Chapter 9

Capital Mobility: Blessing or Curse?

The globalization of financial markets means gains for private capital, which can now flow around the world in search of the highest returns. But how has it affected workers such as Joe, Maria, and Xiao Zhi? Optimists stress the possibilities for mutual gains—capital and labor need each other to produce goods and services of higher value. Where domestic policy is sound, capital flows should follow, reinforcing the effects of open trade in allowing countries to exploit their competitive advantages. Pessimists emphasize the risks and dangers—rich countries fear that an alliance between capital and cheap labor in developing countries will lower wages and living standards at home. Meanwhile poorer countries fear exploitation—that capital will come only when wages are low and leave when wages rise. Both rich and poor countries worry about the limited ability of government to tax capital and about the instability that footloose capital can generate.

Both the optimistic and the pessimistic view have elements of truth. But one fact is indisputable: capital crosses borders more easily than labor and despite the best efforts of national governments to control it. Rising capital mobility intensifies the impact of domestic policy on labor outcomes: success will breed success because it will attract capital, but failure will mean labor is punished harder as capital flees the scene.

This chapter addresses three related issues. First, how can developing and transitional economies attract more private capital? Second, what can policymakers do to maximize the benefits for workers and minimize the risks? And third, could private capital flows out of rich countries hurt workers there?

How to attract capital

The industrial countries have always used the lion's share of global savings. Average capital per worker is $13,000 in developing countries and $150,000 in industrial countries—close to twelve times more. There was some convergence in the 1970s, but the gap grew in the 1980s. For most developing countries the share of foreign inflows in investment is small, averaging 11 percent of the capital stock and ranging between 20 percent for poorer countries (mostly in the form of official debt) and 5 percent for middle-income countries (mainly in the form of private capital).

Recently, however, the picture has been changing: private capital has been flowing to low- and middle-income countries at record levels. These flows are estimated to have totaled $175 billion in 1994, more than four times the 1989 figure of $42 billion, all on a net basis. There are a number of reasons why these flows have accelerated: economic reforms in many countries, the debt reductions of the early 1990s, and the fall in world interest rates. The composition of these flows has also changed dramatically. About two-thirds of recent total long-term flows have gone to the private sector, compared with only 44 percent in 1990. But more than a decade after the onset of the debt crisis, net commercial bank financing continues to be negative. Instead, foreign direct investment (FDI) has surged ahead, to about $67 billion in 1993 (with China alone receiving $26 billion), followed by sharply higher portfolio investments ($47 billion) and a burst of bond issuance by both private firms and governments ($42 billion).

Policies to attract private capital

Workers have an interest in attracting capital to complement their labor and raise their productivity and wages. The recent upsurge in private flows to the developing world has been concentrated in a few successful countries. How can others reap similar gains? Must they grant special favors to capital, and is it necessary to hold wages down or restrict union activity? Although many countries have indeed offered tax breaks and other enticements, and some authoritarian governments have repressed labor, these are not the primary attractions for capital, and over the long term they are more likely to reduce net capital inflows.

Capital holders are, first and foremost, looking for good returns, and they are deeply concerned with risk. The key attractions are good infrastructure, a reliable and skilled work force, guarantees of their right to repatriate both income and capital, and social and political stability. A tradition of prudent fiscal management and deep links with global markets that would be costly to break have more influence on the investment decisions of both multinationals and portfolio investors than special deals. When domestic markets are distorted for the sake of attracting capital, workers end up sharing the excess profits with foreigners. A small minority of workers may gain, but most lose out from the increased labor market dualism. Countries such as
Brazil and Egypt, which in the past offered favors and protected markets, suffered from this syndrome. Similarly, labor repression is unlikely to be sustainable, since sooner or later it leads to social instability. South Africa under apartheid represents an extreme case of a repressive country that at first succeeded in attracting foreign capital but ended up only scaring it away.

Some may take the lesson from Mexico’s 1994–95 currency crisis that deep, NAFTA-style integration heightens a country’s vulnerability. But this would be a misreading of that episode. NAFTA provided an impetus for investors to move in to Mexico, but there were also huge capital inflows to other Latin American countries during that period of enthusiasm for emerging markets and low U.S. interest rates. Mexico went into crisis, but Chile did not, because Mexico’s macroeconomic and financial sector policy was poor, while Chile’s was robust. Moreover, Mexico’s involvement in NAFTA undoubtedly helped the situation once the crisis broke, both by facilitating the preparation of a rescue package and by preventing a major policy reversal. Such a reversal would have had much worse consequences for labor.

The potential for capital flight is, however, a fact of life—for both governments and workers. Capital controls are generally impotent to stop most forms of capital mobility. The capital controls that most Latin American, Middle Eastern, and Sub-Saharan African countries had in place during the 1980s debt crisis failed to prevent massive capital flight—equivalent to 10 to 20 percent of their total capital stocks—which led to deeper domestic recessions and sharper wage declines than would otherwise have occurred.

**Multinational corporations as agents of change**

Multinational corporations have been a major vehicle for the globalization of manufacturing, in which relatively cheap labor in developing countries has been equipped with capital and modern techniques—of storage management and telecommunications, as well as of production. Recently most of the expansion of multinational corporations has occurred in developing countries: 5 million of the 8 million jobs created by multinationals between 1985 and 1992 were in the developing world. The number of workers employed by multinationals in developing countries now stands at 12 million, but the true number who owe their livelihood to multinationals may be twice that, given the prevalence of subcontracting.

FDI flows now respond rapidly to new profit opportunities, shifting production to places where wages are low relative to potential productivity. It is important for countries to attract capital on the basis of sound economic fundamentals, rather than through protection of domestic markets, which multinationals are only too happy to exploit. In the past FDI flowed mainly to countries with large, rich domestic markets such as the United States and the United Kingdom, as evidenced by a strong correlation between FDI stocks and income per capita. More recent flows have tended to be searching for cheaper export platforms, and the relation between the size of FDI flows (as a share of investment) and income per capita has nearly disappeared. Cross-border trade flows within companies now account for roughly a third of world trade and perhaps as much as 15 percent of world GNP.

Multinational corporations account for a sizable share of modern sector manufacturing employment in both small countries and large—more than a fifth in Argentina, Barbados, Botswana, Indonesia, Malaysia, Mauritius, Mexico, the Philippines, Singapore, and Sri Lanka. But many developing countries fear that increased competition for funds by other developing countries will lead to a rise in footloose investments, prone to leave at the slightest shock and unlikely to establish strong links with the rest of the economy. Investment in export processing zones—designated duty-free areas that account for about 45 percent of total employment by multinational corporations in developing countries—is a case in point, with benefits to the recipient country restricted to labor receipts. This problem is especially acute in low-skill industries such as garments and footwear, where firm-specific knowledge is slight and exit costs are low. These fears may be legitimate, but the alternative of multinationals creating no new jobs is even less attractive. Rather, low-skill jobs must be seen as just one step in the growth dynamic. In several successful cases, such as Mauritius, the Philippines, and the Republic of Korea, FDI flows into low-skill sectors have now ceased as domestic wages have risen and domestic firms have matured, and foreign firms in those sectors have moved on to a new generation of export processing zones with cheaper labor—in China, Sri Lanka, and Morocco.

**How can workers gain from capital inflows?**

Workers can benefit from capital inflows, but they are almost always hit hardest by capital flight. During the debt crisis of the 1980s, adjustment costs were high and workers paid a large share of the adjustment burden (see Part Four). In Latin America wages fell an average of 25 percent during this period, even as the regional stock market index rose enormously (Table 9.1). Financial crises are bad for workers for several reasons:

- **Capital is more mobile than labor**, making it harder to tax, so workers normally end up footing the bill. Much of the burden of servicing high levels of public debt falls on labor in the form of reduced social services, less public investment, or higher taxes. The necessary movement of labor toward tradable sectors entails real costs—in transitory unemployment and loss of human capital—that can only be partly compensated by transfers financed by taxes on capital. Sometimes overindebted firms end up being bailed out by public funds. Such
bailouts occurred throughout most of Latin America in the early 1980s and explain part of the debt crisis. In Chile, for example, the majority of public debt was originally contracted by the private sector, especially banks. But workers, through their taxes, picked up the bill when these private debtors went bankrupt.

- **Capital is cautious.** Capital can take a long time to flow back into a country following a crisis, leaving labor short of capital in the meantime. It is not enough for countries to make the needed adjustments in their internal and external accounts—investors must believe these changes to be sustainable. Building this trust may take a while—five years or more—and even then it remains fragile. When risks rise, the expectation of failure can become self-fulfilling, precipitating a financial crisis, especially when the level of indebtedness approaches the danger level. The recent devaluation in Mexico shows how dramatic the influence of expectations can be in an environment with extremely mobile capital.

Making sure that workers gain from capital inflows, and that the risks of capital flight are minimized, requires policy action on a number of fronts, concerning the type of international borrowing and the scope for capital controls and other kinds of domestic action. Investment is a risky business, and as much of this risk as possible should be shifted away from the government budget and onto lenders and private borrowers and markets. Publicly owned external debt is the worst form of finance from the point of view of labor. It tends to crowd out more useful and productive private investment from which workers have more to gain, and, if things go wrong, the burden of debt repayment tends to fall on labor—a burden usually exacerbated by the devaluation required to generate the necessary foreign exchange for debt service. Market-intermediated finance that is allocated through the domestic banking sector and securities markets is better at shifting risk away from labor—so long as the state does not bail out failures. FDI is the best instrument from a risk-sharing perspective.

Recently some countries have become wary of large capital inflows returning in the wake of debt reduction agreements or financial liberalization. But while controls on capital inflows, especially short-term and liquid flows, can be useful, they have become increasingly less so. The fear of hot money is greater when the efficiency of financial intermediation is low and potential losses are likely to be passed on to taxpayers. Workers are more exposed to the effects of excessive risk taking and costly bailouts by the existence of implicit or explicit deposit insurance, excessive borrowings by firms too large to be allowed to fail, or lending by banks that are hostage to weak borrowers. Good financial intermediation requires good intermediaries. Without them, market-based flows will lead to financial blowouts, as has happened many times in the past.

The difficulty of controlling the level and composition of private capital inflows makes prudent macroeconomic policies all the more important—particularly for workers. That means maintaining the right exchange rate, interest rates, and level of reserves to discourage sudden capital outflows.

There are also things that industrial countries can do to keep international interest rates low. In the medium term there are reasons to believe that the supply of global saving may increase in the next decade as demographic factors cause saving in rich countries first to rise and then to fall as their populations age. Between now and 2010 the share of the industrial countries’ population between the ages of forty and sixty-five—a cohort of net savers—is expected to rise from 40 percent to 45 percent, while the proportion of those between twenty and thirty years old—net borrowers—is expected to fall from 42 percent to 34 percent. Over the coming decade, however, what happens to industrial country budget deficits could make all the difference. A rise in deficits could easily offset the expected movement in private saving and send interest rates upward. Unless the recent trend of lower U.S. deficits is sustained, and unless deficits fall further in other industrial countries, interest rates will keep going up—at the expense of workers throughout the developing world. Workers in industrial countries, who own at least 25 percent of financial capital through pension funds, will be partly compensated by higher returns on their savings, but workers in developing countries, whose savings are meager, will not.

### The outlook for capital flows

The globalization of capital is likely to usher in a long and mutually beneficial period of large capital flows from industrial to developing countries. Equipping the increasingly
skilled work force in developing countries with more sophisticated capital will boost workers' productivity, while good long-term investments in those countries will help the aging work forces of the industrial countries get the most out of their retirement funds. The coincidence of increased trade and capital flows is also virtuous; capital flows will help developing countries take advantage of new trade opportunities and increase their incentive to follow sound domestic policies. But capital relocation will not occur overnight, and for industrial countries it will not lead to measurable social dislocations.

Capital flows will remain constrained by country risk and can grow only as fast as the developing countries' creditworthiness improves. These are severe constraints. In the average creditworthy country the ratio of foreign liabilities to exports is two to one, and in the best of cases it has reached three to one; the latter can be taken as an upper bound of the speed at which developing countries' debts can safely grow. Even if all developing countries borrowed enough to reach that limit within a five-year span, the maximum flows would be $500 billion a year. (Actual effective demand for funds is likely to be much smaller because several of the most creditworthy countries, such as Korea, Malaysia, Portugal, and Thailand, have reached a point in their saving-investment cycles where they are becoming capital exporters themselves.) Yet even this amount is small by industrial country standards. During the past twenty-five years the accumulated (net) flows to developing countries were only 2 percent of the industrial countries' capital stock. These rough estimates would at most double the level of the average historical flows.

These capital flows, while having little impact on workers in industrial countries, could have much larger effects in developing countries. These estimates, assuming normal responses, imply a boost to GDP growth of 0.5 to 1 percent a year. But for workers in developing countries the discipline imposed by the mobility of savings—on macroeconomic policy, governance, and institutions—may even be more important than the direct gains involved.

The global capital market is making the differences between winners and losers much starker. The future will be brighter for Maria and Xiao Zhi if their governments manage to strike the right balance between fiscal prudence, reliance on markets, and stabilizing social policies. But capital outflows will tend to reduce investment and growth in those countries that fail to get the balance right—and even to exclude them from the economic mainstream altogether.

### Chapter 10

**International Migration**

Like trade and capital flows, international labor flows offer great potential for benefit for both the home and the host country. Migrants are often more productive—and reduce labor costs—in the host country, and they send remittances to relatives back home, boosting incomes in the (usually poorer) home country. But migration also raises concerns. Not everyone will gain: unskilled workers in host countries are most likely to suffer as jobs are lost to immigrants or wages fall, and, as with capital movements, greater mobility—in this case of highly skilled workers—tends to reward success but punish domestic policy failures severely.

International migration remains much more politically charged than trade and capital flows. In the host countries public opposition to unskilled migrants has risen sharply, exacerbated by domestic employment difficulties not necessarily of the migrants' causing. This chapter investigates whether migrants do take jobs from native workers and contribute to wage inequalities. Do they represent a net burden on government budgets? And can something be done to stop the exodus of trained workers from poorer countries?

**Dimensions of migration**

Throughout history there have been periods when migration has been an important economic and social safety valve, allowing labor to relocate to areas where it was more scarce. Usually the cost and difficulty of travel were a serious limitation, but a major break occurred in the twentieth century, when lower transportation costs made possible a