ELSEVIER

Journal of International Economics 69 (2006) 120–149

Journal of INTERNATIONAL ECONOMICS

www.elsevier.com/locate/econbase

Private capital flows, capital controls, and default risk

Mark L.J. Wright *

Department of Economics, Stanford University, 579 Serra Mall, Stanford CA 94305-6072, United States

Received 20 August 2004; received in revised form 18 April 2005; accepted 10 May 2005

Abstract

What has been the effect of the shift in emerging market capital flows toward private sector borrowers? Are emerging market capital flows more efficient? If not, can controls on capital flows improve welfare? This paper shows that the answers depend on the form of default risk. When private loans are enforceable, but there is the risk that the government will default on behalf of all residents, private lending is inefficient and capital controls are potentially Pareto-improving. However, when private agents may individually default, capital flow *subsidies* are potentially Pareto-improving.
© 2005 Elsevier B.V. All rights reserved.

Keywords: Capital flows; Default; Borrowing constraints; Capital controls; Capital subsidies

JEL classification: F21; F34; F41; O19

1. Introduction

Capital flows to emerging markets have shifted markedly away from public sector towards private sector borrowers. In the past decade, the private sector share of the stock of emerging market debt rose more than fivefold from around five percent in 1990 to more than twenty-five percent of the total by the end of the century. Private non-debt capital flows have also increased rapidly, with gross foreign direct investment as a share of all private capital inflows more than doubling over the same period.

* Tel.: +1 650 725 9967; fax: +1 650 725 5702.
E-mail address: mlwright@stanford.edu.

0022-1996/$ - see front matter © 2005 Elsevier B.V. All rights reserved.
doi:10.1016/j.jinteco.2005.05.007

The rise in private capital flows has been accompanied by a change in attitudes towards capital controls. In the decade of the 1990s, a number of countries, including Brazil and Chile, introduced controls to limit short-term inflows on capital, while others, most notably Spain, Malaysia and Thailand, introduced controls to limit capital outflows. And while many of these actual experiences with controls were justified as temporary measures in the face of a crisis, there have been increasing calls for controls to be used both as a tool for macroeconomic management (for example, Obstfeld and Taylor, 2004), and to correct other financial market imperfections.[1]

Motivated by these developments, in this paper we present a theory of private capital flows in the presence of different forms of default risk and ask the normative question: Does default risk provide a justification for government intervention in *private* international capital markets? We first show that the risk of default by both individual borrowers, as well as by national governments on their behalf, makes *private* financial markets imperfect and introduces the possibility of default crises even in the absence of sovereign debt. We then study the regulation of capital flows to prevent crises by mitigating individual and national incentives to default on foreign borrowing, and show that the optimal role of capital controls, taxes and subsidies depends upon the precise *form* of default risk.

When there is *national default risk*, the government of a developing country has the power to enforce private contracts between individual residents and foreigners, but can default on the nation's entire borrowings through various means such as the nationalization of industries, or by closing the border to private debt repayments via exchange and capital controls. National default risk thus introduces a separation between the decision to borrow and the decision to default which creates the possibility of inefficient capital flows. In particular, as private agents do not take into account the effect of their own private borrowing decisions on the default decision of the government, they tend to overborrow.

In the presence of national default risk, the optimal form of government intervention depends upon the degree of sophistication of financial markets. If financial markets are "simple", in the sense that there is no price-discrimination, government intervention in the form of capital controls (or taxes) is necessary to implement the constrained efficient level of capital flows. That is, appropriate taxes on borrowing in normal (that is, non "crisis") periods constrain private borrowing to the point that the government does not find it optimal to default: default crises never occur. If, however, private capital markets are "sophisticated", in the sense of being able to price discriminate by offering non-linear contracts, the constrained efficient level of capital flows can be attained without government intervention.

We then go on to *add* the risk of *resident default* on international, but not domestic, borrowing. In this case, even if financial markets are "sophisticated", private capital flows are inefficiently low in equilibrium. The reason lies in the asymmetry of enforcement; because contracts between domestic residents are enforced, if the resident of a country

[1] Ariyoshi et al. (2000) provide an excellent review of country experiences with capital controls, and the various arguments in favor of their use. The International Monetary Funds changing views on capital controls are summarized in the *IMF Survey* of May 19, 2003 (for the public reaction, see *The Economist* "A Slightly Circuitous Route" and "A Place for Capital Controls", May 1st, 2003).

Download English Version:

https://daneshyari.com/en/article/963308

Download Persian Version:

https://daneshyari.com/article/963308

Daneshyari.com