External Performance in Low Income Countries
by Chistiansen, L., Prati, A., Ricci, L., Tokarick, S. and Tressel, T.

Discussion
Nicolas Coeurdacier
London Business School and CEPR

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What is it about?

- Very nice paper.
- Investigates empirically the medium-term determinants of Current Accounts and Real Exchange Rates in Low Income Countries (LICs)
- Uses data on 54 LICs. Controls for the standard determinants (demography, fiscal stance, NFA, levels of development) as in Chinn and Prasad (2003) among others but adds some new potentially important variables for LICs (TOT, Foreign Aid, Capital Account Openness, Trade Policies and Natural Shocks)
Why do we care?

- Adjustment of RER and Current Accounts can be very disruptive in LICs.
- To prevent such events, need to know how these two variables are determined in the first place.
- Important policy implications for Foreign Aid Policies, Capital Account Restrictions, Trade Policies
Discussion Outline

- Current Accounts [Most of the discussion]
  - Main Results
  - Interpretation? Theory?
- Real Exchange Rate
  - Main Results
- Conclusion
Main results on Current Accounts in LICs

- Confirms previous studies/theory for some key variables
  1. Fiscal Balance improves Current Account [Failure of Ricardian Equivalence]
  2. Higher Population Growth worsens Current Account [Life-Cycle Hypothesis]
  3. Old Age Dependency ratio worsens it although less robust [Life-Cycle Hypothesis]
Main results on Current Accounts in LICs

- **New Results**
  1. Higher Foreign Aid/Concessional Loans worsens Current Account
  2. Domestic Financial Liberalization and Capital Account Liberalization improves it
  3. Appreciation of TOT improves Current Accounts
  4. Natural Disasters lead to a CA deficit if the capital account is opened \([\text{consumption smoothing}]\)

- Quantitatively large effects. Will focus on the first two.
Simple Neoclassical View of the CA

- Small open economy; 1 good; world interest rate $= r$
- Marginal Productivity of $K$ decreasing in $K$
Role of Foreign Aid

- Foreign Aid worsens Current Account. Driven by Concessional Loans.

- **Reminder**: Foreign Aid is part of the Current Account.
  
  Can be an issue for the exercise here. Would make more sense to put Foreign aid in the Capital Account

- Exogeneity/Reverse Causality?

- What is predicted by the Intertemporal Approach?
  - Fundamental Identity: $CA = S-I$
  - Suppose transitory increase in Foreign Aid of 1$: how does it change NPV of income streams? Depends on future interest payments on the Foreign Aid.
Role of Foreign Aid

- If rate of interest \( = r \), then no change in NPV of income streams so should be entirely saved [infinite horizon].

- As MPK already equalizes world interest rate \( = r \) should be saved abroad \( = \) CA should improve by 1$ today (Financial Account should worsen by 1$). And no impact in the future as interest payments on Foreign Aid compensated by interest incomes on Foreign investment.

- If rate of interest \( < r \) (typically true for Aid) [or finite horizon]
  - increase in NPV and part of the Aid is consumed today and CA improves by less than 1$ today. In the future, consumption smoothing implies that the increase in NPV will translate into a trade deficit financed by the interest subsidy on Aid \( = \) No impact on CA

- In the simple case hard to find what the authors get!
Role of Foreign Aid

- From theory, should distinguish short-run versus medium run effects on current account.
- Should potentially try to distinguish across types of Aids: response should be conditional on future expected repayments. Is it possible?
- But more likely this is not the right model as does not really fit with the data anyway. What are the possible alternatives?
  1. Capital scarcity/Credit constraints/Capital movements restrictions
  2. Uncertainty
Role of Foreign Aid
Capital Scarcity/Credit constraints/Capital movements restrictions

- Small open economy; 1 good; world interest rate $= r$
- But Capital scarcity/Credit constraints/Capital movements restrictions

$r^* > r$: due to credit constraints/capital account restrictions: wedge between domestic MPK and world interest rates
Role of Foreign Aid
Capital Scarcity/Credit constraints/Capital movements restrictions

- In this case, 1$ of Foreign Aid will relax the constraint and **will be fully invested domestically**
- 1$ trade deficit today: no impact on CA today (Foreign Aid is part of the CA) but worsening in the future due to interest payments
- More in line with the empirical evidence provided. Is there a way to test that? Interactions with Capital Account Restrictions/Credit Constraints
Role of Foreign Aid
The role of uncertainty

- As shown by Kraay and Ventura (2000), in presence of risk/weak diminishing returns, the Intertemporal Approach must be modified.
- Income shocks in a SMOE should be invested at the margin in the same proportion as overall wealth: debtor country should run larger current account deficits following an increase in the NPV of their income.
- Does fit the empirical findings. Way to test one story against another?
Capital Account Liberalization/Domestic Financial Liberalization and Current Account in LICs

- Find that Capital Account Liberalization & Domestic Financial Liberalization improves the current account in the medium-run.
- Their interpretation: better functioning financial markets boost domestic savings
- Not sure about the interpretation…
- …But again empirical result very counter-intuitive (which makes it very interesting)
Capital Account Liberalization/Domestic Financial Liberalization and Current Account in LICs

- Same framework as earlier with capital account restrictions/credit constraints/wedge due to financial repression.
- Alleviating these constraints should boost domestic investment to equalize domestic MPK to world rate of interest. Should finance investment by foreign borrowing and we should observe a current account deterioration!
- Remind me the ‘Allocation Puzzle’ of Gourinchas and Jeanne (2008) = LICs with high MPK are exporting capital. Gourinchas and Jeanne (2009) argues that this might be due to financial repression: the evidence here goes against this explanation unless...
Capital Account Liberalization/Domestic Financial Liberalization and Current Account in LICs

… it’s the opposite… in LICs under financial repression MPK is lower than world return. Opening up lead to capital flight.

$r^* < r$ : due to financial repression.

Alleviating these constraints lead to capital flight
Capital Account Liberalization/Domestic Financial Liberalization and Current Account in LICs

- Martin and Rey (2006) have such predictions: capital account liberalization in very poor countries lead to capital flight due to market size effects.

- Interestingly, the authors find opposite effects for higher income countries. [Martin and Rey (2006) predicts such a threshold]

- Yes… but this interpretation does not fit with the results on Foreign Aid. The authors need definitely to strengthen their story.
Alternative story: Jin (2009) solves the ‘Allocation Puzzle’ in a two-good Hecksher-Ohlin type of model. Poorer countries should specialize in labor intensive sectors. Capital account liberalization induces two effects: capital inflows towards the poorer country [neoclassical effect] as well as capital outflows [composition effect driven by specialization] as capital demanding industries are in the North.

Potentially the composition effect can dominate, especially if countries are far apart in terms of factor endowments!
Main results on Real exchange Rate in LICs

- Confirms previous studies/theory for some key variables
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Main results on Real exchange Rate in LICs

1. Government spendings appreciates RER [by raising domestic demand for non-traded]
2. Higher Foreign Aid (to GDP) depreciates the RER
3. Capital Account Liberalization appreciates the RER
4. Fertility appreciates the RER [Population Growth]
Main results on Real Exchange Rate in LICs

- Previous results are broadly consistent with the findings on the Current Account. Makes sense as RER and Current Accounts are simultaneously determined.
- Any worsening of the CA [Fiscal spending, Population Growth] should go with an appreciation of the RER.
- Resp. any improvement of the CA [Capital Account Liberalization] should go with an depreciation of the RER
- Only the case of Foreign Aid does not fit. Why? Indicates that selection bias/endogeneity issues are maybe severe?
Conclusion

- Very interesting paper.
- Challenging for economic theory.
- The authors need to provide a more consistent story to interpret their empirical findings.
- They should also try to distinguish better short-run responses to medium-term responses as in some cases they might be different.