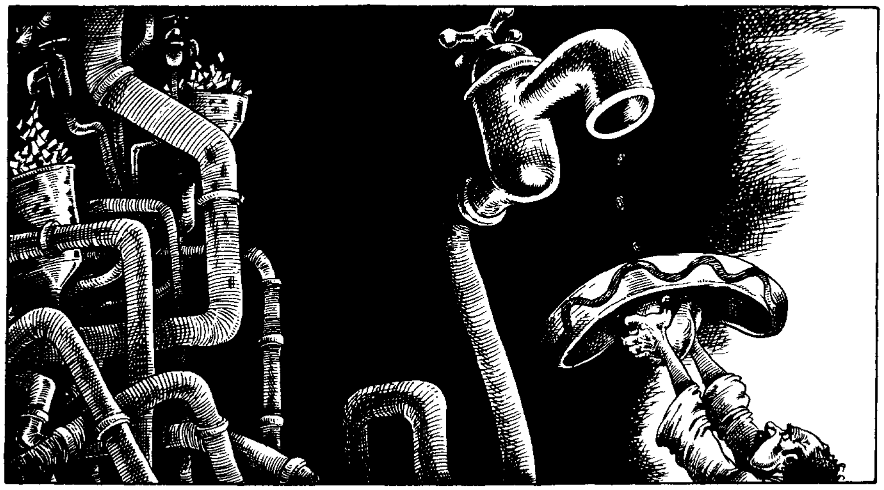
GLOBAL CAPITAL FLOWS



Too little, not too much

Mexico's recent economic crisis has been widely blamed on the country's exposure to the global capital market. Martin Feldstein, a distinguished Harvard economist and president of America's National Bureau of Economic Research, argues that this is wrong. Mexico's problem was that too little capital crosses borders, not too much

BY INVITATION

THE most fundamental cause of Mexico's economic crisis is the segmentation of the global capital market. Although most of the legal barriers to international capital mobility are now gone, the world capital market remains essentially segmented along national lines. Capital may be free to move internationally, but its owners and managers prefer to keep almost all of each nation's savings at home. Future policy in Mexico and elsewhere must take that key fact as its starting point.

A year ago Mexico was widely admired as a Latin American model of good economic policy and a country with a bright economic future. For seven years the Mexican government had pursued sound monetary, budget, tax and trade policies. The country was enjoying low inflation, solid economic growth and rapidly rising exports. The Achilles heel in the Mexican economic programme was, however, a low rate of national saving: Mexico's gross saving last year was only 14% of its GDP—well below the average of 20% among the world's industrial countries and of more than 25% among developing countries.

Mexico's low saving rate was a problem because of the limited international flow of capital. If capital flowed among countries in the same way that it does among the regions of a single country, the Mexican economy would not be suffering today.

This emphasis on the limited net international movement of capital is the opposite of the conventional wisdom, which attributes Mexico's current troubles to an excess of international capital mobility. There is, paradoxically, truth in both views. The rapid exit of flight capital exacerbates the basic problem of inadequate long- and medium-term foreign investment. But the fundamental problem is the small volume of sustained net international capital flows.

The limited net international flow of capital means that a country's level of investment is essentially constrained by its domestic savings. Put another way, the limited net flow of capital implies that a relatively large trade deficit (or, more accurately, a large current-account deficit) generally cannot persist for more than a few years. Mexico got into trouble because it tried to invest substantially more than it saved, looking to the rest of the world to finance the difference through a current-account deficit of more than 6% of GDP in each of the past three years. This became impossible to sustain because the global capital market is far less integrated than the domestic capital markets of most industrial countries.

This picture of a segmented global capital market seems contrary to the common assertion that the world now has a single capital market in which funds flow internationally to the investments with the highest rates of return, much as money does within domestic boundaries. That description is wrong. Most saving stays in the home country in which it originates. Much of the capital that does move internationally is pursuing temporary gains and shifts quickly as conditions change. The patient money that will support sustained cross-border capital flows is surprisingly scarce.

The best evidence of this segmentation is the strong correlation between national rates of saving and investment. OECD countries differ substantially in their saving rates, with America generally close to the bottom of the list (with average saving of 18% of GDP since 1970) while Japan is at the top (with average saving of 34% of GDP).

These large, inter-country differences in saving rates reflect a variety of factors, including differences in national culture, demographic structure, tax rules, and the nature of the public and private pension systems. If there were a perfectly integrated world capital market, the differences in national saving rates would not lead to differences among countries in national rates of investment in business equipment and inventories. Funds would flow from the high saving countries to the best investment opportunities around the globe.

Save and prosper

In fact, high saving countries have high rates of investment whereas low saving countries have low rates of investment. Since 1970 Japan has had a gross investment rate equal to 32% of its GDP and a capital outflow of only 2% a year. In contrast, America, with a very low saving rate, has an investment rate of only 19% of GDP and a capital inflow equal to about 1% a year.

The strong relationship between national saving and investment is not limited to the extremes of Japan and America. The chart on the next page compares average investment-GDP ratios for 1970-92 with average saving-GDP ratios for those same years among the top OECD countries. It implies that about two-thirds of each additional dollar of sustained saving remains at home to finance additional domestic investment. This relationship, which I first presented in an article co-written with Charles Horioka, "Domestic Saving and International Capital Flows," in the *Economic Journal* in 1980, is quite robust to changes in the sample of years and of countries.

Although there are large daily flows of capital around the world, when the dust settles most of the saving done in each country remains in that country. The large gross international flows of funds are often part of offsetting transactions that leave no net transfer of capital from one country to another. A portfolio manager who hedges the currency risk of an overseas investment can bet on foreign stocks or bonds without any net cross-border capital transfer. Similarly, a corporate treasurer who hedges his foreign borrowing may get a lower interest cost without causing a net cross-border transfer of capital.

The segmented nature of the world capital market is confirmed by the strong, home-country bias in the composition of institutional portfolios. Only 10% of the value of the assets in the 500 largest institutional portfolios in the world is invested in foreign securities. Although mutual funds provide an easy way for individuals to diversify their portfolios internationally, it is the rare individual who has a substantial fraction of net worth invested abroad. The observed extent of segmentation contradicts the advice of economists and financial analysts who advocate global diversification as a way of increasing returns and reducing overall portfolio risk.

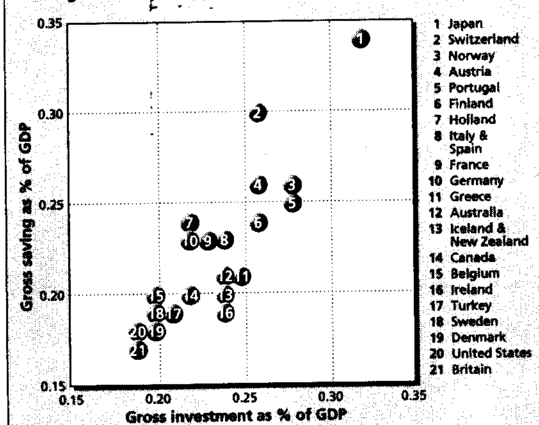
The reluctance of portfolio managers to invest more in foreign securities may reflect a broader measure of risk than the historic covariances on which the economic analysis is based, including a concern about low-probability events such as repayment default or currency non-convertibility. Portfolio managers and fiduciary committees may also see their task as "acting prudently" rather than maximising a risk-adjusted return.

Whatever the reason, the behaviour of portfolio managers means that countries cannot count on sustained inflows of foreign capital to finance domestic investment, even when their local investment opportunities are attractive. The exceptions to this rule have been few. America's current-account deficit reached 3.7% of GDP in 1987, but has since been forced down by the unwillingness of foreign buyers of bonds and stocks to increase their American exposure. The result has been a falling dollar and a shrinking current-account deficit.

Some smaller and fast-growing Asian countries, such as South Korea, Malaysia and Thailand, have attracted sustained capital inflows that have supplemented their very high saving rates. But big Latin American countries—including Brazil and Argentina—have had only small current-account deficits and capital inflows.

Starting in 1991, it looked as if Mexico might become another exception to the rule that large capital inflows cannot be sustained. In that year, it had a current-account deficit of 4.8% of GDP and a capital inflow equal to 7.2% of GDP. Between 1991 and 1993, Mexico attracted more than $75 billion of capital, more than any other developing country. This inflow of private money financed current-account deficits that totalled $62 billion, while Mexico's foreign-exchange reserves grew by $15 billion.

An almost perfect match
Saving and investment, 1970-92 average



Source: OECD

The capital inflow permitted gross investment in 1991-93 to continue at about 22% of GDP, up from less than 20% in 1987-88. Consumption also rose, with private, inflation-adjusted saving falling from 14% of GDP in 1989-90 to less than 10% of GDP in 1991-93. This rise of consumption is easy to understand: with personal incomes expected to grow substantially in the future, individuals were naturally tempted to cut their saving and spend more straight away.

Although the current-account deficit rose from 3% of GDP in 1989-90 to 5% in 1991, and then to more than 6.5% in 1992-93, the finance ministry argued persuasively that such current-account deficits were not a problem: they were financed voluntarily from private sources and the capital inflow was paying for business investments rather than government deficits.

Mexico's ability to attract foreign capital and finance large current-account deficits nevertheless ended abruptly in 1994. By the end of the year, its foreign reserves were nearly exhausted and the government was forced to devalue the peso. Mexico now faces a severe recession that is needed to eliminate the current-account deficit.

What went wrong? Mainly, Mexican officials misunderstood the capital inflow of 1991-93. Much of the $75 billion inflow during that period was presumably intended by foreign investors as a one-time portfolio reallocation, including a repatriation of previous Mexican flight capital. Although some continued flow of both portfolio investment and direct investment could be expected in future years, it was wrong to assume that the $25 billion annual inflow would continue, permitting Mexico to finance a current-account deficit of that magnitude for a substantial period in the future.

In addition, global financial markets became more risk-averse in February 1994. The Federal Reserve's decision to increase the federal funds rate that month led to a sharp fall in long-term bond prices and a sharp rise in the value of the yen. Both of these developments caused substantial losses for hedge funds, banks and others who were making large bets on movements of interest rates and currencies. These losses led to a reassessment of the riskiness of existing positions and a desire to reduce portfolio risks.

On top of this, political unrest added to the risk of investing in Mexico. The Chiapas uprising in January and the Colosio assassination in March added to the sense that Mexican investments were riskier than had previously been assumed. This was compounded by the uncertainty surrounding Mexico's presidential election in August and a second political assassination in September.

Together, these were enough to bring on the crisis. A series of attempted remedies failed, and in some cases made matters worse. But ultimately it was the lack of a large enough pool of internationally mobile long-term investment capital that made it impossible for Mexico to go on financing a current-account deficit of $30 billion.

Looking ahead, policy must concentrate on raising national saving. The Mexican government has been developing plans for some time to establish a mandatory private funded pension system similar to that in Chile. Although the Retirement Saving System was formally launched in May 1992, the total accumulated wealth in it is still less than 2% of GDP. If that system had been expanded more aggressively, the national saving rate could have been substantially higher in 1994 and the existing rate of investment could have been financed with much less foreign capital. As a result, the economic crisis might well have been averted.

Unfortunately, there is nothing in Mexico's agreement with either the IMF or America that requires it to focus on raising its long-term saving rate. Such policy changes nevertheless deserve the highest priority in Mexico's current economic reforms.