Decree
Zimbabwe	1993	Policy Decree

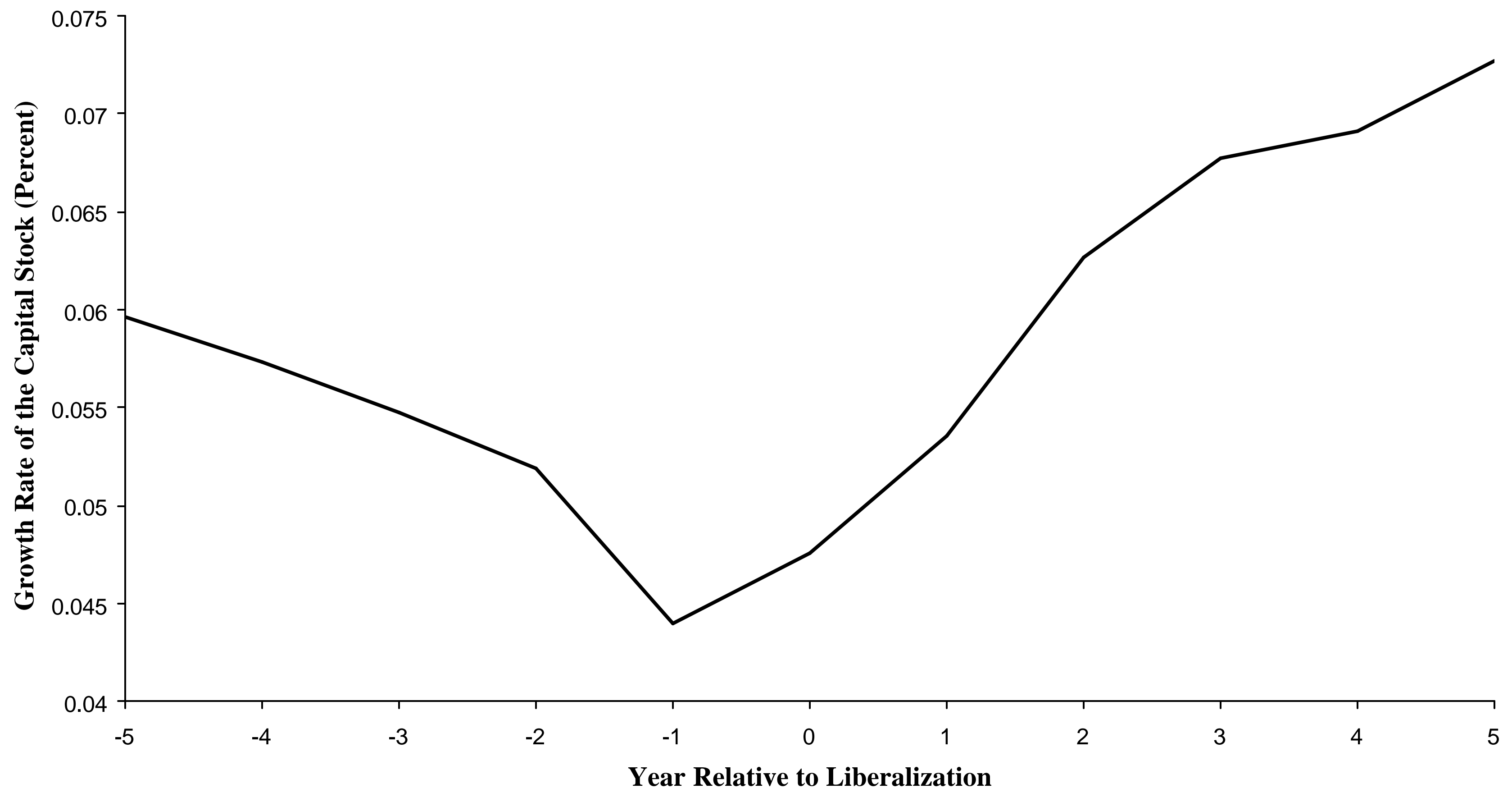

Figure 2. Investment Booms When Countries Liberalize the Capital Account .

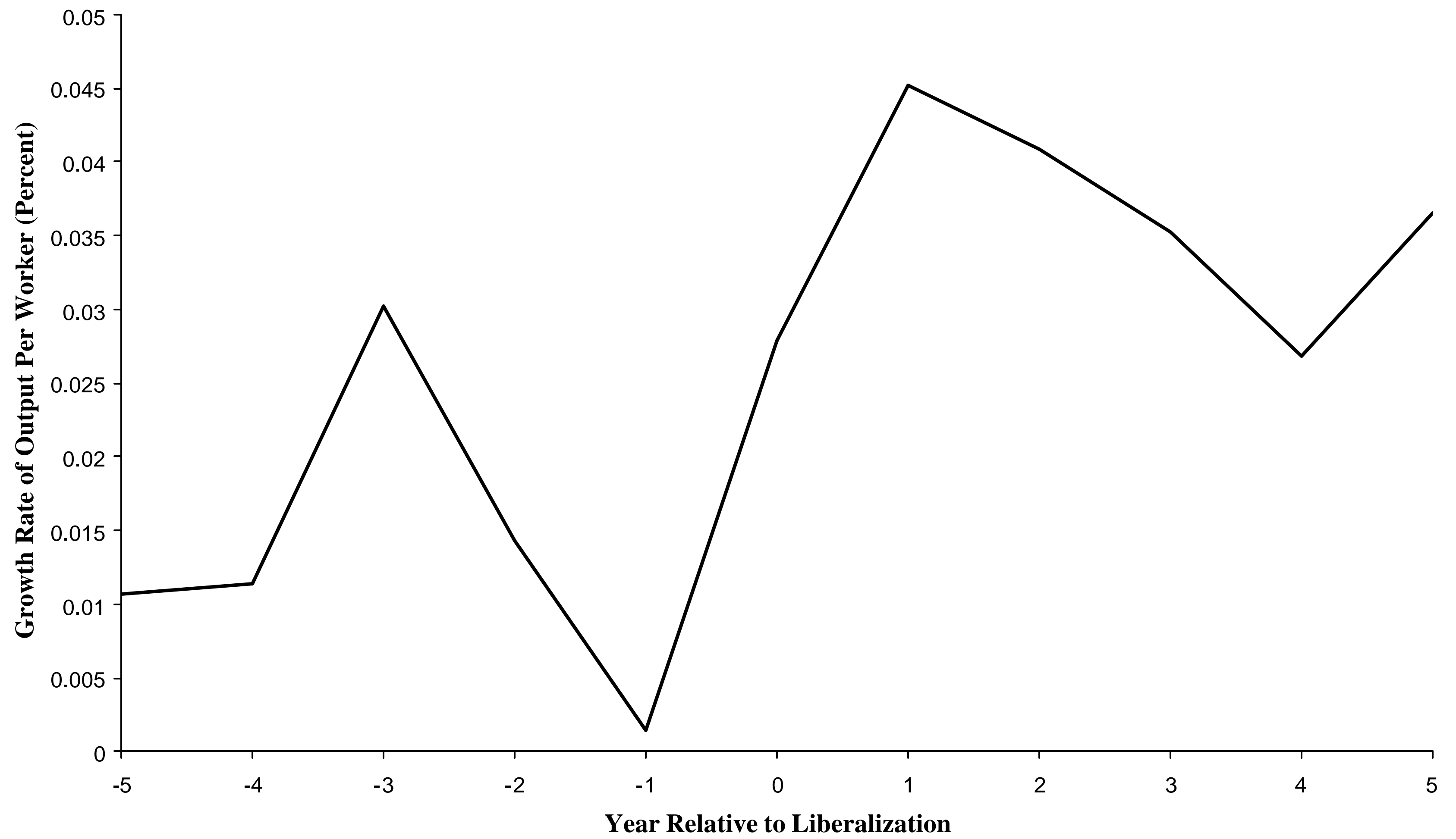

Figure 3. The Growth Rate of Output Per Worker Increases When Countries Liberalize