

ECONOMICS – Discussion Paper

“How Persistent are International Capital Flows?” by Vahagn Galstyan

This paper seeks to make a contribution to the ‘persistence of capital flows’ literature by examining “a wider range of capital flows using two possible approaches...” (p9), probit and nonparametric estimation. Accordingly, it decomposes the financial account of the balance of payments into FDI, portfolio, other investments and reserve assets and examines also the current account and trade balances. The observation period is 1970-2005, using annual data for a sample that comprises 52 countries of which 19 are “industrial countries” and 33 are “developing countries.” Its summary finding is the unqualified conclusion that “deficits and net inflows are more persistent than surpluses and net outflows” (p9), and that the probability of transition between negative and positive imbalances differs across the various selected component accounts.

The paper reports on an empirical investigation of the time series of select component balances of the financial and current accounts of the balance of payments of the sample countries. It is entitled “How persistent are international capital flows?” However, given the fundamental simultaneity of flows across the current and financial accounts, the paper could equally have been titled ‘how persistent are current account flows?’ Indeed, the empirical tests do include the current account and trade balances in the balance of payments component balances that are being examined. Unfortunately, no justification is given for choosing the “capital flow” angle other than some selective references to the persistence of capital flow literature. Specifically, no analytical framework is insinuated, let alone developed, in the paper that places the empirical exercise into a structural perspective that could provide context for statements about the medium-term behaviour of capital flows.

This raises questions about the uses to which the findings can be put. While ostensibly motivated by the question, “relevant in policy circles,” of “How does the history of a variable matter for its current state?” (p2) the paper fails to establish the usefulness of its findings for the policy process. While careful analysis and interpretation of the time series of variables can provide immensely useful insights, that prospect is exceedingly remote when highly disparate subjects (countries) are bundled into heterogeneous aggregates and information about the behaviour of these composites is reported. The two subsets are quite heterogeneous, with the 19 “industrial countries” including such diverse countries as Australia, Iceland, Japan and the US and the 33 “developing countries” covering a disparate set that ranges from Argentina to Côte d’Ivoire to Singapore. The author recognises some of the resulting limitations, in particular the potential bias of pooled probit estimates, and conducts individual probits for a truncated sample. The truncation is necessitated by data limitations of particular countries. However, this exercise hardly addresses the fundamental point since only the

arithmetic averages for the individual country estimates are reported (Table 3). Such composite findings are unlikely to be of much use to policymakers in any particular country.

Aside from the use of heterogeneous aggregates it is not clear what information the calculation of transition probabilities between deficit and surplus states provides. These calculations are based exclusively on the sign of the imbalances. Policymakers, however, are concerned not only with the sign of an imbalance but, more importantly, with its magnitude. The persistence of ‘minute’ imbalances is a rather different story from, and poses different policy challenges than, the persistence of ‘substantial’ deficits or surpluses, or outflows and inflows. The empirics of the paper shed no light on that distinction notwithstanding the fact that the Edwards (2004) study is prominently cited (on p7). Further, the observed “persistence” of imbalances is likely to vary systematically with their size. Large surpluses or deficits are less likely to be reversed in the subsequent period than are small imbalances. Lastly, and most importantly, flow (im)balances are not generated in a vacuum. Specifically, they emerge in settings that are potentially subject to significant policy actions which typically are specific to individual countries and may well be aimed specifically at curbing those imbalances. Such policy activism would need to be acknowledged in a meaningful analysis of the persistence of external imbalances. If the current analysis is to be “relevant in policy circles” then it ought to address these dimensions of the external imbalances that it investigates.

Lastly, aside from the occasional instance of inadvertent misrepresentation of the findings¹ very little attention is paid to their qualitative nature. There are significant differences in the magnitudes of the persistence estimates which should be explored more intensively than is done in the summary evaluations in sections 3.3 and 4. Indeed, these repetitive sections tend to oversell the basic finding of “asymmetric adjustment.” The categorical assertion that “deficits and net inflows are more persistent than surpluses and net outflows” (p8 and p9) sits uneasily with the observation (p7) of the statistical “failure to reject the null hypothesis of symmetry in *all* of the cases” (emphasis added).

In sum, this paper presents a potentially interesting statistical exercise. In particular, its decomposition of the balance of payments accounts demonstrates significant variation in the average time profiles of the aggregated component accounts under investigation. However, its contribution to the formation of economic policy – or in its own terms, its relevance in policy circles – is not readily evident. Hence, I cannot detect any promise of a significant contribution in this paper.

¹ p.7, para2: last but one sentence should read “In the sample of developing countries...higher persistence of *deficits* and net outflows.” p8, para4 seems to contradict the evidence reported in Table 4.

