Business Standard

Capital flow conundrums

Recent two-way movements have highlighted the complexity of managing the capital account

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Global thinking on capital controls, or the more politically correct capital flow management measures (CFMMs), has changed considerably over the past few years. Many countries, primarily emerging market economies (EMEs), were always extremely sceptical of the earlier, rather categorical "capital controls are bad" view. This scepticism was validated when the International Monetary Fund (IMF), which was typically identified as a proponent of this view, suggested that there were circumstances in which CFMMs were an appropriate policy response.

Several conditions and caveats were articulated, but at the end of the day, it seemed that a barrier had been broken and the nature of the debate had shifted from black or white to shades of gray. A significant event impacting the debate was the decision by Switzerland to prevent the Swiss franc from appreciating beyond a level, when if faced enormous pressure from capital inflows in the wake of instability in the euro zone.

I had the opportunity to participate in a number of seminars and other events that have reflected the evolution of the post-crisis debate on CFMMs and their flip side, exchange rate management. Significantly, an important discontinuity has taken place during this time, which should reflect in the debate in the future. The view that CFMMs might be appropriate in certain circumstances essentially emerged in the context of large and potentially destabilising inflows into EMEs, at a time when the central banks of advanced economies were infusing liquidity into their financial systems. The most dramatic characterisation of the spillovers from these actions was the "currency wars" expression by the Brazilian finance minister in late 2010. CFMMs in this situation were visualised as instruments to deal with these inflows in order to prevent the exchange rate from appreciating. Theoretically, any country has an unlimited capacity to resist exchange rate appreciation even without using CFMMs. However, this could have many other adverse consequences, so CFMMs inevitably become part of the toolkit.

But, from August 2011 onwards, the discontinuity appeared. From a situation in which EMEs were trying to deal with large inflows, they had to quickly shift gears to deal with large outflows. This change involves a fundamental asymmetry. While the capacity to deal with inflows is unlimited, the capacity to handle outflows and the consequent depreciation of the currency is not. Without resorting to CFMMs that actually restrict outflows, the capacity is constrained by the foreign exchange reserves of the country. Global thinking on the use of CFMMs in this situation has not covered the same distance as it has on the handling of inflows.

While this reversal affected EMEs as a group, capacities and, hence, responses varied significantly across countries. In terms of structural factors, the presence and size of the current account deficit were key differentiators. Countries with deficits, particularly large ones, obviously saw far more pressure on their currencies to depreciate than those with surpluses. As regards policy responses - and here, I would treat the size of the foreign exchange reserve as a reflection of the policy position on exchange rate management - both the reality of market intervention to prevent depreciation and the expectation of this happening in the future, based on the size of the reserves, played a role.

I participated in a seminar organised by the IMF and the People's Bank of China a few days ago, titled "Capital Account Management: Lessons from International Experience". Representatives from several countries, spanning both the current account surplus and deficit categories, spoke about their longer-term experiences with capital account liberalisation as well as the more recent episodes of volatility resulting from both surging inflows and rapid outflows. A number of common themes emerged from these country narratives. From the long-term perspective, clearly, early experiences with big-bang capital account liberalisation suggested that it just might be too difficult to handle. These experiences strengthened the case for a gradualist approach, drawing on both theory and evidence to identify preconditions for each step. Most countries that have taken the phased liberalisation route did not go through major upheavals, which might have led to a complete rethink and reversal.

As might have been expected, things are far fuzzier when it comes to drawing conclusions from the more recent episodes. When dealing with surges of inflows, while the new view broadly identifies domestic macroeconomic conditions within which the use of CFMMs is warranted, it is less explicit on what specific measures might work best in which circumstances. This is, ultimately, a matter of trial and error and only cumulative experience can provide any real guide. However, it is clear from experience that lack of theoretical or empirical guidance cannot be used as an argument against a very strong "compulsion to act" when the currency is under extreme pressure.

Even more complex is when this pressure is to depreciate. Own reserves and access to others' through agreements are only a partial line of defence when the current account reinforces downward pressure. In these circumstances, the compulsion to act usually means using instruments that are associated with a control regime. Even if outright limits on outflows are not imposed, these instruments involve reducing the flexibility to transact for many market participants.

This raises dilemmas for both market participants and policy makers. For the former, do they read into this a reversal of the policy direction, which will inevitably impact their long-term view on investment in the economy? Or do they take the chance that this is only a temporary deviation from an otherwise robust commitment to a freer capital account? For the latter, do such measures erode credibility, without achieving very much in terms of the fundamental objective of containing currency movement and volatility? And, once a course of action is decided on, how much room is there for fallback measures if the plan does not work?

On exchange rates themselves, floating rates were seen in some narratives as effective indicators of stress, allowing for policy responses - whether these worked or not was another story. The exchange rate becomes both a barometer of stress and an initial shock absorber. However, in instances of extreme volatility, which several countries experienced, the availability, let alone the costs, of hedges is an issue. Unhedged exposures, in turn, can seriously damage both balance sheets and profitability of firms, which may impact investment activity, even after stability returns.

Clearly, recent experience with sharp movements in both directions needs to be systematised and analysed carefully in trying to find the right balance between sequencing, pace, timing and risk mitigation in managing the capital account.

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