High-Level Seminar on Capital Flow Management and Liberalisation

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Stanley FISCHER speech

Mr. Secretary-General, Representatives of the member countries, Representatives of the non-member countries:

Thank you for inviting me to speak today. This is a very important topic and the initiative that the OECD has taken in opening the Code of Liberalisation of Capital Movements to non-members is one that shows real imagination and real understanding of the needs of the international system and of the potential role of the OECD. So, I am delighted to have been invited to this event.

With respect to the current account - international trade in goods and services - the international community has built up an impressive and successful framework of governance. It started with the GATT, which was replaced by the WTO, whose grievance framework provides a reasonably effective mechanism of enforcement. In addition, we have in the IMF Articles of Agreement the promotion of current account liberalisation as one of the goals of the Fund. Article 14 allows countries to declare that they are not ready to adhere to the requirements of trade liberalisation, until at some point they move on to Article 8, in which they accept the liberalisation of trade as being their fundamental approach.

This two-stage approach has worked very well. I say very well, despite the fact that in every global crisis, the alarm is sounded against imminent protectionism, as it is being sounded now, but these bouts of protectionism, by and large have not happened. That's remarkable, because each of us is born with a protectionist gene. There is nothing more obvious than that you should help the companies in your country by preventing foreigners from undercutting them. The theory of comparative advantage is far from being intuitive or obvious, but that is the approach that the international community has adopted by and large, based on a good deal of empirical work and possibly on the fact that within each country, there are both export interests as well as those who want protection against the exports of other countries.

The situation is very different in the case of capital flows. It is generally accepted that FDI is a good thing, so much so that there is a need for international agreements on how to limit the concessions that countries compete to give to attract FDI. But the overall view that FDI is desirable is, I think, accepted in the soft infrastructure of our beliefs. However there is no global agreement regulating or promoting international capital mobility: there are regional agreements, for example within the EU, and there is of course the

OECD Code of Liberalisation of Capital Movements, now fifty-one years old. When I heard about this conference, I thought it was a celebration of fifty years since the Code was initiated, with the usual lag for getting things done in time, but this turned out to be incorrect.

There is an excellent eight-page summary (from July of this year) on the OECD website of the Code and its purposes, with the first heading being, "*Promoting Orderly Capital Flows: the Approach of the Code*." That brings me to the 1997 attempt by the IMF - by leading members of the IMF, led by the UK, with the support of the management - to make the liberalisation of capital flows a goal of the Fund along the same lines as the Fund deals with current account liberalisation. In the speeches of the then Managing Director, Michel Camdessus, and in speeches that I gave, we emphasised that we were seeking the orderly liberalisation of the capital account - and we emphasised *orderly*. We made it clear that the process of liberalising the capital account could take a long time. However the gods could not have chosen a worse time to speak favourably of capital movements; this was the height of the Asian crisis and the proposed amendment died, in light of the widespread belief that many of the excesses of the Asian crisis had been created by hedge funds speculators and others of their like.

How should we think of capital flows fifteen years later? We still do not have the basic theoretical reassurance about capital flows that the theory of comparative advantage offers for trade in goods - and that matters to how economists think about these things. Of course, if one thinks of a simple two-period model, capital flows are simply the intertemporal counterpart of trade imbalances and one can then say that they too are covered by the theory of comparative advantage. Let's assume we agree that long-term capital flows, FDI, not investment in long-term financial instruments, is the counterpart of goods-side flows. That would mean that there is a theory that covers FDI, but there isn't at this point of time a satisfactory theory point that deals with short-term capital flows (and *short-term* is the emphasis).

These short-term capital flows can have a major impact on the exchange rate, which can seriously complicate the operation of monetary policy. This was seen in the attempts to stabilise high inflations in the 1980s and it has been seen repeatedly since then: it is the familiar *capital inflows problem* when a country tightens monetary policy, and this problem is now at the centre of discussion. In addition, capital inflows can be very volatile and their volatility can do damage to domestic financial institutions, particularly those, for example, banks, that finance themselves significantly from abroad. Further, there is the systemic problem: if every country neutralises capital flows, an important part of the transmission mechanism of monetary policy in the countries that want to use monetary policy is neutralised and there is in principle a need to prevent beggar-thy-neighbour policies in this regard as well as in the current account context. If we didn't know that before, we would know it now because the last round of quantitative easing by the Fed led to an outpouring of complaints about the effects of the QE on the exchange rate. I must confess that I didn't understand those complaints, because normal monetary policy also affects exchange rates and it has been accepted as part of the transmission mechanism for a very long time. I don't think there is much evidence that QE has more of an impact on the exchange rate than other types of intervention. Nonetheless it is certainly an issue, and we simply don't have a good enough economic understanding of the costs and benefits of short-term capital flows.

So what needs to be done? First we need to produce a knowledge base. Work on the welfare economics of capital flows is being undertaken at present in the IMF. I recommend to you a recent paper by Ostry, Ghosh and Korinek. There is work on multilateral aspects of managing the capital account, which will be presented in a while by Ratna Sahay, and there is also a paper of that title from the IMF, which contains a section on the pure theory of capital controls. Second, we need an understanding of what types of capital controls work and which don't and in what circumstances, circumstances such as what sort of structure of the domestic economy and the domestic financial system enables a country to deal relatively easily with the volatility of short-term capital flows. Material on that issue will be presented in the paper by Jørgen Elmeskov, which we'll be hearing shortly and also in some papers that have been written in the IMF.

We need this base of knowledge in order to think clearly about short-term and other capital flows, and then we need international agreements on what is acceptable and what isn't. The OECD Code is flexible in that countries that adhere to it can negotiate temporary exemptions from some of its provisions. We have the EU, in which capital flows are required to be absolutely free. We have some regional agreements, including some FTA agreements in which controversially there are agreements on not using capital controls, and there are also some elements of what the IMF does that relates to capital controls.

Do controls on short-term capital flows work?

As someone who has in a small way used capital controls, I think the answer is yes. The evidence is that they work for a while and then the financial markets find their way around controls on short-term flows. Now we have the inspired proposal out of the OECD of allowing non-members to adhere to the OECD Code. This removes some of the compulsion and possibly some of the potential surveillance that must have bothered certain member countries of the Fund, when they were considering the proposed capital account liberalisation extension of the Fund's Articles of Agreement.

I believe we should agree to the underlying assumption of all these agreements and codes, that in the long-run capital flows should be freer, provided the process is undertaken in an orderly way. Let me comment briefly on the arguments of the 1990s against the view that capital flows should be freer in the long-run. It was frequently asserted that the countries that got into trouble in Asia were those that had opened their capital account, and therefore it was argued that capital accounts should not be liberalised. In fact, some of the countries that got into trouble on the capital account were in trouble because they had opened the capital account wrongly. Two of the countries that got into a deep crisis liberalised short-term flows and did not liberalise long-term flows - exactly the opposite of what should have been done. Another reason I believe that capital flows will be freed up in the longer run is that more advanced countries typically have relatively few controls on capital and countries that have less developed financial systems and less developed economies typically need to use capital controls. We in Israel have used capital controls, so I am not accusing anybody of moral turpitude. It's just that more advanced countries are less inclined to use capital controls, and those controls that they have in place tend to be more related to prudential controls. So I believe that countries should gradually and in an orderly way liberalise their capital accounts, once they have put in place the elements that will make the financial system sufficiently robust to deal with the volatility and other aspects of capital flows.

Finally, let me conclude with a reflection on the issue of whether capital controls can fit in with inflation targeting. At present we have central banks all over the world who three years ago were explaining that if you controlled inflation everything worked perfectly - and now here we are doing macroprudential and capital controls, and looking much more like central banks of the 1960s and 70s than we would have thought possible only a few years ago. Can this possibly be consistent with the inflation targeting approach to monetary policy? Well I think the inflation targeting rhetoric of some who said that the only thing of interest was the inflation rate – "we have only one instrument and therefore can have only one target" - was never convincing. I think there was never a central bank that targeted only inflation, whatever it said it was doing. I think they all took output movements into account, even if they didn’t say so. So it doesn’t bother me very much that we think of more than one target, and use more than one instrument. Capital controls, like macroprudential tools, provide a means that may enable a country to deal with unwanted aspects of disturbances from abroad or from home on the economy. And that means they may enable a country to conduct its own monetary policy, with fewer negative side effects like a strong appreciation of the exchange rate accompanying a tightening of monetary policy.

But that leaves the issue of international coordination, the avoidance of beggar-thy-neighbour policies, to be dealt with. That is one of the main and most important reasons for this conference and it is one of the most important topics on which we can hope to continue to make progress today and in the future.

Thank you very much.