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# The impact of surges in net private capital inflows on manufacturing, investment, and unemployment

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## ABSTRACT

We use local projection methods to examine the dynamic response of surges in net private capital inflows on the output and employment shares of manufacturing, the investment output ratio, and the unemployment rate. High income countries are studied separately from emerging economies, both from Asia and Latin America. Our sample covers the years from 1970 to 2010. We find that surges in high income countries do not magnify the trend toward deindustrialization. However, the persistent decline in the investment to GDP ratio and the rise in the overall unemployment rate suggest that surges may negatively affect longer run growth prospects and employment opportunities in these countries. In middle income Asian countries, surges tend to induce deindustrialization in both output and employment in the medium run, but they do not lower the investment to GDP ratio. In middle income Latin America, surges speed up deindustrialization, lower investment and raise economy-wide unemployment.

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## 1. Introduction

With increasingly more countries allowing for cross-border capital mobility, the impact of capital inflows on the economy has become a matter of considerable policy relevance. Theoretically, capital inflows can increase access to finance and, thereby, promote domestic investment, consumption smoothing, and international risk sharing.<sup>1</sup> The series of financial crises in the 1990s raised the awareness of the potentially negative aspects of unregulated capital inflows on both macroeconomic stability and growth (Blanchard et al., 2016; Prasad et al., 2007; Reinhart and Reinhart, 2008). The recent wave of capital inflows to emerging markets following the global financial crisis has renewed interest in these potential negative impacts, which include threats to (i) financial stability as a result of excessive growth in lending, and (ii) the competitiveness of the tradable sector as a result of an appreciating real exchange rate. Caballero (2016), for example, finds that a surge in capital inflows increases the odds of a banking crisis by a factor of three to eight. If surges are accompanied by a lending boom, the odds of banking crises rise even more.<sup>2</sup> Similarly, Furceri et al. (2012) explores the impact of capital inflow surges on domestic credit

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<sup>1</sup> More generally, financial openness can promote better macroeconomic policies, help with the development of the domestic financial sector, and raise the level of efficiency in the economy by increasing competition for domestic firms. See Kose et al. (2006) for a review of the literature on the costs and benefits of financial globalization.

<sup>2</sup> In an interesting study Ranciere et al. (2008) suggest that financial crises per se may not be a problem for economic growth. In fact, financially liberalized countries tend to be more likely to have such crises, but these countries also tend to experience stronger growth because they encourage systemic risk taking and that increases investment.

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expansion and finds evidence of an expansion in the first two years following the beginning of a surge. Cardarelli et al. (2010) shows that capital inflow surges are often associated with real exchange rate appreciations, short-term credit booms, and only a temporary increase in output.

Given the potential harm caused by capital inflow surges, policy measures to mitigate the negative impact of surges have attracted attention. Ghosh et al. (2016) suggest in this context to avoid the buildup of macroeconomic imbalances and financial vulnerabilities through credit expansion, currency overvaluation, and economic overheating. Their recommendations support earlier conclusions by Cardarelli et al. (2010) who suggested to cut government expenditures during surges to limit the real exchange rate appreciation and reduce their harmful effects.

Another active area of interest has been to analyze the impact of surges by type of inflow. Whether surges happen primarily in foreign direct investments or in portfolio investments can influence the ultimate impact of capital inflows (Aizenman et al., 2013). According to Ghosh et al. (2016), who study surges for 53 emerging economies over the 1980–2014 period, countries that receive most of their inflows in the form of debt are significantly more likely to end surge episodes with a crash. Caballero (2016), who differentiates among FDI, portfolio debt and portfolio equity surges, indicates that surges in all flows increase the probability of banking crises when they take place concurrently with a lending boom. Surges in portfolio equity flows appear to have an independent effect, even when not accompanied by a lending boom.

Recently, Benigno et al. (2015) and Kalantzis (2015) have examined the impact of surges on sectoral resource allocation, such as manufacturing output and employment shares.<sup>3</sup> Both studies conduct an event analysis to explore the changes in the size of the manufacturing sector during episodes of large capital inflows. They both find evidence of a resource reallocation away from the manufacturing sector during surges. Resource allocation effects of surges are also the focus of this study.

In particular, the purpose of this study is to advance the empirical evidence on the impact of *largenet* private capital inflows (surges) on some important, yet relatively unexplored variables: sectoral resource allocation, investment and unemployment. Our empirical study builds upon the theoretical model developed by Benigno and Fornaro (2014), which explores the impact of capital inflows on sectoral allocation of productive resources and the long run growth of the economy. Their model is based on two main assumptions: (i) productivity growth is faster in the tradable sectors than in the non-tradable sectors; (ii) externalities associated with the process of knowledge accumulation are stronger in the tradable sectors than in the non-tradable sectors.<sup>4</sup> They show that episodes of cheap and abundant access to foreign capital lead to a consumption boom that affects both tradable and non-tradable goods. While a trade deficit can finance the consumption of tradable goods, the consumption of non-tradable goods requires reallocation of productive resources from the tradable sectors (such as manufacturing) toward the non-tradable sectors, such as construction, in which the scope for productivity gains is limited. This resource reallocation hinders productivity growth, prevents the development of a dynamic export sector, and threatens the long run competitiveness of the economy.

The model of Benigno and Fornaro (2014) is closely related to the early theoretical study of the natural resource curse developed by Corden and Nearey (1982). However, the resource curse in the model developed by Benigno and Fornaro (2014) does not arise from the discovery of natural resources or due to an exogenous transfer from abroad, but rather because of a period of abundant access to foreign capital. The literature on deindustrialization is also closely related to our study.<sup>5</sup> This literature emphasizes the importance of the manufacturing sector for long-term growth and, thus considers deindustrialization harmful to growth. All studies of this genre see the tradable sector and manufacturing in particular in a special role for growth and stability, and that for a number of reasons. First, manufacturing offers more opportunities for capital accumulation and economies of scale than other sectors.<sup>6</sup> Second, a key driver of the growth dynamics for the tradable sector is the fact that it is tied to the disciplinary forces of world markets, not only in terms of prices, but also in terms of quality, innovation, and general know-how. Third, being a tradable sector, the manufacturing sector does not face domestic demand constraints and can grow even when the domestic economy is stagnant (Rodrik, 2016). This also implies that the manufacturing sector is the one from which countries can earn their foreign exchange and avoid balance of payment crisis.<sup>7</sup> Because some level of deindustrialization is natural as the income level grows, the deindustrialization literature is mainly concerned with the negative impact of 'excess' deindustrialization or 'pre-mature' deindustrialization on economic growth and explores the contributing factors.<sup>8</sup> A key question in this context is whether capital inflow surges magnify or speed up the deindustrialization trend (*trend* decline in manufacturing output and employment) or whether their impact is only temporary. A related question is

<sup>3</sup> Earlier studies by Tornell et al. (2004) and Mendoza and Terrones (2008) have already documented that episodes of strong capital inflows tend to be coupled with increases in the relative importance of non-tradable sectors vis-a-vis of sectors producing tradable goods.

<sup>4</sup> The empirical literature provides evidence for both of these assumptions, especially when manufacturing is used as a proxy for the tradable sector (Duarte and Restuccia, 2010; De Gregorio and Wolf, 1994; Rodrik, 2013).

<sup>5</sup> Some studies define deindustrialization as a decline in both the share of manufacturing output and employment (e.g. Tregenna, 2009). Others associate the term with a decline in either the share of manufacturing employment or of output (e.g. Palma, 2005; Rowthorn and Ramaswamy, 1997). See Rowthorn and Ramaswamy (1997) or Rowthorn and Coutts (2004) for a detailed analysis of the factors accounting for deindustrialization.

<sup>6</sup> Duarte and Restuccia (2010) find that productivity grows faster in the tradable goods sector relative to the non-tradable sectors for data from 29 countries, including both OECD and emerging economies, for the period 1956–2004. Similar conclusions were reached earlier by De Gregorio and Wolf (1994) for OECD countries for the period from 1970 to 1985. Rodrik (2013) finds that cross-country convergence in productivity is only present in the manufacturing sectors.

<sup>7</sup> In this context, it is no surprise that Kalantzis (2015) connects a shrinking tradable sector during episodes of large capital inflows to an increase in the likelihood of balance of payment crises, in particular for countries with borrowing constraints and currency mismatches. Earlier work of Schneider and Tornell (2004) also showed that a shrinking tradable sector (manufacturing) may trigger balance-of-payment crises.

<sup>8</sup> See Haraguchi et al. (2017), Felipe and Mehta (2016), Rodrik (2016), Rodrik (2013), Palma (2005), and Su and Yao (2016).

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