



Expert Comment

# Does Russia Need an Inflow of Foreign Capital?

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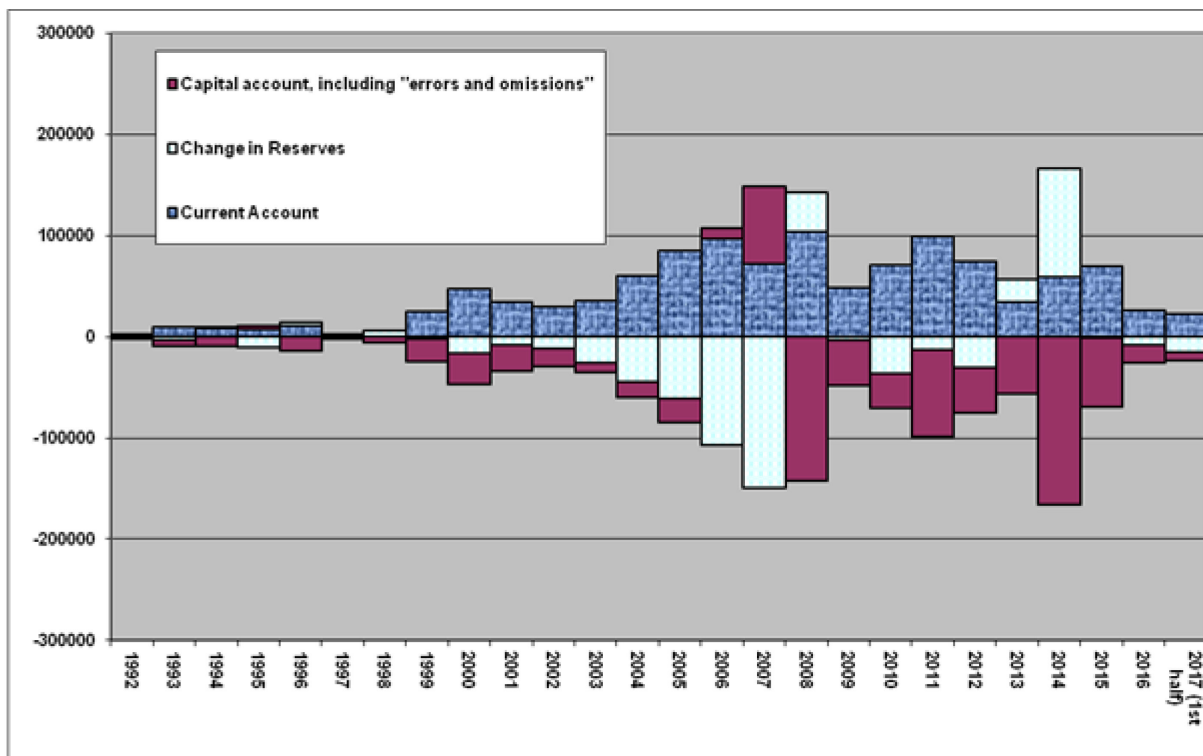
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## Does Russia Need an Inflow of Foreign Capital? Or Does It Need to Rely on an Export-Oriented Growth Model, Based on Domestic Savings?

Vladimir Popov

With the exception of only two years – 2006-07, when oil prices were at their highest – capital has been flowing out from Russia since the early 1990s (Fig. 1). In order to finance this capital outflow, Russia has had to earn a current account surplus by exporting more than importing, producing more than consuming, and saving more than investing. This problem is known as ‘capital flowing uphill’, i.e., from poor to rich countries; whereas general economic logic suggests the opposite – as a rule, capital should flow from capital-abundant (developed) countries to capital-scarce (developing and transition) countries.

**Figure 1. Balance of Payments items, Russia, 1992-2017, million US\$**



Source: Central Bank of Russia.

The usual explanations – poor investment climate; lack of liberalisation; corruption; slow growth; poor institutions; chaos and disorder within Russia – may be missing the point, because countries with a good investment climate and rapid growth also often have a current account surplus: China is the primary example. Even though there is an inflow of private capital into China, until recently the Chinese monetary authorities had been exporting capital in the form of an increase in foreign exchange reserves, so China was also saving more than investing, and producing more than consuming. Like Russia, China has had a current account surplus; unlike Russia, it has been a net importer of private capital rather than an exporter. What are the origins and implications of the similarities and differences between the Chinese and Russian models, in terms of capital flows and balance of payments?

Most developing and transition countries in recent years have had current account deficits, balanced by a net inflow of capital. In the years 2000-14, out of the 19 most populous (with populations of over 50 million people) developing and transition economies,<sup>1</sup> 12 had exactly this type of balance of payments, as shown in the upper-left quadrant of the chart in figure 2. Other countries, however, have done the opposite – while exporting capital, they financed this export through a current account surplus (Nigeria, Russia). A third group of countries – rapidly growing East Asian economies for the most part – had both current and capital account surpluses, involving the accumulation of foreign exchange reserves, i.e., exporting ‘government capital’. Which model is better?

In **the first group of countries**, the inflow of capital has often been greater than the current account deficit, with the result that there has been some accumulation of foreign exchange reserves. This type of the balance of payments may be characterised as ‘normal’

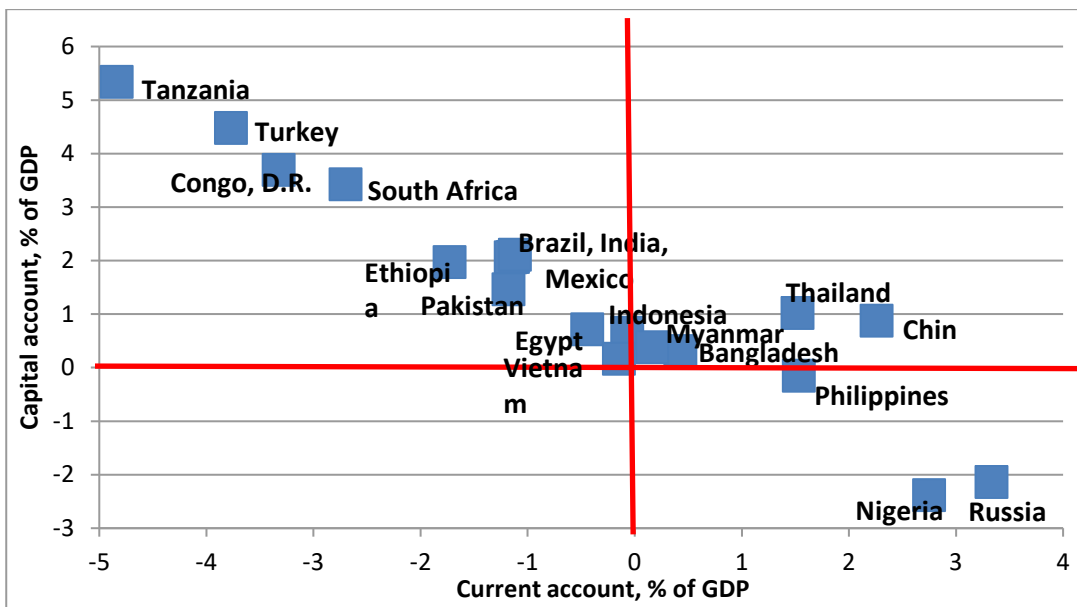
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<sup>1</sup> Overall there are 20 developing and transition economies with a population of over 50 million people – 19 are shown in the chart, but not Iran, for which comparable IMF current account data are missing.

or 'justified' – capital flows 'downhill' – from rich (capital abundant) countries to poor countries experiencing capital shortages. Developing countries are able to absorb more than they produce, for the use not only domestic, but also external savings, to finance investment.

**The second group of countries** (Nigeria, the Philippines, Russia) had current account surpluses that were balanced by a net outflow of capital. In some periods the outflow of capital was greater than the current account surplus, so reserves declined, whereas in other periods the current account surplus was larger than the outflow of capital, so reserves increased. These countries were obviously not able to supplement their domestic savings with foreign savings. On the contrary, they produced more than they absorbed and exported part of their domestic savings abroad to finance investment in other countries.

**Figure 2. Current and capital accounts of the largest developing and transition economies, % of GDP, averages for 2000-14 or the closest available period**



Source: IMF. Net inflow of capital is computed as the difference between the increase in foreign exchange reserves and the current account surplus.

**The third group of countries** (Bangladesh, China, Myanmar, and Thailand) had a surplus for both their current and capital accounts, and a very large accumulation of reserves. If

these countries had allowed their exchange rates to appreciate, they would have been able to increase imports and consumption at the expense of an accumulation of foreign exchange reserves, and they would have been able to join the first group of countries, with capital account surpluses, but current account deficits, but they choose not to do so.

What determines the different balance of payment structures across various countries and periods? Both circumstances and choices. There are two objective factors that act as independent variables: the investment climate, which influences the inflow/outflow of capital, and the terms of trade, which impact on the current account. Both factors are very volatile, so countries can easily belong to one group during one period and move to the other group in a following period. For instance, countries with a bad investment climate and capital flight, if no special measures are taken, experience a depreciation of the national currency that leads to lower imports and (sometimes) an increase in exports, which leads to a current account surplus that balances the capital outflow. These countries are often resource rich, and in periods of high resource prices suffer from the 'Dutch disease' symptom of an overvalued exchange rate.

However, policy matters a great deal as well – the rate of accumulation of foreign exchange reserves is a policy variable; it is up to central banks to choose the pace of accumulation of foreign exchange reserves. In recent decades not only East Asian countries, but many other countries as well, have been accumulating reserves at an accelerated pace, so the ratio of reserves to imports and GDP has increased considerably. Recent research shows that a policy of an undervaluation of the exchange rate has costs,<sup>2</sup> but can have important externalities in terms of preventing the Dutch disease and stimulating export oriented development (Polterovich and Popov, 2004; Rodrik, 2008). Greenwald and

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<sup>2</sup> **Developing countries are paying a high (and preventable) cost for self-insurance against capital-market follies (Rodrik, 2005).**

Stiglitz consider the exchange rate an instrument of industrial policy and argue that governments should keep it low and less volatile (2013).

In fact, countries that managed to achieve high growth rates were mostly net creditors, not net borrowers; their current accounts were positive, i.e., they were saving more than they were investing (Fig. 3). Even controlling for the level of development – i.e., PPP GDP per capita – towards the beginning of the period 1970-2013, the relationship between the current account surplus and growth rates is still positive and significant.<sup>3</sup> As Prasad, Rajan, and Subramanian show, foreign financing of developing countries (implying a current account deficit) is associated with lower, not higher, growth rates, whereas in developed countries this relationship tends to be positive (Prasad, Raghuram, and Subramanian, 2006). They explain the effect by the fact that “successful developing countries have limited absorptive capacity for foreign resources, whether it be because their financial markets are underdeveloped or because their economies are prone to overvaluation caused by rapid capital inflows”.

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<sup>3</sup> The relationship is significant, even after controlling for the level of development:

$$y = 0.85^{***} Ycap + 0.08^{**} CA + 1.06,$$

(3.07)            (2.19)

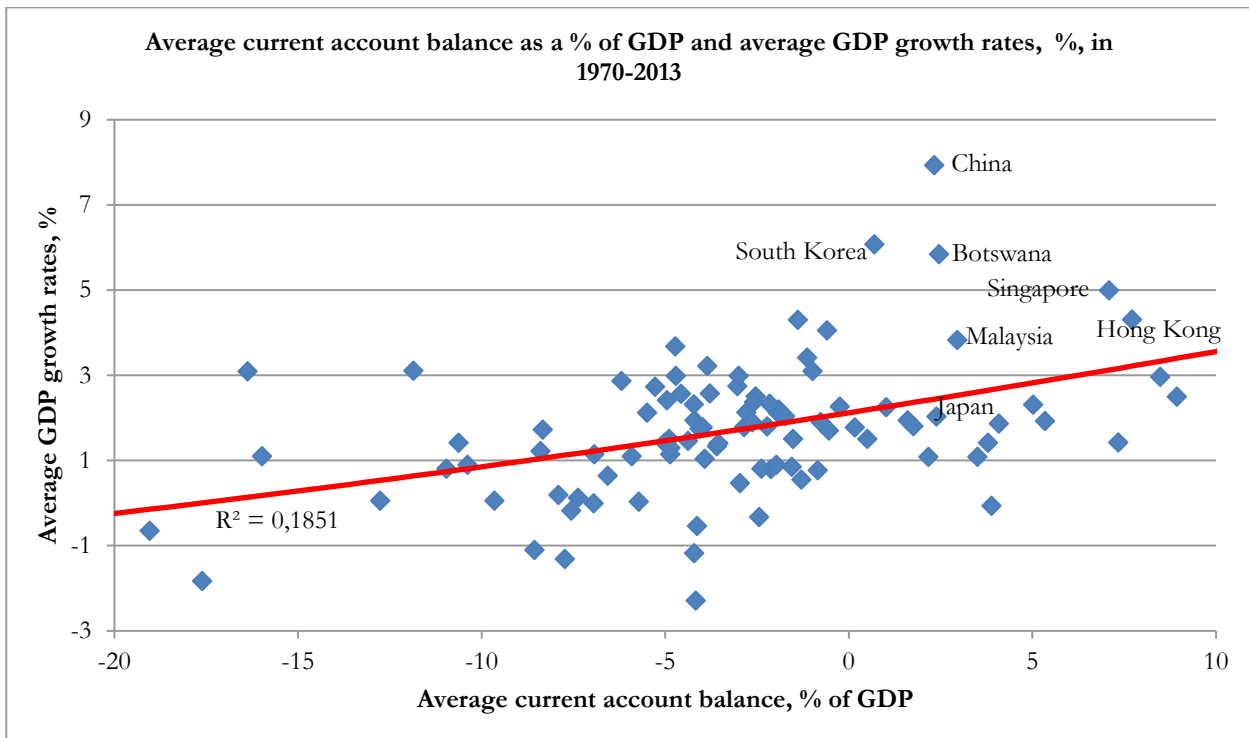
N=91,  $R^2 = 0.23$ , robust standard errors, T-statistics in brackets below, where

**y** – annual average growth rates of per capita GDP in 1970-2013, %,

**Ycap** – logarithm of per capita PPP GDP in 2000,

**CA** – average current account to GDP ratio in 1970-2013, %.

**Figure 3. Average annual growth rates of GDP per capita and average current account balance, 1970-2013**



Source: World Development Indicators, IMF Balance of Payments; various years.

In the words of Paul Krugman (2009), since the early 1980s there have been three big waves of capital flows to developing countries, but none of them have resulted in a growth miracle:

“The first wave was to Latin American countries that liberalized trade and opened their markets in the wake of the 80s debt crisis. This wave ended in grief, with the Mexican crisis of 1995 and the delayed Argentine crisis of 2002.

The second wave was to Southeast Asian economies in the mid-90s, when the Asian economic miracle was all the rage. This wave ended in grief, with the crisis of 1997-8.

The third wave was to eastern European economies in the middle years of this decade. This wave is ending in grief as we speak.

There have been some spectacular development success stories since 1980. But I’m not aware of any that were mainly driven by external finance. The point is not



necessarily that international capital movement is a bad thing, which is a hotly debated topic. Instead, the point is that there's no striking evidence that capital flows have been a major source of economic success".

In view of this evidence, a developing country policy choice of a determined attempt to rely on external financing is ironic. It is also ironic that while development economists are preoccupied by the 'capital flowing uphill' problem (from developing to developed countries), the best growth records are exhibited by exactly the countries with current account surpluses and large accumulations of reserves that are generating this uphill movement of capital.

Not all the countries that have pursued the strategy of mobilising domestic savings have achieved a breakthrough; some have failed, but without such a mobilisation there have been no breakthroughs either. To put it differently, the mobilisation of domestic savings and a government policy of allocating these savings across industries appears to be a necessary, although not a sufficient, condition of development success.

Why does the Big Push<sup>4</sup> not work with funds supplied through external financing? One reason may be that domestic savings follow investment opportunities – countries with strong institutions that create a good investment climate raise the national savings rate almost automatically. The other reason may be the proliferation in the global South of a special type of industrial policy that promotes growth of the tradable goods and export sectors, undervaluing the domestic currency via accumulation of foreign exchange reserves. This non-selective industrial policy became very common in Asian countries in the second half of the twentieth century – first in Japan and South Korea in the 1950s-70s (before the 1985 Plaza Accord), then in China since the 1980s, and later in virtually all major developing countries since the 1997 Asian financial crisis. This policy allowed the keeping in check of

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<sup>4</sup> The Big Push theory is the idea in development economics that a large increase in investment (a big push) is needed to get out of the low income stable equilibrium (poverty trap).

wages and prices for non-tradables, while giving a huge boost to tradables, exports, profits, savings, and investment (Popov, 2010).

One way or another, economic miracles have happened only in countries that have relied on a mobilisation of domestic savings, not in countries that have sought to bridge the financing gap through borrowing from abroad. The crucial question then is how national governments can mobilise domestic savings and alter the allocation of resources in such a way as to achieve rapid, balanced, sustainable, and equitable growth. This is not only a matter of getting policies right, but also of having the appropriate institutional capacity, which allows the design, adoption, and enforcement of the right policies.

The Big Push theorists were right in arguing for the mobilisation of savings, but their theories had a couple of weaknesses (Popov, 2011). First, it turned out that foreign savings alone, without mobilisation of domestic savings, cannot produce rapid growth. There were no cases of economic miracles based solely on foreign – not domestic – savings. Second, quite a number of national experiments involving mobilisation of domestic savings on a massive scale have failed. Domestic saving is a necessary, but not a sufficient, condition of fast growth. Mobilisation of domestic savings, and even successful transformation of these savings into investment, does not guarantee fast growth. Investment should be channelled to projects with the highest externalities and these projects finally have to pass the test of world market competition. Import substitution strategy can be good at the initial stages of the Big Push, but if it is not supplemented later by export orientation, it leads to a dead end: the creation of non-viable industrial complexes unable to compete in the world market. Protection is a necessary condition of take-off growth, but should be supplemented with export promotion if growth is to continue and become efficient.

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