

IMF MACRO CONFERENCE

Transcript of Mohan Presentation

I found Deputy Managing Director Lipsky's luncheon address today of great interest. It is perhaps signaling a welcome change within the IMF on the view of capital account management. The basic assumption most of us seem to have in a lot of discussions about the capital account is that, in principle, the flow of capital across borders brings benefits to both capital importers and capital exporters. But historical evidence, reinforced by the current North Atlantic financial crisis—not global financial crisis—clearly shows that it can create new exposures and bring new risks. The failure to understand and analyze such risks, as well as the excessive haste that many countries have shown over time in liberalizing capital accounts, has compromised financial or monetary stability, particularly in many emerging-market economies. Such liberalization has usually been done without placing adequate prudential buffers that are needed to cope with the greater volatility characteristic of market-based capital movements. Such failure became manifest in the current crisis in an even more virulent form in the North Atlantic advanced economies.

In addressing issues related to capital account management, I see them in the broader context of prudent macroeconomic and monetary management, with a particular focus on maintaining financial stability. I believe that some of the errors in the approach to capital account management arise from looking at it from a very narrow viewpoint of capital controls. The reality of capital flows to emerging markets over the past decade and a half is one of rising volumes accompanied by high volatility. The optimal management of these large and volatile flows is not one-dimensional.

Let me state the bottom line first. Overall, my conclusion is that what is needed broadly is a combination of policies:

- sound macroeconomic policies, both fiscal and monetary
- exchange rate flexibility with some degree of management
- relatively open capital account but with some degree of management
- prudent debt management

- the use of macro prudential tools
- accumulation of appropriate levels of reserves as self insurance and their symmetric use in the face of volatility in capital flows
- and the development of resilient domestic financial markets

That sounds like motherhood and apple pie, but it is what I really believe. You can't talk about capital account management in isolation; you must talk about it as part of an overall toolkit with sound macroeconomic policies, both fiscal and monetary. The use of macro-prudential tools was talked about a lot this morning, and this afternoon there was discussion of exchange rate flexibility but with some degree of management. I think that a lot of the discussion is contaminated by going to the extremes of total flexibility or fixed exchange rates. In fact, what emerging markets have practiced since the Asian crisis is a greater degree of flexibility in exchange rates, but with some degree of management. Similarly, emerging markets have maintained a relatively open capital account, but again with some degree of management. A lot of the discussion is contaminated by going to extremes here as well: either a totally open capital account or totally closed, when the reality for Latin and Asian Emerging Market Economies (EMEs) has been somewhere in the middle over the past decade or so.

There has also been discussion on the accumulation of appropriate levels of reserves as self-insurance, and on their use in the face of volatility in capital flows in a symmetric fashion: injecting dollars into the market when there's a shortage of capital flows and, of course, doing the opposite when there are excess capital flows. That is what emerging-market countries have been doing since the Asian crisis. It is often proposed that the way to cope with capital flows is to let the exchange rate appreciate. Further, it is said that volatility is a problem because of the underdeveloped nature of domestic financial markets, which are inadequate to cope with such volatile capital flows, and so the answer really is to develop such capital markets.

That is obviously not the case. With this kind of menu, there is clearly no one size that fits all. There is another part of this discussion that we need to look at: how to decide what to do, when, and to what extent. Let me elaborate.

Theory versus Practice

The guiding principle underlying most discussions on free capital mobility across borders is that it would lead to more efficient allocation of resources and hence, would be welfare-enhancing to both borrowers and lenders. In principle, capital should flow from high-income capital-surplus countries to capital-scarce developing countries. But the reverse has been happening since the Asian crisis and particularly over the past decade. Capital has flowed from EMEs to advanced economies. Free capital flows should serve to lower the cost of capital in recipient countries and hence promote higher growth. They should be an important catalyst for a number of indirect benefits, such as development of domestic financial markets, improvements in local institutional development, and practice of better macroeconomic policies.

If all these indirect benefits do indeed fructify, they should eventually show up in higher economic growth in the recipient countries.

What I find to be an enduring mystery in economic reasoning is that despite numerous cross-country studies that analyze the effects of capital account liberalization, there is little evidence that capital account liberalization enhances growth. In reviews of such studies, fewer than a quarter find any such relationship. It seems that economists in general don't like that result. They continue to insist that free cross-border capital flows are still a good idea, despite their own empirical studies that do not give any evidence that there are such growth-enhancing benefits. And those studies that do find such evidence usually find it with a very, very mild effect. Yet the predominant view among economists and international policy advisors continues to be that open capital accounts are the first best, whereas any form of capital account management is decidedly a second-best approach.

Even when any form of capital account management or capital control is proposed, the reason given is that this has to be done because domestic financial markets are not developed enough, the implication being that when they are developed enough, such management would not be necessary. But is there evidence that developed and deep domestic financial markets would be enough to withstand the kind of volatile capital flows that have been commonplace over the past decade? Such capital flows actually reached something like

10 percent of GDP in the case of India in 2007-08. I should mention that India succeeded in managing these flows in that period. We got battered and bruised in so doing, but we are here to tell the tale!

The best clue as to whether developed financial markets can cope with this comes from the very interesting analysis provided a couple of weeks back by Chairman Bernanke, in a speech he gave at the Bank of France on the role of international capital flows in the current financial crisis in the United States. He recounted the various domestic and institutional factors that had led to the crisis there. I quote:

“In addition to [these] domestic institutional factors, international capital flows likely played a significant role in helping to finance the housing bubble and thus set the stage for its subsequent bust.”

After analyzing in detail the flows that came into the U.S. during the years before the crisis, both from official sources from what he calls the “emerging markets’ global savings glut”, and from largely private sources in Europe, Chairman Bernanke then concluded, “The United States, like some emerging-market economies during the 1990s, has learned that the interaction of strong capital flows and *weaknesses in the domestic financial system can produce unintended and devastating results.*” (Emphasis added)

But then, like most other economists, he goes on to say, “The appropriate response is not to reverse financial globalization, which has considerable benefits overall. Rather, the United States must continue to work with its international partners to improve private-sector financial practices and strengthen financial regulation, including macro-prudential oversight. The ultimate objective should be to be able to manage even larger flows of domestic and international capital.....”

What do we learn from this? That even the most sophisticated, diversified, and deep financial market in the history of the world had weaknesses that inhibited it from absorbing large capital flows that came into the United States prior to the crisis. And that *stronger financial regulation and macro-prudential oversight is required.* This would presumably apply to emerging markets even more strongly.

The Impossible Trinity

Much of the discussion on capital account liberalization arises from belief in the impossible trinity. But what EMEs have demonstrated since the Asian crisis, both in Latin America and in Asia, is that the “impossible” trinity can indeed be managed. How has this been done by them? Basically from the realization that there is no need to be at the corners of the trinity. First, the exchange rate should clearly be largely market-determined and flexible, but still managed to a certain extent. Second, the capital account should be largely open, but again not fully open, with some degree of management including the exercise of controls. And in such circumstances, it has been shown—and I think Governor Ortiz as well as Sri Mulyani mentioned this—that the major emerging-market economies both in Asia and Latin America survived the effects of the North Atlantic financial crisis without any financial institution in major Asian or Latin American countries getting into trouble. They have also demonstrated that by not being at the corners of the trinity, you can still manage or even practise independent monetary policy and have a certain degree of management of the capital account and a certain degree of management of the exchange rate. Most emerging-market economies have done exactly this. They also achieved during this period high growth, low inflation, and price and financial stability, and I suppose this is what we all want.

We can go a little further and ask: Why is it that the emerging-market economies have to resort to this kind of policy mix?

The Need for Capital Account Management

First, the record of capital volatility is indeed stark over the last couple of decades. To gain a sense of this, consider that prior to this decade the previous peak of net capital flows to emerging-market economies was around US \$190 billion in 1995. The average over the four years prior to that was around US \$100 billion. There was a big reversal after the Asian crisis, but then these recovered to about US \$240 billion, on average, during 2003-06. Net capital flows jumped to almost US \$ 700 billion in 2007 but then slumped to an average of around US \$ 200 billion during 2008 and 2009. That is the kind of volatility that we have. So regarding the first point—why the emerging-market economies had to resort to this kind

of management—it has indeed been due to the record of huge volatility in capital flows. It is a little difficult to imagine what would happen if capital account management was not resorted to in active fashion in these countries.

Second, on average, there is a persistent inflation differential between advanced economies and EMEs. It is very interesting that in the 10 or 12 years before the crisis, there was a persistent inflation differential of around 2 or 3 percent on average between advanced-economy inflation and emerging market inflation, though with lots of variance between different countries. Hence there was a persistent interest rate differential as well, and that gave rise to huge opportunity for the carry-trade on an enduring basis, since the differential has been persistent and is still continuing.

Third, there has been a good deal of volatility in the monetary policies of the advanced economies, and that has also given rise to capital flow volatility. If you go back around 30 years, there has been broad correspondence between episodes of accommodative monetary policy in advanced economies and capital flows to emerging-market economies. And there has also been the reverse. Each tightening produced the reversal of capital flows and the crises that occurred in EMEs in the 1980s and 1990s. These episodes were well documented in the Committee on the Global Financial System (CGFS) Report of 2009 on capital flows to EMEs.

Since the policies of advanced economies are driven by their own domestic needs, emerging markets need to take adequate defensive action. And then there is the growth differential, which has been getting starker. Overall, there is a huge incentive for high capital flows, which then lead to large exchange rate appreciation, credit booms, and asset-price boom, followed eventually by higher trade and current account deficits over time. There is then a reversal of capital flows at some point or other, leading to substantial output and unemployment costs. All of this could not have been managed by financial development, as shown by the United States itself. This demonstrates the need for a combination of measures, including capital management, particularly since markets can be irrational for extended periods.

Forex Reserves

There has been a lot of discussion in recent years on the very large increases in forex reserves of emerging-market economies. Most discussion focuses on the precautionary motive, and on the search for rules that should govern the accumulation of such reserves.

Very clearly the existence of substantive forex reserves did cushion emerging market economies from the significant reversal of capital flows that took place in 2008-09 after the Lehman crisis. But it is difficult to know what level of reserves is adequate and to devise principles that can guide countries in their accumulation in the face of a rapidly changing and globalizing financial world.

What has not received adequate attention in this discussion is the need for expansion of central bank balance sheets in the face of consistently high economic growth accompanied by financial deepening., which then requires corresponding growth in monetary aggregates. This requires expansion of base money, i.e. the central bank balance sheet, by an order of magnitude that is similar to that of financial growth. Hence there has been a continuous demand by EME central banks for safe assets to add to their balance sheets. Such assets can be either safe domestic assets or foreign ones. If the country practices prudent macroeconomic and fiscal policy the supply of domestic government securities may be inadequate to satisfy the central bank's demand for safe securities. EMEs, in general, exhibited high rates of economic growth over the past decade or so along with the practice of prudent macro and fiscal policies. Hence their central banks have exhibited a continuing demand for safe foreign assets, which the US Treasury has obligingly supplied over this period, along with a large current account deficit that also needed to be financed. Apart from other reasons for the large accumulation of forex reserves in recent years, there has been little discussion on this issue. An economy growing at around 15 percent annually in nominal terms, while also undergoing associated financial deepening, would typically need to expand the balance sheet of its central bank by a similar order of magnitude; hence a growing and continuing demand for safe foreign assets.

A good understanding of this motive for accumulating forex reserves could lead to coordinated international policy action that addresses this need for safe assets by EME central banks.

Conclusion

In conclusion, at least for emerging-market economies, capital account management in its broad form should become part of the normal overall toolkit for macroeconomic management, oriented towards ensuring growth with price and financial stability. It should not be regarded as a tool that is only used as an extreme measure. The accumulation and management of forex reserves needs to be consistent with this overall approach.

Thank you very much.