Openness, Finance and Growth: Capital flows & Aid

Darryl McLeod
Economic Growth & Development
Econ 6470 Spring 2017
Finance and growth:

• Early example of Institutions banking systems
• Ross Levine *Finance and Growth* slides:
• Aghion and Howitt, *Chapter 11* Institutions and non-convergence traps
• Access to finance: WB *the unfinished agenda*
• Levine et al. 2009 *Finance Inequality* and the poor
• Gould et al. 2016 *Beyond Financial Deepening*
Financial Openness & growth:

• **Two gap model** (Aid and Growth)
• **Prasad et al. 2006 Foreign Capital** & Economic growth (surplus countries do better)
• Equity Markets better than banks?
Prasad et al. 2006 Foreign Capital & Economic growth (surplus countries do better)
Financial development entails risk

- Capital Flows and Growth JEL Survey Henry 2007

Capital controls: Lucas Why doesn’t capital flow?

Capital flows and growth: Two gap model

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relax savings constraint</td>
<td>Real Fx Appreciation</td>
</tr>
<tr>
<td>New technologies/firms</td>
<td>Risky loans (moral hazard)</td>
</tr>
<tr>
<td>Risk Sharing/ Equity markets</td>
<td>Volatility sudden stops</td>
</tr>
<tr>
<td>Borrowing</td>
<td>Debt overhang, default</td>
</tr>
</tbody>
</table>


Finance and Economic Opportunity

Asli Demirgüç-Kunt
Ross Levine
Henry, 2007 Financial liberalization & growth

Figure 1. Capital Account Liberalization in the Neoclassical Growth Model

\[ y = f(k) = k^\alpha. \]  

\[ f'(k_{s, state}) = r + \delta. \]
Henry, 2007
Financial liberalization & growth
Figure 1 Finance and poverty
Integration and growth:

- Aid: Institutions matter, ease of doing business, access to credit helpful
- Trade and financial integration complements?
- Proposal for East African monetary Union,
- Trade agreements and Investment agreements
- MIGA: worked in Mozambique
- Openness Levers: weak RER, EPZs + SOEs
Financial integration helps after you reach a threshold (emerging markets?)

THRESHOLDS IN THE PROCESS OF INTERNATIONAL FINANCIAL INTEGRATION

M. Ayhan Kose
Eswar S. Prasad
Ashley D. Taylor

Working Paper 14916
http://www.nber.org/papers/w14916

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
April 2009
Figure 1. Thresholds in the Process of Financial Integration

Financial Globalization \times

Above Thresholds
- GDP / TFP growth
- Risks of Crises

Below Thresholds
- GDP / TFP growth
- Risks of Crises

Threshold Conditions
- Financial market development
- Institutional Quality, Governance
- Macroeconomic policies
- Trade integration

Financial globalization leads to better macroeconomic outcomes when certain threshold conditions are met.

Source: Kose, Prasad, Rogoff and Wei (2009)
Figure 3. Average Private Credit to GDP Relative to Estimated Thresholds: Emerging Market Economies, 1975–79 and 2000–04

Notes: Thresholds taken from quadratic interaction specification in Table 2, Panel 5.
Barriers to growth

• Poor institutions, property rights, credit markets etc. (corruption, misuse of aid)
• Resource curse.. Nigeria, Venezuelas
• Capital and trade flows: handmaidens
• Debt crises... many debt crises
• In Africa especially: poverty traps, low savings, low public investment, poor health rapid population growth...
Post 2000 growth

• Absolute convergence 2000-2014
• Reversal of fortune (China and India)
• Capital and trade flows: now working?
• Debt crises... Greece’s odious debt
• In Africa: poverty traps vs. commodity booms and conflict... HIV/Aids and Ebola
Rodrik and Subramanian (2003) F&D

Chart 1
The "deep determinants" of income

Development and its determinants are related in multiple and complex ways, making the task of determining and quantifying causality difficult.

Income level

- Efficiency and dissemination of technology
- Demand for foreign goods and services
- Property rights and rule of law
- Demand for good institutions

Integration

- Openness and transparency
- Capacity to trade

Institutions

- Natural resources and institutions
- Distance from markets
- Health of population and agricultural productivity

Geography
Justin Lin’s variation on the Akamatsu model: garments first, then....
Geese still flying (Akamatsu)

Table 1
Geese still flying in Asia: country rankings in selected industries, 1992 and 2008

<table>
<thead>
<tr>
<th>Country</th>
<th>Live animals</th>
<th>Pharmaceuticals</th>
<th>Footwear</th>
<th>Iron &amp; steel</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>India</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Korea Rep.</td>
<td>2</td>
<td>5</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Thailand</td>
<td>4</td>
<td>2</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Plastics</th>
<th>Electrical machinery, parts</th>
<th>Television receivers</th>
<th>Toys</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>India</td>
<td>5</td>
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Note: Rankings established from data at the two-digit level for exports in the WITS database.
Geese still flying (Akamatsu)

Table 2
Flying geese and the international division of production: Asian economies with a revealed comparative advantage in footwear, 1962–2000

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Japan</td>
<td>China</td>
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<tr>
<td>Taiwan, China</td>
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<td>Vietnam</td>
<td>Sri Lanka</td>
<td>Myanmar</td>
<td>Bangladesh</td>
<td>Fiji</td>
<td>Cambodia</td>
<td></td>
</tr>
</tbody>
</table>

Note: Revealed comparative advantage is calculated as the share of footwear in the economy’s exports divided by the share of footwear in global exports. The comparative advantage of a particular economy is ‘revealed’ when this ratio is greater than 1. All economies in the table except China are ranked by income level.

Source: UN COMTRADE data.
Summary: who will be the next China?

• Justin Lin says golden Geese are flying from China, wages are rising, productivity in increasing, where will they go next? 85 million jobs shed by China?

• Japan, Korea and now China the Dragons: Asian tigers to lions: boom spreads to Africa

• Monkeys in trees (industrial policy vs. free trade?)

• An African/Latin growth miracle? Latin America & Africa are growing faster, will it last? Can they replicate China’s EPZ strategy? Or a new model?
Latin America is bit spread out but its industry forest is denser than Africa’s.
But Africa has one great advantage Latin America does not have

• Very low incomes and wages in Africa, but then perhaps Latin America has better institutions, education, etc.

• The poorer countries of HND, SLV, NIC, GTM and Bolivia can choose export led growth, but will they?

• What about the DR and Haiti? People are hopeful (see Haiti’s OTEXA agreements... are they working?)

• Which LatAm countries are doing best in garment trade? (the first goose...) see otexa data...
Consensus on growth strategies: post East Asian miracle (institutions?)

**Early Washington Consensus**
- Trade liberalization
- Open capital account??
- Macroeconomic stability
- Privatization

**Sachs-Warner Index:**
- Tariffs < 10%, quotas <40%
- BMP < 20%
- Non-socialist government
- No export monopoly

**Post EA miracle consensus**
- Weak RER
- Macro stability
- Exports and FDI
- EPZ + socialism works too

**Africa w/poverty traps:**
- Levers for growth
- Macro stability, weak RER
- Aid OK, resource rents?
- Aid can break poverty trap
- Debt relief?
What about institutions?

Institutions fundamental but,

- Country specific (Rodrik) hard to change
- May be endogenous (Resource curse- Collier)
- Correlated with Geography (Sachs- malaria, landlocked)
- Some work-arounds: (Collier– ISA, military, EPZs)
- Asset redistribution shocks

Not essential as there are other levers for growth (Johnson et al. below)

- Trade- EPZs
- Competition, open capital markets
- FDI- new technologies
- Education
- Political coalitions (Marshal plan)
- Black and white cats both hunt mice… (China, HRS, etc.)
Lucas, Robert E. "Why doesn't capital flow from rich to poor countries?." The American Economic Review 80, no. 2 (1990): 92-96