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Capital-Account Management: Key Issues

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The basic assumption 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 (not global) financial crisis that began in 2008, shows that it can create new exposures and bring new risks. In many emerging-market economies, financial or monetary stability has been compromised by the failure to understand and analyze such risks and by the excessive haste that many countries showed over time in liberalizing capital accounts. 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 a 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 focus on maintaining financial stability. Some of the errors in the approach to capital-account management arise from looking at it from the 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.

A combination of policies is needed:

- Sound macroeconomic policies, both fiscal and monetary,
- Exchange-rate flexibility with some degree of management,
- A relatively open capital account, but with some degree of management and controls,

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- Prudent debt management,
- The use of macroprudential 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 capital-account management cannot be examined in isolation. It must be part of an overall toolkit with sound macroeconomic policies, both fiscal and monetary. Going to the extremes of total flexibility or fixed exchange rates needs to be avoided. Since the Asian crisis, emerging markets have practiced 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. The reality for Latin and Asian emerging-market economies has been somewhere in the middle over the past decade or so, as they avoided the extremes of the prevailing orthodoxy.

Appropriate levels of reserves need to be accumulated as self-insurance, and they can be used in the face of volatility in capital flows in a symmetric fashion—by injecting dollars into the market when there is a shortage of capital flows and doing the opposite when there are excess capital flows. That is what emerging-market countries have been doing since the Asian crisis.

Some propose that the way to cope with capital flows is to let the exchange rate appreciate. Further, volatility is said to be a problem because of the underdeveloped nature of domestic financial markets, which are inadequate for coping with such volatile capital flows, and so the answer really is to develop such capital markets. That is not the case.

With this kind of menu, there is no one size that fits all. The other part of this discussion that needs to be looked at is how to decide what to do, when, and to what extent.

Theory versus Practice

The guiding principle underlying most discussions on free capital mobility across borders is that it leads to more efficient allocation of resources and hence is welfare-enhancing to both borrowers and lenders. In

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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 emerging-market economies to advanced economies. Free capital flows should 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 do not like that result. They continue to insist that free cross-border capital flows are a good idea, despite their own empirical studies that do not give any evidence that there are such growth-enhancing benefits. And the studies that do find such evidence usually find it with a very mild effect. Yet the predominant view among economists and international policy advisers continues to be that open capital accounts are the first-best approach and that any form of capital-account management is decidedly a second-best one.

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 will not be necessary. But is there evidence that developed and deep domestic financial markets are enough to withstand the kind of volatile capital flows that have been commonplace over the past decade? Such capital flows reached something like 10 percent of gross domestic product in India in 2007 and 2008. India did succeed in managing these flows in that period. We got battered and bruised in so doing but are still here to tell the tale!

The best clue to whether developed financial markets can cope with this comes from the interesting analysis provided by Ben S. Bernanke in a speech he gave at the Bank of France in February 2011 on the role of

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international capital flows in the current financial crisis in the United States. He recounted the various domestic and institutional factors that led to the U.S. crisis: "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" (Bernanke et al. 2011).

Bernanke analyzed the flows that came into the United States 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. He then concluded that "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" (Bernanke et al. 2011).

But like most other economists, he went on to say that "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 macroprudential oversight. The ultimate objective should be to be able to manage even larger flows of domestic and international capital" (Bernanke et al. 2011).

What can be learned from this? 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. Stronger financial regulation and macroprudential oversight is required. This presumably applies to emerging markets even more strongly.

The Impossible Trinity

Much of the discussion on capital-account liberalization arises from belief in the impossible trinity, that the combination of an open capital account, a fixed exchange rate, and an independent monetary policy is not feasible. But since the Asian crisis, emerging-market economies in Latin America and in Asia have demonstrated that the "impossible" trinity can indeed be managed. They have realized that there is no need

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to be at the corners of the trinity. First, the exchange rate should be largely market-determined and flexible but still managed to a certain extent. Second, the capital account should be largely open but not fully open, with some degree of management including the exercise of controls. In such circumstances, the major emerging-market economies 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, they can still manage or even practice 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, which are things that we all want. We can go a little further and ask: Why do 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 stark over the last couple of decades. Prior to this decade, the previous peak of net capital flows to emerging-market economies was around U.S. $190 billion in 1995. The average over the four years prior to that was around $100 billion. There was a big reversal after the Asian crisis, but then these recovered to about $240 billion, on average, in 2003 to 2006. Net capital flows jumped to almost $700 billion in 2007 but then slumped to an average of around $200 billion during 2008 and 2009. That is the kind of capital-flow volatility that the emerging-market economies have experienced. 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 were not resorted to in active fashion in these countries.

Second, on average, there is a persistent inflation differential between advanced economies and emerging-market economies. In the ten or twelve years before the crisis, there was a persistent inflation differential of around 2 or 3 percent on average between advanced-economy

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inflation and emerging-market inflation, though with lots of variance between different counties. 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. For thirty 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's (CGFS) 2009 report on capital flows to EMEs.

Because the policies of advanced economies are driven by their own domestic needs, emerging markets need to take adequate defensive action. The growth differential 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 booms, 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.

Foreign-Exchange Reserves

A lot of discussion in recent years has centered on the large increases in foreign-exchange 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.

The existence of substantive foreign-exchange reserves did cushion emerging-market economies from the significant reversal of capital flows that took place in 2008 and 2009 after the Lehman Brothers crisis. But it is difficult to know what level of reserves is adequate and to devise

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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 (that is, the central-bank balance sheet) by an order of magnitude that is similar to that of financial growth, so there has been a continuous demand by the central banks of emerging markets 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. In general, emerging-market economies exhibited high rates of economic growth over the past decade or so along with the practice of prudent macro and fiscal policies. Their central banks have exhibited a continuing demand for safe foreign assets, which the U.S. 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 foreign-exchange reserves in recent years, there has been little discussion on this issue. An economy that is 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, which results in a growing and continuing demand for safe foreign assets. A good understanding of this motive for accumulating foreign-exchange reserves could lead to coordinated international policy action that addresses this need for safe assets by emerging-market economy central banks.

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 and be oriented toward ensuring growth with price and financial stability. It should not be regarded as a tool that is used only as an extreme measure. The accumulation and management

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of foreign-exchange reserves needs to be consistent with this overall approach.

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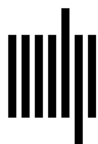

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