OECD High-Level Seminar on Capital Flow Management and Liberalisation: the Role of International Co-operation

Paris 9 October 2012

Introductory Comments to Session 4: Looking Ahead
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Introduction

Before opening up this discussion on future issues pertaining to capital flow management, let me provide an overview of the earlier sessions. In effect, Sessions 1 and 2 looked backward with a view to identifying the benefits and costs associated with highly mobile international capital flows. In contrast, the perspective of Session 3 was how internationally coordinated policies, in particular adherence to the OECD Codes of Conduct, might help to raise the benefits while reducing the costs. To put this another way, the earlier sessions asked "What is the problem?", while the later sessions (including this one) rather focus on "What is the solution?"

To my mind, the single most important conclusion from the discussion to date is that there is not yet a consensus on optimal policies in this area. The closest we got today was that, in responding to undesired capital flows, capital controls should be more a last resort than a first resort. Indeed, the current debate on policy issues is as vigorous as it has been over the last thirty years or so. Why are the policy issues pertaining to international capital flows still unresolved? It is certainly not due to a lack of analytical attention. Since the early 1990's, I personally participated in extensive studies on capital flows under the aegis of the G-10 Deputies, the Willard Group, the Financial Stability Forum and various committees at the Bank for International Settlements. And the OECD and IMF, among others, have been almost ceaselessly active in producing serious analytical studies.

One reason for this lack of resolution is that there is in fact no right answer to the "problem" of international capital flows. Rather, there is a tradeoff between the perceived longer term benefits (better international resource allocation) and the perceived shorter term costs (international contagion of shocks and high volatility with macroeconomic consequences). These tradeoffs might well differ from country to country depending on their circumstances. Moreover, perceptions can also change with time, particularly if objective circumstances and economic understanding are also evolving.

Various participants in Sessions 1 and 2 underlined important changes with implications for how one evaluates the costs and benefits of international capital flows. By way of example, Stanley Fischer noted that the current crisis had generally undermined the previous consensus on the efficiency of financial

markets. Similarly, the previous agreement among central bankers that price stability was sufficient to ensure macroeconomic stability was now being fundamentally questioned. Thus, volatile capital flows might still have bad effects even if their implications for prices were understood and well offset.
Manuel Ramos emphasized another form of change; namely that emerging market economies might, for a long time, have higher growth rates than advanced market economies. This implied that they would also have a higher "natural" rate of interest and that capital inflows and real currency appreciation might be a secular phenomenon. In this longer run context, the distinction between "pull me" and "push me" explanations of capital flows was fundamentally false. Instead of trying to resist the inevitable, emerging market economies should cooperate with others to make sure that they occurred in an orderly way. Of course, this did not rule out the possibility that temporary "push" factors (like QE3?) might also have unwelcome effects on the currencies of emerging market economies.

Finally by way of example, Ratna Sahay emphasized how the character of the financial system and the nature of international capital flows had changed in recent decades. In particular, internationally active banks had become much more reliant on wholesale funding, much of it raised cross-border. While this certainly had implications for capital flows between advanced market economies and emerging market economies, the increased flows among advanced market economies and among emerging market economies were also remarkable.

Concerning the former, it was noted that loans made by core European banks were heavily reliant on dollar funding raised in large part in the United States. Further, within the eurozone, peripheral countries were heavily reliant on capital inflows in euros from core banks. When these sources of funding dried up, after more than a decade of easy access, the crisis was on. Concerning capital flows between emerging market economies, a number of speakers noted how these flows had increased substantially and how measures to restrict inflows simply diverted them to other countries in the region.

Changes of the sort just mentioned above, and a host of others, have implications for the perceived costs and benefits of adopting policies to better manage capital flows. This goes a long way in explaining why there is no consensus on what to do. A further, and perhaps even more fundamental explanation, recognizes that capital flow issues must be nested within the much broader macroeconomic issue of how to manage the "Impossible Trinity".[1] This is particularly so since the reaction of policymakers to the dilemma has become much more nuanced. A decade or two ago, the tendency would have been to give up on the pursuit of one element of the "Trinity", with the fixed exchange rate being top of the list for most academic observers and for the IMF. Today, however, it is more widely recognized that the theory of Uncovered Interest Rate Parity fails to hold except over very long periods. This implies in turn that

[1] It is not possible to purse simultaneously a fixed exchange rate, an independent monetary policy and highly elastic international capital flows.

capital flows can cause exchange rates to overshoot their fundamental values by large amounts and for long periods.

Policy makers have responded by seeking, not to jettison one element of the “Impossible Trinity”, but to constrain the pursuit of all three such that they can be achieved simultaneously. Thus, it is becoming more common to have a “managed float” (often with a significant use of foreign exchange rate intervention), “regulated capital flows” (to reduce currency and maturity mismatches) and “constrained independence” for central banks as they seek to use the policy rate as their principal instrument for reaching domestic objectives.

Central banks, and associated authorities are also increasingly turning to macroprudential instruments in their pursuit of policy goals. On the one hand, these instruments can be thought of as restoring some part of the “independence” constrained by international capital flows. On the other hand, recourse to macroprudential instruments also recognizes that monetary policy might have broader macroeconomic objectives than just price stability. Low policy rates, for example, could lead to various imbalances in the real economy (say, unprofitable investments in property and other long lived assets) and the financial sector (say, unsustainable asset prices and high leverage ratios) that could lead to a sharp and prolonged downturn even in the absence of inflationary pressures. One practical problem with such instruments is that their use can sometimes have effects similar to capital controls. This could raise questions as to their consistency with the OECD Codes.

Evidently, with a wider set of policy objectives, a wider set of available policy instruments, and a wide range of objective circumstances across countries, how best to manage capital flows will depend on a much wider range of tradeoffs than the stylized “long run benefits versus short term costs” referred to above. In Session 1, Jorgen Elmeskov recognized this by noting how structural policies could actually improve the tradeoffs available. In particular he stressed that policies which encouraged foreign direct investment (for example, product market reform) and discouraged short run foreign financing via banks, could materially lower the risks of financial instability sparked by tighter policy rates.

During the discussions in Session 3 there was general agreement that the OECD Codes of Conduct had been very useful over the last fifty years. The IMF delegate, noting that the Fund was trying to develop a new policy on capital flows, stressed that the basic principles underlying the Codes were sound and needed to be preserved. It seemed generally agreed as well, that allowing non-OECD members to accede to the Codes was a welcome step going forward. The Colombian delegate suggested that Colombia was thinking seriously of using this opportunity.

All that said, a number of suggestions were also made for improving the OECD Code of Liberalization of Capital Movements. The need to allow different procedures for countries in different circumstances was noted, as was the need to recognize financial stability as an explicit objective of policy. A number of participants noted that “market failures” in this area could go on for long periods and that derogations and the like might have to be similarly long lasting. Finally, the Fund and others noted the need to recognize the impact of one country's policies on others. Big countries in particular needed to internalize the externalities of their policies, including monetary policy. Given the revolutionary nature of this suggestion, the effective loss of sovereignty that it implied, and the fact that it might conflict with domestic laws, a lively discussion followed. As with the nature of the "problem", there was also no consensus on preferred "solutions".

In opening up Session 4, under the heading "Looking Forward", I suggested that we proceed in two rounds. Analogous to the distinction drawn in earlier sessions, the first round would focus on "what is the problem" likely to be going forward. The second round would then focus on "what is the solution" with a particular emphasis on the potential role for international cooperation. The following questions were suggested to the panelists as possible guideposts for the discussion.

What is the problem?

Are international capital flows likely to increase further or not? Is the current retreat from cross-border banking (a particular source of volatility) likely to continue or be reversed?

Is the current tradeoff between perceived benefits of more capital flows (presumed better resource allocation) and the risks they involve (exchange rate misalignments, financial instability) correct?

What developments might alter that tradeoff going forward? On the one hand, if still more market participants engage in "momentum" investment strategies, exchange rate misalignments will increase. On the other hand, better regulation and supervision might make financial systems inherently more stable.

Capital inflows to Emerging market Economies (EME's) seem to be increasingly dominated by "push me" factors (eg low interest rates and QE) in the Advanced Market Economies (AME's). Is this likely to continue or even intensify, raising the likelihood of "currency wars"?

Against this background is the likelihood of recourse to capital controls going to rise?

What risks might be associated with this: capital controls that perpetuate undervaluation of currencies rather than resisting overvaluation; contagion to other countries resulting in capital controls that are collectively "too tight"; capital controls that help avoid the use of better macroeconomic instruments (eg fiscal constraint) to respond to unwanted inflows?

Is more international cooperation part of the solution?

Is the current network of international agreements robust enough to prevent a dangerous escalation of capital controls and countermeasures, should recent trends in this direction continue?

How specifically might international cooperation respond to the individual risks (noted just above) posed by a growing reliance on capital controls?

We normally think of the recipients of capital flows as having problems, and therefore the need to find solutions. In a “push me” world, should the source countries also have some responsibilities. For example, in setting monetary policy should policymakers in AME’s also take account of the externalities of their policies for EME’s?

Are circumstances changing in ways that encourage more international cooperation with respect to capital flows, or the opposite. In particular, are the incentives for source country central banks and regulators to cooperate with recipient countries increasing or decreasing?

What are the implications of a system with adherents to the OECD Codes and non-adherents? Of what relevance is the fact that most adherents are source countries for capital flows whereas many of the recipients are non-adherents?

What can be done to improve the likelihood of more international cooperation in this area? Is there a need for improving clarity and consistency in the international architecture governing international capital flows?