

MONETARY STABILITY, EXCHANGE RATE REGIMES, AND CAPITAL CONTROLS: WHAT HAVE WE LEARNED?

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Few topics in macroeconomics are as contentious as capital account liberalization and exchange rate regimes. This article attempts to briefly summarize what we have learned through the turbulent 1990s and the relatively benign 2000s. It is obviously not intended to review the massive literature on these topics, only to distill the main policy conclusions—or at least what I think are the main policy conclusions.

In contrast to current account liberalization, which is enshrined in the Articles of Agreement, the International Monetary Fund has no explicit mandate to promote capital account liberalization. Even so, the IMF seeks to be a “center of excellence” in analyzing capital account issues, in light of the growing financial globalization and its implications for macro management in member countries. To deal with surges in capital inflows, the IMF has generally advocated tightening fiscal policy to prevent overheating and limit real appreciation (IMF 2007a). Such a policy response helps reduce the economy’s vulnerability to a “hard landing” after the inflows abate. However, counter-cyclical fiscal policy is no panacea, because governments may be unable to change the fiscal stance to the extent and at the speed required to offset the impact of shifts in capital inflows.

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Are capital controls the answer? Controls have been occasionally imposed to discourage capital inflows and reduce appreciation pressures (Chile in 1991, Thailand in 2006, Colombia in 2007) or to discourage outflows (Malaysia in 1998). In the process, they may entail substantial microeconomic costs, *inter alia* by raising the cost of capital (Forbes 2007). There is little empirical evidence that controls are effective in stemming capital flows, especially over the longer term, as markets find ways around them. With the possible exception of market-based prudential measures, controls have a negative signaling effect and markets tend to view them as a country risk factor.

Removal of controls on outflows is another policy countries have adopted to deal with recent surges in capital inflows. However, empirical evidence from the 1980s and 1990s suggests that eliminating controls on outflows can attract inflows by sending a positive market signal (Bartolini and Drazen 1997).

The Case for Free Capital Mobility: Theory and Evidence

There is an analogy between trade in goods and trade in capital, since cross-border investment is a form of intertemporal trade: The lender/investor delivers present goods on the expectation that the user of the funds will deliver future goods. It is therefore natural to presume that capital mobility promotes growth just as trade promotes growth. The theoretical justification for this presumption is based on allocative efficiency considerations. However, while there is much empirical evidence that trade is good for growth, the evidence on capital mobility is mixed at best. Why is that? Various explanations have been put forth.

First, the theoretical presumption that capital account liberalization is good for growth applies only in a first-best world. When other distortions exist, liberalization may in fact *reduce* growth, by shifting resources to less productive sectors. It has been argued that a second-best outcome is more likely in the case of capital account liberalization, because information asymmetries are intrinsic to financial markets.¹ Some economists, therefore, consider capital account liberalization

¹This is the “market for lemons” argument—that is, cross-country contagion effects (as in the Russian and LTCM crises of the 1990s), or loss of trust among market participants (as in the current credit crunch), both based on incomplete information, are triggering capital outflows to limit possible losses.

as a threat to economic and financial stability (Rodrik 1998, Stiglitz 2000).

Second, capital account liberalization is a continuum that extends over time and across different types of capital flows. Early empirical studies based on “on-off” liberalization—as if it were a binary choice—oversimplify reality. More recent studies that distinguish between different types of flows and different degrees of liberalization have found evidence of positive growth effects. Disaggregating the data also sheds light on the link between liberalization and crises. Research points to substantial benefits from liberalizing equity flows, while debt flows dominated in foreign exchange can be problematic (see Henry 2007).

Third, a strand of the literature suggests that, besides the neoclassical allocative efficiency channel, the benefits of financial globalization are also realized through “collateral benefits” (Kose et al. 2006). These benefits are hard to uncover in cross-country regressions that try to explain growth, because their impact works through other explanatory variables such as financial sector development and institutional quality. For example, opening up the capital account can force the pace of domestic financial development and put pressure on the authorities to follow sound macro policies. It also exposes firms to greater competition for capital, thus improving efficiency. However, to reap those collateral benefits and minimize the risk of crisis, countries have to meet certain threshold conditions in terms of institutional development and macro stability.

These considerations argue for close coordination between financial sector reform and capital account liberalization. Underdeveloped and weak domestic financial institutions are incapable of intermediating large inflows of capital efficiently. In such an environment, capital inflows can compound financial fragility and raise crisis risks. Foreign direct investment (FDI) inflows are most likely to be growth-promoting because, unlike portfolio investments, they do not require domestic financial intermediation while they contribute technical and managerial know-how likely to increase total factor productivity (TFP). A recent IMF study on financial globalization (IMF 2007b) thus concludes that capital account liberalization should be pursued as part of a broader reform package encompassing a country’s macro policy framework, domestic financial system, and prudential regulation. In terms of sequencing, long-term flows, such as FDI, should be liberalized before short-term, debt-creating inflows.

The Tradeoff Is Shifting in Favor of Liberalization

Over the past decade, the cost-benefit tradeoff of capital account opening has improved for a number of reasons: (1) the share of FDI (and the associated technological/managerial know-how) has been rising; (2) the counterpart of this increase is a decline in the share of debt (which is least likely to contribute to increased TFP), with little change in equity flows; (3) the investor base for emerging market assets has been broadened to include more “buy-and-hold” investors, such as pension funds, contributing to more stable, less volatile portfolio flows (IMF 2007c); (4) foreign exchange reserves of developing countries have risen exponentially since the Asian crisis, from less than \$1 trillion at end-1997 to \$4.7 trillion at end-2007, creating a big cushion against external shocks; and (5) many emerging market countries have improved their macro frameworks and reformed their economies over the past decade, helping them reach the threshold where the benefits of an open capital account begin to outweigh the risks.

A word of caution is in order here: Markets are international but governments are national. Although markets are becoming increasingly global, regulation and supervision remain stubbornly local. This issue needs to be urgently addressed by tightening cross-border supervision to make the world safer for capital flows.

Capital Account Liberalization and Exchange Rate Regimes

How flexible should exchange rates be? Many observers (for example, Eichengreen 2007 and Rogoff 2004) consider that exchange rate flexibility is a precondition for full capital account liberalization. Their main argument is that currency pegs are untenable in a world in which \$3 trillion transit through foreign exchange markets every day. I am in a minority of skeptics who believe that most developing countries should have fixed exchange rate regimes, especially if their economies are small and open, are dollarized, lack a well-developed financial system and hedging instruments, and lack an independent and sophisticated central bank.

In these economies, an independent monetary policy is unfeasible, undesirable, or both, for at least one of the following reasons: (1) the pass-through of exchange rate movements to domestic prices is high; (2) the interest rate channel of monetary policy transmission is

weak; (3) balance sheet mismatches in the banking system could trigger a financial crisis in the absence of hedging instruments; and (4) the central bank lacks the capacity or independence to target inflation. Under the principle of the “Impossible Trinity,” countries have to give up one of the following targets: monetary independence, exchange rate stability, or financial market integration. For most developing countries, the choice is clear.

All small economies—the bulk of IMF members—are better off with fixed exchange rates to a large stable anchor currency. A well-known proponent of flexible rates, Milton Friedman, wrote back in the 1970s: “For a small country, the best policy would be to eschew the revenue from money creation [and] unify its currency with the currency of a large, relatively stable developed country with which it has close economic relations.”² Indeed, the dollar area encompasses much of Asia (ex-Japan), the Middle East, and part of Latin America; the euro area includes the CFA franc countries and new/prospective EU members queuing to join the euro area. Some notable examples cast doubt on the view that currency pegs are a “recipe for disaster” with an open capital account. The hard pegs of Hong Kong and Bulgaria held firm through the Asian crisis, the LTCM shipwreck, and the Russian default of the 1990s, because domestic policies remained compatible with the maintenance of the peg. A credible peg reduces the incentive for speculative “hot money” flows because interest rates converge with those of the anchor currency. Comparing Bulgaria’s currency board with Romania’s inflation targeting regime—both prospective euro area members—it is clear which country receives stable, long-term flows as opposed to short-term speculative capital.

Consistent with the Articles of Agreement, the IMF recognizes its members’ right to choose their exchange rate regime, but seeks to ensure that economic policies are compatible with the chosen regime. The IMF’s Research Department periodically reviews the trends in exchange rate behavior with a view to distilling the key lessons for policymakers. In its latest review—now being updated—it concluded that fixed or relatively rigid exchange rates have performed well for poorer countries, but there are benefits to adopting greater exchange rate flexibility as countries develop their economies and financial systems (Rogoff et al. 2004). It should be noted, however,

²Quoted in Friedman and Mundell (2001).

that empirical evidence regarding the macroeconomic performance of different regimes depends entirely on the classification scheme adopted (Frankel 2004).

Exchange Rate Management during the Recent Surge in Capital Inflows

The past decade is characterized by two distinct sub-periods as regards private capital flows to emerging market countries (EMCs): the 5-year period 1997–02, characterized by crises, massive capital outflows, and devaluations in Argentina, Brazil, Indonesia, Korea, Russia, Thailand, and Turkey; and the 5-year period 2002–07, characterized by benign global financial conditions and massive inflows into EMCs.

Three stylized facts stand out during the recent period of abundant global liquidity since 2002: (1) practically all EMCs, including those with *de jure* floating regimes, have been intervening in foreign exchange markets to counter appreciation pressures; (2) EMCs display “fear of floating” by declaring a *de jure* floating rate regime when in fact they intervene vigorously to resist exchange rate movements—indeed, there is a growing disconnect between *de facto* and *de jure* exchange rate regimes (what countries do and what they say they do); and (3) although intervention typically was undertaken to resist appreciation pressures, it also was undertaken to resist downward pressures on the exchange rate during periods of market turbulence, such as those experienced in May–June 2006, February 2007, and August 2007.

What motivates these exchange rate management practices? Following the turbulent period 1997–02, a growing number of EMCs adopted inflation targeting (IT), moving away from fixed exchange rate regimes. But IT gives rise to a policy dilemma during surges in inflows: on one hand, appreciation pressures raise concerns about export competitiveness; on the other, resisting appreciation by accumulating reserves generates inflation pressures. As a way out of this dilemma, countries engage in sterilized intervention to prevent overshooting while keeping inflation low. But sterilized intervention is costly if domestic interest rates exceed those of the reserve currency, and there is also a limit to how much Treasury paper domestic banks are willing to accumulate in their portfolios. Thus, if the pressures persist, the real exchange rate may eventually appreciate either

through nominal appreciation or inflation (or both), as was the case in most countries with dollar pegs (or near-pegs) in recent years.

The recent literature on the classification of exchange rate regimes identifies a growing disconnect between de jure and de facto exchange rate regimes. Specifically, countries display “fear of floating” by declaring a floating rate regime when in fact they intervene vigorously to resist exchange rate movements (Barajas, Erickson, and Steiner 2008). Why so? Possibly because declaring a floating rate regime simply signals lack of commitment to any particular exchange rate level, rather than a market-driven exchange rate (Genberg and Swoboda 2005).

During the risk-reduction episodes of May–June 2006, February 2007, and August 2007, the same countries that previously intervened to resist appreciation intervened to resist depreciation. This “leaning against the wind” central bank reaction function suggests that the key concern is to curb excessive volatility rather than resist nominal adjustment. The reason seems simple enough: EMCs with underdeveloped financial systems cannot afford to relegate the exchange rate to benign neglect, as required by IT, because the exchange rate is the main determinant of inflation expectations as well as the main instrument of monetary policy—much more so than in highly leveraged advanced countries where interest rate movements get far more traction. More broadly, EMCs that typically cannot carry out their international transactions in their own currency have every reason to be concerned about the exchange market value of their currency.

The IMF’s Surveillance Decision

In June 2007, the IMF adopted a new Decision on Bilateral Surveillance, intended to improve the effectiveness of surveillance by focusing on the question of whether members’ policies are supportive of external stability. The new Decision replaces the 1977 Decision, adopted in the aftermath of the collapse of the Bretton Woods system of fixed exchange rates.

The 2007 Decision expands the scope of its predecessor in two important ways. First, it adds a new principle recommending that members avoid exchange rate policies that result in external instability *regardless of their purpose*. It thus shifts the focus from “exchange rate manipulation for BOP purposes” under the old Decision to

exchange rate policies adopted *for domestic purposes*, but leading to external instability (for example, containing inflation by maintaining overvalued pegs, or reducing unemployment by maintaining undervalued pegs). Second, it expands the scope of the Decision to cover domestic economic and financial policies.

How the new Decision is put into practice will matter. Obviously, exchange rates (and reserve accumulation) are a symptom, rather than a cause, of external imbalances. It is the policy mix that determines exchange rates and that is what IMF surveillance should focus on. The IMF's multilaterally consistent equilibrium exchange rate methodology is a useful tool, but has limitations. The methodology is in the process of being refined to take into account intergenerational equity considerations for exporters of nonrenewable resources. Even so, there is no generally agreed methodology to assess equilibrium exchange rate levels or optimal foreign exchange reserves with any precision. Accordingly, the focus of analysis should be on macro policies and their consistency with external stability, taking country-specific factors into account, rather than on quantitative estimates of misalignment. Even if misalignment could be accurately estimated, what needs to be corrected is the policy mix that gives rise to misalignment, not necessarily or even typically the exchange rate.

Conclusion

There is no doubt that countries should open up their capital accounts at some point. It is no coincidence that all developed countries, without exception, have done so. The only question is, What are the prerequisites? I have argued that exchange rate flexibility is not one of them.

Financial globalization is a fact that needs to be better reflected in the process by which countries liberalize their capital accounts. Vulnerabilities can be reduced through stability-oriented policies and effective regulation/supervision of local capital markets. The institutional and regulatory regime governing the financial sector should achieve a minimum standard ("threshold") before the capital account is fully liberalized. Indeed, financial deepening is a prerequisite for both capital account liberalization and exchange rate flexibility.

Capital controls are not a substitute for sound macro policies. They entail micro costs and are unlikely to be effective beyond the

near term. They are likely to do less damage if they are market-based (for example taking the form of reserve requirements on capital inflows) rather than quantitative.

The cost-benefit tradeoff of capital account liberalization has improved over the past decade because capital flows have become more stable while the reserve cushion of recipient countries has increased significantly and their macro policies have improved. Given the variety of country circumstances in terms of financial sector development and macro conditions, it would be useful for the IMF to develop a taxonomy of cases to guide its advice on the proper sequencing of liberalization steps and on the policy responses to surges in capital inflows.

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