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Capital Controls in Post-War Europe

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1. Introduction

According to the critics of globalization, unfettered capital flows wreak havoc all over the world. Greater economic instability is seen as the most important disadvantage of “globalization” – in addition to greater misery in Third World countries. Trade integration is sometimes considered a benign force, but capital markets integration are almost universally viewed with scepticism. In a widely cited essay in the *Financial Times*, George Soros described the dangers: “...the global financial system still has fundamental flaws... booms and busts are endemic... markets can move like a wrecking ball, knocking over one economy after another”.¹

Current scepticism about the benefits of free capital movement goes back at least to the godfathers of the Bretton Woods System. With memories of the Great Depression and the collapse of international lending in 1929-33 still fresh on their minds, politicians and academics alike had turned their backs on free capital flows. John Maynard Keynes argued in the early 1930s:²

“I sympathize with those who would minimize, rather than ... maximize economic entanglements between nations. Ideas, art, knowledge, hospitality and travel should be international. But let goods be homespun whenever reasonable..., and above all let finance be primarily national.”

Until recently, the doubts of the Bretton Woods system’s architects were little more than a distant memory – strangely outdated, irrelevant. As late as 1996, there was considerable agreement among economists that full capital account liberalization was beneficial, and that the IMF should pursue it explicitly as one of its aims. Reflecting on the experiences of the 1980s and 1990s immediately before the outbreak of the Asian financial crisis, Stanley Fischer argued that “... even... countries in crisis have derived many benefits from capital inflows, a fact that should remind us that no country can afford to cut itself off from the international capital markets”.³ The crises in Asia and Latin America after 1997 have changed the intellectual climate; capital controls are once more on the policy agenda. Massive capital outflows, combined with financial and economic collapse in East Asia and Argentina, have done much to undermine the earlier policy consensus. Malaysia, defying economic orthodoxy, imposed controls. Nonetheless, its recovery may have been every bit as vigorous as the ones in countries that pursued orthodox IMF

policies.⁴ Chile’s restrictions on capital inflows are suddenly held up as a positive example. Paul Krugman argued that it was time for “heresy” – by rethinking the usefulness of capital controls.⁵ Even the arch-liberal *Economist* today concedes that its long-standing support of free capital movement may have been mistaken, and that keeping some controls may be prudent, at least in developing countries.⁶

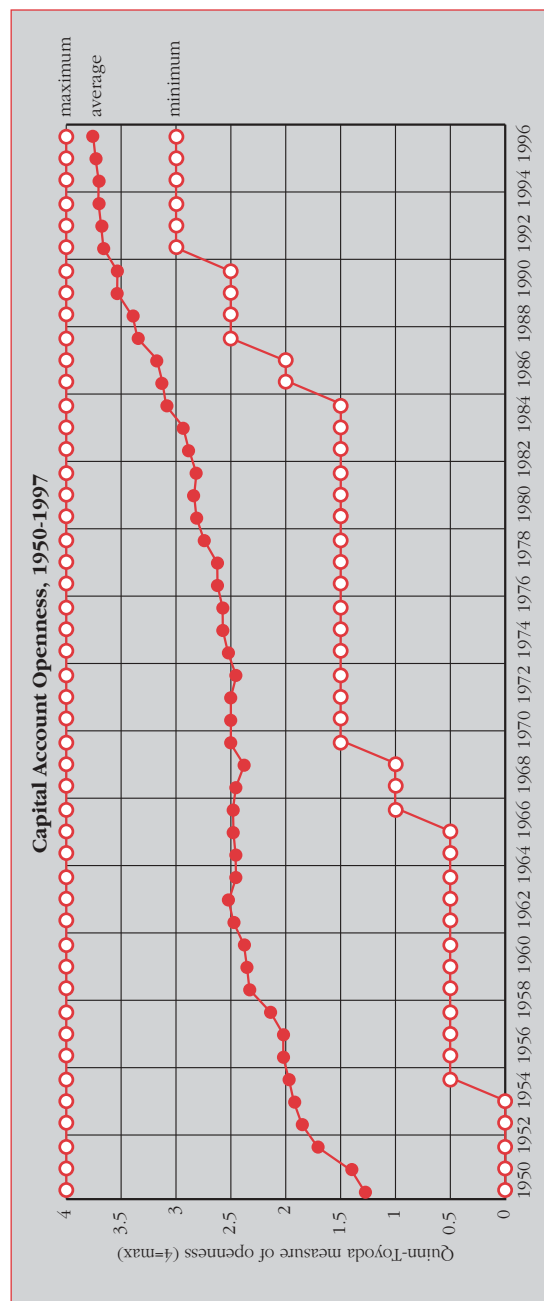
Much of the discussion about the costs and benefits of capital controls has used evidence from Third World countries and the OECD during the last twenty years.⁷ This research strategy has obvious advantages in terms of data availability and the relevance for policy. Yet it may not be able to tell us as much about the economic impact of capital controls as one might hope. Most of the controls in place during this period were applied in less developed countries, and they were often relatively mild and ineffective. Also, much attention has focused on the ability or otherwise of controls to reduce contagion effects, and to lower the risk of financial crises. This type of analysis, by its very nature, focuses on short-term effects. Since most of the benefits one would normally expect from free capital movements are, by their very nature, long-term, this may skew the assessment. The true effect of controls in recent samples is also hard to distinguish because of a number of factors that are specific to less-developed economies (such as relatively high levels of corruption, underdeveloped property rights etc.). This opuscle summarises recent research on the economic effects of capital controls and their political and social correlates, with an emphasis on post-war Europe.

Controls after 1945 were comprehensive in the beginning, and were applied much more stringently than in most Third World countries

today. After the end of the war, it was next to impossible to obtain foreign currency for trade purposes, let alone for cross-border capital transfers.⁸ The Bretton Woods rules had not envisioned a return to fully open capital accounts at all, emphasizing instead the importance of current account convertibility. Figure 1 plots the degree of financial openness in a set of Western European countries (plus the US, Japan, New Zealand, and Australia). We use the Quinn-Toyoda measure of capital account openness, with a scale from 0 (most closed) to 4 (most open) – a scale now widely used by political scientists and economists. It is based on the IMF's Annual Reports on Exchange Restrictions.⁹ In the early 1950s, controls were on average quite extensive, and the range of policies pursued in this group of comparatively similar countries was very wide. Half a century later, rich countries' policies have converged at a very high degree of openness. Even the most restrictive countries maintain a score of 3 out of 4 points.

In post-war Europe, the capital controls were dismantled at varying speeds. Fully open accounts were not common before the the run-up to the euro's introduction in the 1990s. Germany and the Netherlands, for example, liberalized to a large extent in the early 1960s, and then re-imposed stringent controls in the late 1960s and early 1970s. The UK used elaborate controls until 1979, and then abolished them quickly; France and Italy retained numerous restrictions until the early 1990s. These considerable differences in a group of countries that otherwise share a set of common characteristics provides a “natural experiment” for the effects of controls, and will also be useful in gauging the interactions between different political systems and the extent to which controls were imposed and revoked in response to crises. Analysing the case of post-war

Figure 1



Europe can therefore shed light on a number of important policy questions. First, some scholars have argued that the period of very rapid growth between 1950 and 1970 proved that capital controls are not harmful.¹⁰ By focusing on this period, we effectively stack the odds against finding a negative effect – and if one emerges nonetheless, there are good reasons to think that it will be even larger under less favourable circumstances. Second, the transition to openness occurred – at least in retrospect – without major breakdowns and crises. While the speculative attacks on the Bretton Woods system and on the ERM in 1992 caused some upheaval, Europe never had a “lost decade” similar to the experience of Latin America during the 1980s, or a contraction of output that would rival the declines seen in East Asia in 1997/98. A better understanding of the factors that facilitated this smooth transition will be useful to policy-makers. Third, we can examine the determinants of capital account openness – what political, institutional and economic factors enable countries to pursue integration into world capital markets?

2. Theoretical considerations

Free capital movement ought to be unambiguously good for welfare. This is for a number of reasons – domestic savers find outlets for surplus funds, or alternatively, financing needs can be met with foreign capital. Also, aggregate risk should decline. Without the possibility to import or export capital, countries would have to invest exactly as much as they save. Rapidly growing economies could not borrow abroad to finance new equipment or infrastructure; countries with surplus savings would have to accept ever-declining returns on their

investments. The promises of capital mobility are such that economists for a long time have puzzled over the lack of large-scale inflows in the developing world.¹¹ The possibility to diversify risks should increase dramatically once capital markets open up to cross-border flows. Risks that, in any one country, may be too large and too concentrated for investors should theoretically be borne with much greater ease by the world-wide pool of capital. This is partly because the minimum efficient size of projects may be too high for domestic investors, given their risk appetite. Also, country-specific risks should matter much less in a world-wide portfolio of projects than in a domestic one.¹² Integration into global capital markets should thus lower the cost of risk-bearing capital.¹³

Explaining why cross-border capital flows have become associated with instability is more difficult. In frictionless markets without transaction costs and informational asymmetries, crises should be few and far between. Yet sudden, sharp reversals in the direction of flows are an empirical reality. They often impose very considerable costs. A country faced with a capital outflow (often in the middle of a crisis) will often have to raise interest rates sharply, accelerating the fall in output. If the slump is severe, deflation may occur, saddling borrowers with higher-than-expected costs. The number of bankruptcies will soar, and many banks will face problems with bad loans. Sudden exchange rate depreciation – especially after a country abandons a peg – will amplify these effects, leading to the insolvency of domestic borrowers. Depending on the extent of foreign borrowing, the banking sector may be pushed to the brink.

Explaining how sudden changes in the volume and direction of capital flows can occur is a major

challenge. Asymmetric information is often invoked as a main contributing factor – since borrowers know much more than lenders about their financial position, the latter will continuously have to update his beliefs about the likelihood of repayment, based on observable factors. The less informative the initial set of observations, and the more revealing later information, the greater the risk of sudden changes. Also, if lenders realize they only have limited information, they will try to infer the true health of their borrowers from other banks' actions, giving rise to lemming-like behaviour. Shocks are thus amplified. Whether currency and financial crises are largely the result of economic fundamentals, or are driven by financial market “irrationality”, is a matter of continuing debate. Yet in the world as a whole, crises have not become any less frequent.¹⁴

3. The benefits of free capital flows – some empirical evidence

For a long time, the onus of demonstrating a positive effect from free cross-border capital flows was on their proponents. Early empirical work showed few benefits. Dani Rodrik, for example, plotted growth during the period 1975-89 against the financial openness, using IMF data.¹⁵ Neither growth nor investment were clearly and positively correlated with financial liberalization. In the case of investment, a negative relationship appeared to hold. At a time when the dangers of free capital movement had just become apparent, the absence of a positive relationship strongly appeared to suggest that the risks of free capital movement outweighed the benefits. In addition, work on Western Europe by Charles Wyplosz appeared to suggest that capital controls added as much as 0.9% per annum to average GDP growth over the period 1960-95.

Subsequent research has improved on the early work by Rodrik and Wyplosz by examining a larger set of countries over longer periods, and by using more appropriate measures of capital controls. Instead of a simple, dichotomous dummy variable (such as the one constructed by the IMF), political scientists have compiled a more finely graded four-point measure.¹⁶ Analysis using better data and improved techniques suggests that unfettered capital flows do more good than harm, at least on average and over longer periods. Cross-country regressions appear to bear out the detrimental effects of capital controls most clearly in the case of developed countries. Where financial markets themselves are relatively deep and liquid, where supervision and regulation of the banking system is strong, and where financial liberalization follows trade integration, there are strong positive effects on growth.¹⁷ On average, countries that liberalize can reap additional growth of up to 1.1% per annum. Additional “pre-requisites” that boost positive effects include high levels of secondary schooling, and an Anglo-Saxon legal tradition. Careful analysis has documented that the measured benefits of revoking controls do not simply proxy for other improvements in the macro-economic environment (such as a sustained program of reform) that may accompany financial liberalization.

Understanding the mechanisms responsible for the benign consequences of financial integration remains an ongoing task. In principle, three factors could be responsible. In practice, all may be involved simultaneously. Revoking capital controls could lower the cost of capital, by turning idiosyncratic, country-specific risks into diversifiable ones. Second, the volume of investable funds could increase. Third, the efficiency of allocation may rise if foreign

investors are also more savvy, and move funds to industries and firms where they will yield the greatest pay-offs. One way of opening the “black box” of apparently benign financial liberalization is to analyse individual liberalization episodes, and to determine the magnitude of changes.

One useful event is the introduction of currency convertibility in Western Europe in 1959. For some 14 years after the end of World War II, European countries operated with a system of netting accounts (known as EPU – the European Payment Union), thus minimizing the need to transfer dollars across borders. Eventually, as foreign exchange reserves rose, a return to currency convertibility could be contemplated. Once it was in place, capital flows could not be avoided altogether if importers and exporters engaged in over- and underinvoicing.¹⁸

In order to determine the effect of liberalization on the cost of capital, we can analyse stock prices or dividend ratios. The price at which firms can sell their equity (in terms of a multiple of earnings, normally measured by dividend ratios) is a good indicator of their cost of capital. Growth was rapid, and dividends were increasing. We would expect rising stock prices in such a context – as long as dividend increases were unexpected. Yet the jump in stock prices around the introduction of convertibility is much larger (and much more concentrated timewise) than can be explained by general improvements in economic conditions. Figure 2 shows the changes in stock market indices in four major European countries – Italy, France, Germany and the UK. Since these four countries implemented freedom of currency movement at different points in time, we align them in event-time, with month 0 indicating the time of the introduction of current account convertibility. During a 12 month

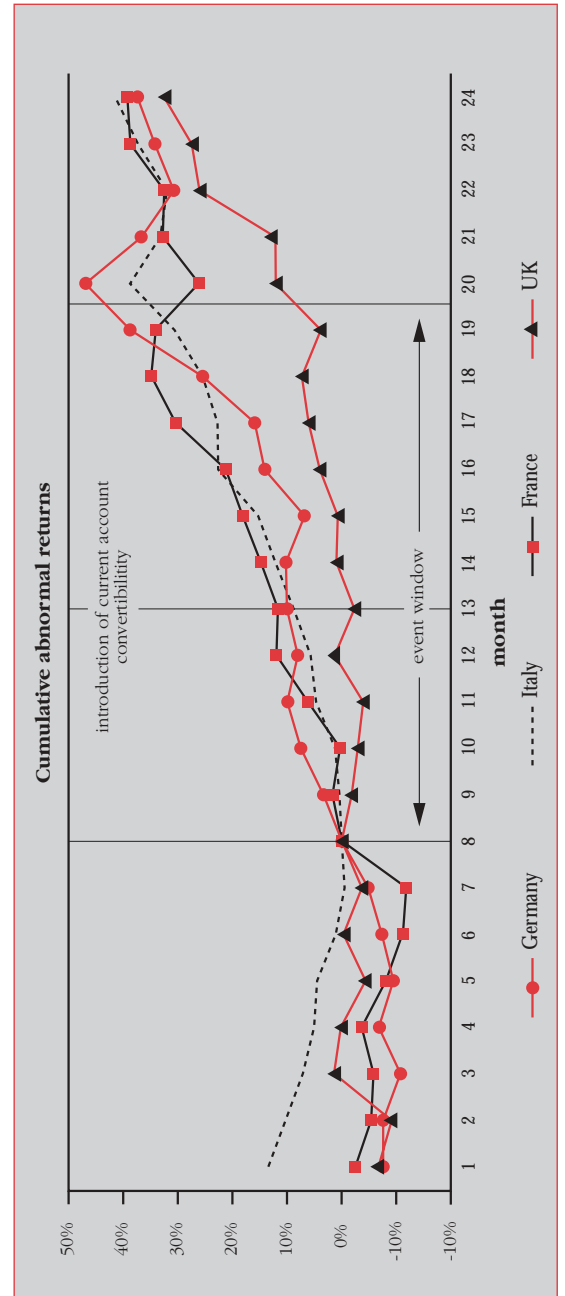


Figure 2

period centred on the month of the switchover (from five months before to six months thereafter), we find a rise in stock prices by 23 to 34%. This rise is relative to “normal” returns expected over the period, given macroeconomic fundamentals. Such an increase in the valuation of stocks suggests a reduction in the cost of capital by up to one third – similar to the effects found in recent studies of liberalizations in the Third World.¹⁹

An alternative way of examining the effects of capital controls on the cost of finance uses the large variations in policy during the late 1960s and early 1970s. As the Bretton Woods system of fixed exchange rates increasingly became more difficult to operate, numerous European countries introduced or tightened controls on capital in- and outflows. A useful measure of the severity of these restrictions is the spread between on- and off-shore interest rates, denominated in the same currency. In the absence of controls, the spread should be zero – any interest rate differential would be arbitrated away by agents in financial markets. Actual spreads were often substantial, indicating that significant obstacles to capital mobility remained in the 1960. The more restrictive policies of the late 1960s and 1970s increased spreads substantially. Germany, for example, tried to keep out capital to avoid overheating and inflation. The difference between domestic interest rates and DM-deposits abroad was 0.11 percentage points in April 1970, but it rose to 2.64 points during the period April 1970-September 1974. Other countries also experienced sizeable increases. If the argument about the significant benefits of risk diversification is right, we should expect a strong decline in equity values as capital markets became more segregated – independent of whether central banks are trying to capital in or

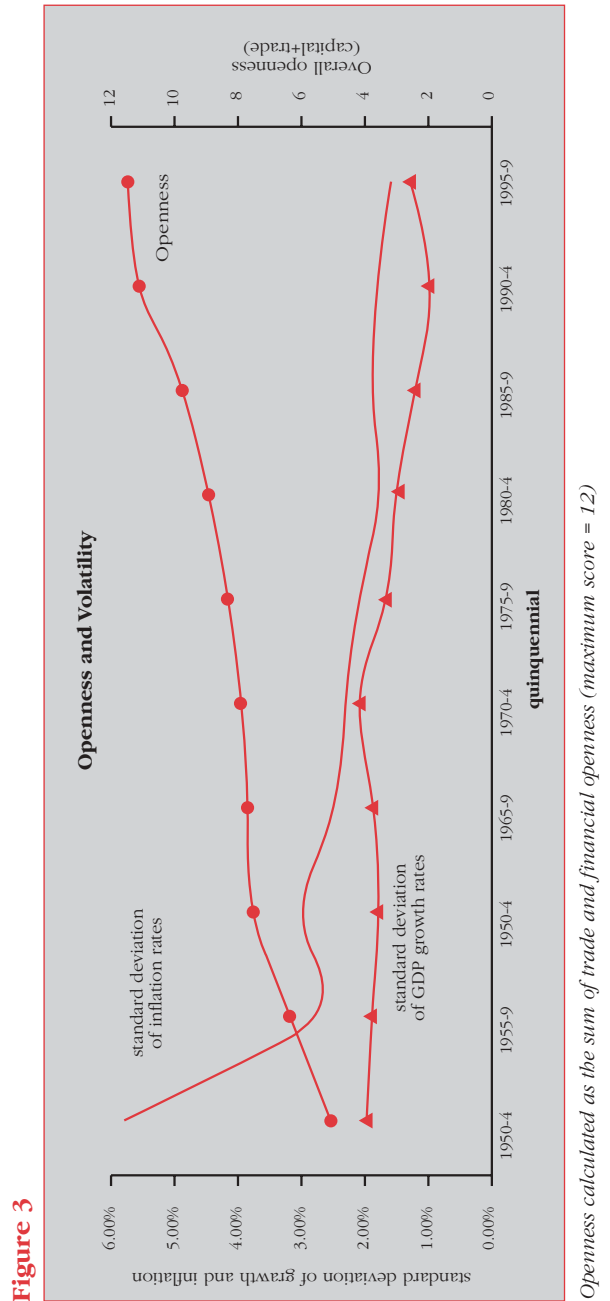
out. Also, the decline should be similar in countries that tried to stop inflows (Germany, Netherlands) and in those that attempted to stem outflows (UK, France, Italy). This is precisely what the examination of stock returns during periods of increasing capital controls suggests. As previously diversifiable risk became “nationalized”, equity returns plummeted, suggesting that the cost of capital rose markedly. In the case of Germany, the cumulative effect of controls caused an increase in the cost of finance by about one third.

The evidence on the cost of capital strongly suggests that one of the main benefits of international capital market integration arises from cheaper equity financing. The more sensitive measures of integration can also be used to examine if capital controls during Europe’s “golden age” were actually beneficial for growth, as some scholars have argued.²⁰ In our panel of European countries, we find strongly negative effects of capital controls. Using the newer, more finely graduated measures of policy intervention is critical for this finding. If we use the Quinn-Toyoda measures of financial openness (on a scale from 1 to 4) or the spread between on- and off-shore rates, we consistently find controls were detrimental. The effect is also large in an economic sense. The best-guess estimate implies that, for every increase in the difference between on- and off-shore spreads by 1%, growth slowed by 0.3% per annum. This also implies that, impressive as the high growth rates in Europe between 1950 and 1970 may appear, they could well have been higher still if liberalization had occurred earlier. The benign, long-run effects of capital market integration may be harder to detect than the occasional, dramatic crisis that causes news-grabbing economic problems, but they are no less important.

4. Capital controls and instability

It is commonly believed that free capital flows can be destabilizing. Yet the impact of occasional – if spectacular – crises has to be balanced against the stabilizing properties of capital markets integration. Sudden shifts in economic conditions can cause spectacular boom-and-bust cycles in isolated economies. Had Germany not had access to international capital markets to borrow the funds needed after reunification, for example, domestic interest rates would have been even higher than they already were. Consumption and investment smoothing enabled by cross-border transfers ought to dampen volatility.²¹ It is therefore not a foregone conclusion that integration into international capital markets undermines stability. Whether the crisis effect or the investment and consumption smoothing dominates is an empirical question. Some authors, based on theoretical considerations, have argued that international financial integration should raise the volatility of output in low income countries, and lower it in rich ones.²²

In most rich countries, the variability of key macroeconomic variables has declined substantially over the last half-century (Figure 3). The standard deviation of output growth (relative to trend) in the late 1990s was approximately only two thirds of its level at mid-century.²³ Even more impressively, the variability of inflation has declined to less than one third of its initial level. Lower volatility went hand-in-hand with a large increase in financial and trade openness (calculated as the sum of financial openness, with a maximum score of 4, and trade openness, with a maximum score of 8).



Is there any reason to think that the connection is causal? Other factors are clearly at work, too. Output has become more stable in developed countries as a result of deeper structural changes, such as the decline of agriculture and the rise of service industries.²⁴ Some authors have concluded that equity market liberalizations dampen the volatility of output changes.²⁵ Yet equity market liberalization (in their case, defined as opening up to foreign capital inflows) are highly correlated with other reforms such as trade liberalizations, making it harder to identify the effects separately. We can use the evidence from 21 countries over almost half a century to investigate the relationship between financial openness and the variability of output more closely. If we simultaneously control for trade openness, greater financial openness is actually destabilizing – but only for output. One key transmission mechanism for the destabilizing effects of capital account openness appears to be stock market “contagion”. In countries that have comparatively liberalized equity markets, price fluctuations are more pronounced. This may spill over into the rest of the economy via wealth effects and IPO/investment cycles. Trade integration, on the other hand, is unambiguously beneficial. The data suggest that a country moving from the average trade openness score in 1950-54 to the average for 1995-98 will see a fall in output volatility of 0.61%, or almost exactly one third of average volatility over the period as a whole. The same calculation suggests that greater capital account convertibility over the period raised average volatility by 0.52%. The impact of openness on inflation volatility is larger – and unambiguously benign, for both capital and trade liberalizations. Fewer restrictions on the flow of goods and funds translate into markedly lower volatility.

What do we conclude from these mixed results? Are capital controls good or bad for macroeconomic stability? In order to understand the causes of volatility, I examine the sources of shocks. In the case of demand shocks, output and inflation will move in the same direction. Supply shocks, on the other hand, will induce opposite movements of these two variables.²⁶ The policy instruments in the hands of central bankers are similar to a demand shock – they allow for movements of inflation and output in the same direction. With perfect foresight, central banks should be able to neutralize demand shocks completely. Supply shocks, on the other hand, present a conundrum. If output stability is seen as the main policy objective, the volatility of inflation will rise. In the opposite case, the variability of output will increase as the monetary authorities try to stabilize the rate of price increases. A good measure of the efficiency of monetary policy takes both the volatility of output and of inflation into account.

If we analyse macroeconomic instability over the last 50 years, we find that efficient monetary policy is much more common in countries with open capital accounts. Table 1 gives an overview. Each country contributes an observation for every five-year period. These are then ranked by capital account openness. In the least open economies, the Quinn-Toyoda index only shows an average of 1.2 out of 4 possible points for financial openness. They also tend to have less than half of the maximum score in terms of trade liberalization. Both the volatility of output and inflation are higher when capital account and current account openness are low. Going from the second to the fourth quintile of capital account openness reduces the volatility of output by 0.5%, and the volatility of inflation by 0.8%. Also, inefficient monetary policy coincides with

Table 1**Openness, volatility and the inefficiency of monetary policy**

	Capital account openness	Current account openness	Volatility of output*	Volatility of inflation*	Inefficiency of monetary policy**
lowest quintile	1.2	3.6	2.5%	4.0%	83.3
second quintile	2.1	4.7	2.0%	3.0%	72.3
third quintile	2.9	5.5	1.5%	2.1%	32.8
fourth quintile	3.4	7.2	1.5%	2.2%	16.5
top quintile	4.0	7.8	1.2%	1.4%	10.3

* calculated as the standard deviation of annual changes over 5-year intervals

** calculated as the sum of the variances of output and inflation, minus their covariance

less capital mobility and more trade restrictions. The inefficiency of monetary policy declines steadily as capital and current account openness increases.²⁷

Intuitively, this appears to make sense – if central banks are not burdened with other tasks (such as defending fixed exchange rates, facilitating fiscal repression, or providing seignorage revenues for the treasury), they will be more effective in stamping out undesirable deviations of output and inflation from their equilibrium paths. We also find that central banks in countries with open capital accounts pursue more interventionist interest rate policies.²⁸ Capital account liberalization has to be analysed in a context of broader institutional reform, where central banks are free to pursue stabilization policies, and trade integration is considerable. Under such conditions, the benefits of openness appear to outweigh the costs, at least in terms of volatility. What countries may lose in terms of

output stability from greater capital account openness, they easily gain in inflation stability. If international capital markets constrain economic policy – as many critics of global capital flows claim – then these shackles are best thought of as golden handcuffs.

5. The political economy of financial integration

Why are some countries more open than others? Are different preferences of policy-makers sufficient to account for the wide differences in financial openness that could be observed in post-war Europe? Or do the benefits from liberalization differ systematically across countries, leading some to open up to international capital flows much earlier than others? For anyone familiar with the history of capital controls during the Bretton Woods era, it would be hard to deny the influence of ideas and of individual policy makers' preferences. Without Keynes and the experience of the Great Depression, policies would undoubtedly have been much more liberal early on. Yet this does not suffice as an explanation for the wildly different paths taken by European countries. Little in the general political and intellectual climate in Germany, for example, predestined the country to adopt a much greater degree of openness than, say, the UK – for at least the period 1950-1980.

Recently, economists have begun to investigate the links between constitutional characteristics and economic outcomes. In contrast to political variables such as right- or left-wing orientation of governments, constitutional features change only rarely. Is there a link between these deeper, structural features of a country's political system and key economic variables? Persson and

Tabellini, two of the leading practitioners of this approach, argue that countries with presidential systems of government and with majoritarian voting rules have markedly smaller governments – the state’s share in total spending is approximately 30 percent of GDP instead of 40 percent in a typical country with proportional representation and heads of government elected by parliamentary majority.²⁹ In other words, in countries where the head of government does not need a continuous parliamentary majority, and voting is first-past-the-post, the total share of output controlled by the state will be only three quarters as large as in states with parliamentary government and proportional representation.

Do constitutional features also offer an explanation for why some countries’ capital accounts are much more open than others? At first glance, similar arguments ought to apply. Proponents of the “new political economy” maintain that governments are smaller in majoritarian countries because tax-and-spend policies will benefit small pressure groups and electorates in marginal constituencies disproportionately; support for such policies is thus reduced. Since capital controls are akin to a tax on capital owners (whose assets will be more heavily taxed, and who may see their value eroded by higher inflation), we should also expect openness to vary with electoral rules. Empirically, there is only weak support for this idea. Countries with first-past-the-post voting rules have fewer restrictions on capital mobility, but the differences are minor.³⁰ In contrast, presidential government appear to go hand-in-hand with markedly more open capital accounts. Yet there are only two countries classified as presidential in our dataset.³¹ Common sense cautions against attaching too much importance to this effect, especially since it does not appear

in cross-sections that include data from developing countries and the OECD in the 1990s.

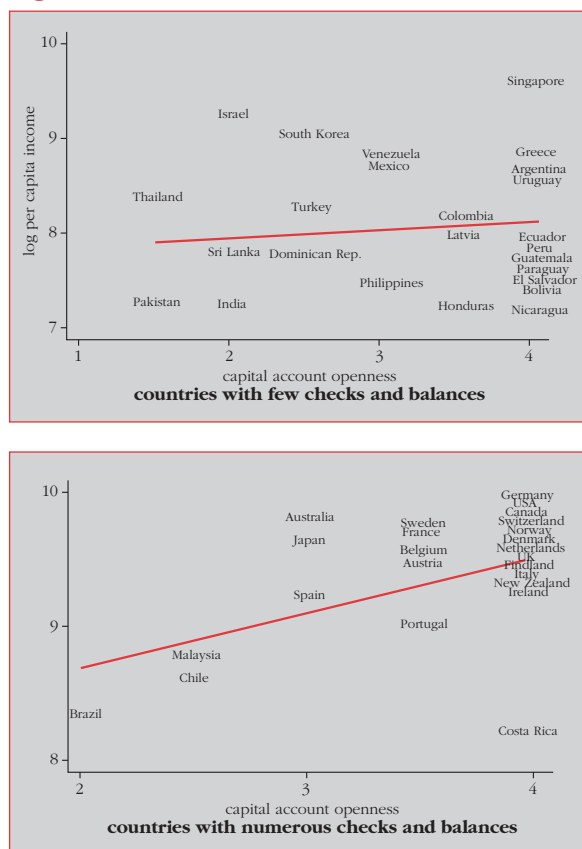
In my work, one constitutional feature that is strongly and robustly associated with openness is the strength of checks-and-balances. The more independent institutions that can – partly or completely – block new policies, the greater overall openness appears to be. Interestingly, the result is reinforced if we take account of the political parties that have control over different parts of the state – such as in classical “cohabitation” in France, when presidents come from a different party than the prime minister and the majority in parliament. The correlation therefore does not simply reflect the positive interaction between independent central banks and capital market liberalization. Countries with constitutions that have an above-average number of “veto points” are approximately one full point more open than those that are not.³²

One possible interpretation of this interaction is that countries with more veto points potentially benefit more from opening up to international capital flows, and thus are more likely to do so. This should not be surprising – transfers of capital often involve long-term commitments (especially in the case of foreign direct investment). Greater uncertainty about future policy ought to act as a powerful deterrent against foreign investment – and political systems with more checks-and-balances should *ceteris paribus* be more stable. Empirical studies show that countries with more veto points actually pursue more steady fiscal policies, and the argument should extend to structural policies as well.³³ If so, countries that can credibly commit to orthodoxy ought to be able to reap the benefits of international capital mobility much more readily than those that lack such a commitment device. In other words, it may

well be that, in addition to education and an Anglo-Saxon legal system, other constitutional features may act as catalysts of growth that combine with financial liberalization. Figure 4 offers some impressionistic confirmation of this hypothesis. It plots the log of output per person against capital account openness in a cross-section of 50 countries, with data from the period 1985-1995. While early studies in the empirical growth literature focused exclusively on rates of change in per capita outcome, recent work has devoted much greater efforts to explaining the *level of per capita output*.³⁴ For the group as a whole, the correlation is weakly positive. Next, we subdivide the sample into countries with strong checks-and-balances and those without. The slope of the red line shows that countries with numerous veto points can expect much greater economic benefits from liberalizing their capital accounts than those with few veto players in the political process. For countries without strong checks-and-balances, the fitted line is almost flat, suggesting that they will profit little – or not at all – from greater integration into global capital markets.

An alternative – but not mutually exclusive – interpretation would be that greater openness tends to create winners and losers – even if, in the aggregate, output increases. Since social groups do not know *ex ante* who will benefit from liberalization measures, potentially disadvantaged groups will only live with greater integration if they can be certain of compensation. Credible commitment to redistribution is easier in democracies; it also ought to be easier in countries with larger welfare states, and with more extensive checks-and-balances that reduce the danger of sudden policy reversals.³⁵ This argument is reinforced by the finding that more open countries have larger welfare states – and this extends to capital account openness.³⁶

Figure 4



6. Conclusions

That capitalism should tend towards self-destruction was Marx's original contention, and present-day critics of "globalization" see similar forces at work. One of the popular critics of globalization, William Greider, argued that the imposition of "national controls over capital" should be on the top of the policy agenda. Otherwise, "the global system will... probably experience a series of terrible events – wrenching calamities that are economic or social or

environmental in nature”.³⁷ Recent research has done much to provide a more balanced assessment of the benefits and costs associated with global capital flows. There is now good evidence that greater financial openness is unambiguously good for economic growth. Not only is a more liberalized capital account associated with higher per capita incomes and higher productivity – studies of liberalization episodes also document the subsequent acceleration of growth. The most likely channel is cheaper access to capital. Once capital flows across borders, risks that previously could not be reduced can be diversified more readily. As a result, the cost of equity finance probably falls by up to one third. There is also good reason to think that the efficiency of capital allocation increases as countries liberalize.

There is some limited evidence – even in a set of relatively highly developed European countries – that there is a darker side to capital mobility. Greater capital account openness is associated with greater volatility of output. Yet it also appears to go hand-in-hand with lower swings (and levels) of inflation. Aggregate macroeconomic stability actually increases as financial openness grows. The effect is even stronger in the case of trade openness. The most likely explanation is institutional – countries that adopt relatively open capital accounts also have more independent central banks, and do not rely on seignorage to finance government expenditure. Monetary policy can be used more easily to combat the effects of shocks – and all the more so if interest rate policy does not have to be used to defend a pegged exchange rate.

Capital market liberalization is also significantly related to constitutional features. While electoral rules and the type of government

matter less, having an elaborate system of checks-and-balances is important. The greater the number of independent “veto points” in a political system (and the larger the welfare state), the more likely a country is to be open to cross-border financial flows. Europe’s period of stellar growth during the “golden years” from 1950-1970 occurred at a time of very low capital mobility. Recent research strongly suggests that this does not imply that capital controls are good for economic performance. To the contrary, imposing restrictions had a measurable effect even during the heyday of government intervention in cross-border transactions. The reason why European countries have become markedly more open over the last 50 years, and why they have done so largely without the kind of wrenching crises that often beset Third World countries, appears to lie in the development of complementary institutional and political structures. Greater delegation of political and economic powers to autonomous regions, to supranational institutions and to independent central banks has increased the number of veto players in most European countries – an effect that has been reinforced by the rise of greater heterogeneity in the political orientation of legislatures and governments, and by markedly greater redistribution. Where political systems can credibly commit to stable policies and to compensation for those who lose out as a result of openness, liberalization is more likely to occur – and to yield substantial economic benefits. If the European experience of the last fifty years has anything to teach policymakers today, it is the importance of institutional and social conditions to turn openness into a success. Capital account openness, pursued in isolation, may not be a useful aim for policy. In this sense, the IMF’s 1996 policy proposal discussed in the introduction may well have been misguided.

Social transfers need to be sufficient to compensate potential losers, and political systems have to be stable enough to guarantee the continuity of policy. If these preconditions are fulfilled, there is no reason to fear that global capital markets will have a destabilizing effect.

These findings also suggest that much hand-wringing about the power of anonymous markets (and the impotence of democratically elected governments) is misguided. Instead of undermining the influence of politics and the achievements of the welfare state, successful capital market liberalization may crucially depend on both. And while authoritarian regimes (and democratic, but politically fragile countries) may open up their capital accounts, they are unlikely to reap the same benefits as democracies with an elaborate system of checks-and-balances.

Notes

- (1) Soros 1999.
- (2) *Cit. acc. to Rodrik 2002.*
- (3) Fischer 1998.
- (4) *This is the argument by Rodrik and Kaplan, which is, however, not without critics. Kaplan and Rodrik 2001.*
- (5) *Krugman 1998. Analysis of company-level balance sheets suggests that short-term debt did actually not decline in the way that earlier authors suggested. Cf. Gallego and Hernandez 2003.*
- (6) Crook 2003.
- (7) *The only notable exception is recent work by Arteta, Eichengreen and Wyplosz 2001, as well as other work by Wyplosz (Wyplosz 1999, Wyplosz 2000).*
- (8) Bakker 1993, Eichengreen 1993.
- (9) Quinn and Inclan 1997, Quinn 1997.
- (10) Wyplosz 1999.
- (11) Lucas 1990.
- (12) Obstfeld 1994.
- (13) Stulz 1999.
- (14) Bordo, Eichengreen, Klingebiel and Martinez-Peria 2001
- (15) Rodrik 1998a.
- (16) Quinn and Toyoda 1996; Quinn and Inclan 1997.
- (17) Arteta, Eichengreen and Wyplosz 2001; Bekaert, Harvey and Lundblad 2001.
- (18) Voth 2003c.
- (19) Henry 2000.
- (20) Wyplosz 1999.
- (21) *There is new evidence that actual international risk sharing may be markedly larger than previously thought. Cf. Brandt, Cochrane and Santa-Clara 2002.*
- (22) Kraay 1998, Aghion, Bacchetta and Banerjee 1999.
- (23) *We use the standard deviation of actual output minus the Hodrick-Prescott filtered trend.*
- (24) Sheffrin 1988, Blanchard and Simon 2001. *Cf. the work by Romer 1989.*
- (25) Bekaert, Harvey and Lundblad 2002.
- (26) Cecchetti and Krause 2001.
- (27) Voth 2003b.
- (28) *Ibid.*

- (29) Persson and Tabellini 2003.
- (30) Voith 2003a.
- (31) The two countries are the US and Switzerland. In the latter case, many political observers would take issue with the classification.
- (32) The correlation is also not driven by a positive association of presidential regimes with the number of veto points. To the contrary, the correlation between veto points is small (0.2) in panel data, and negative (-0.44) in cross-sections.
- (33) Henisz 2001.
- (34) Hall and Jones 1999.
- (35) Acemoglu and Robinson 2000. Social welfare spending as a share of GDP and the number of veto points are significantly correlated in a cross-section of countries (0.38, significant at the 1 percent level).
- (36) Rodrik 1998b, Voith 2003a.
- (37) Greider 1997: 472-3.

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