E.V.K. FitzGerald. Short-term capital flows, the real economy and income distribution in developing countries. Queen Elizabeth House working paper no. 8 (QEH: University of Oxford).

Short-term capital flow instability arises from the desire of investors to hold liquid assets in the face of uncertainty. This affects the real economy through variations in prices, such as the interest rate and the exchange rate, and in quantities, such as the level of bank credit and government bond sales. The main propositions of the paper with respect to the impact of exogenous changes in short-term capital flows are:

- the main direct transmission effects on the real economy are through variations in credit available to firms and in the demand for government bonds; and the main indirect effects are through variations in the real exchange rate and the level of economic activity;
- the impact on the fiscal sector is mainly seen in sudden shifts in the perceived solvency of the public sector, and thus upon the level of debt believed by foreign investors to be sustainable; the effect of these fluctuations is felt in volatile levels of public investment, which reduces the efficiency of public provision of infrastructures and social services. This may result from the impact of capital flows on the exchange and interest rate (that effect the costs of the debt service and the ability of the government to raise funds at an acceptable interest rate), and may result in asymmetric cuts in capital expenditure given the government's commitment to paying wages, debts and other transfers;
- the impact on the firms is mainly through the supply of working capital, which generates asymmetric responses in terms of investment and output due to impact on firms' balance sheets. When credit availability increases and interest rates fall, firms invest in working and fixed capital. Due to irreversibilities associated with fixed capital investment, in the downturn the only adjustment available to firms is to cut employment and output by reducing expenditure on working capital. On the other hand, the volatility of expected profits resulting from this has a strong depressive effect on private investment. These negative impacts will usually be stronger for small and medium firms because: (i) of capital market bias in favour of large firms and economic groups (which usually include a bank) and foreign companies (which may rely of foreign capital markets); and (ii) dependency of small firms to subcontracts from larger firms;
- the impact on households is the result of the employment and wage effects, which occur as a result of firms' responses to short term capital flows and of the consequences of fiscal instability, as well as an indirect result of the impact of exchange variations on real wages and aggregate employment.

Policies that can help to cope with the volatility of short-term capital flows:

- main macro-policies:
  - ensure economic stability;
  - overriding goal should be to keep and sustain high rates of private investment in trading sectors through macroeconomic stability and low interest rates;

- meso policies:
  - sustain public investment by avoiding the use of short term debt as a source of funds; tax reform to generate a structural fiscal balance; avoid the refinancing of long-term external debt with short-term internal debt;
  - avoid high real rates of interest, which do little to increase savings but clearly depress private investment, and also attract volatile capital flows;

- ensure that long-term credit is available to firms in order to sustain private investment through the cycles caused by short-term capital flows. This can be done by the provision of rediscount facilities at the central bank and tax incentives to long-term profit retention;
- protect small firms and homebuilding from the effect of credit restrictions; and restrict the capacity of large firms and banks to borrow abroad if this makes their capital structure vulnerable to exchange rate fluctuations;
- maintain and stable real exchange rate in order to avoid excessive fluctuations in real wages resulting from capital inflows and outflows. This can be done by using sterilization and variable reserve requirements on banks to avoid fluctuations in employment.