A Pragmatic Approach to Capital Account Liberalization

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Presentation partly based on my joint work with:

- Ayhan Kose, Kenneth Rogoff, Shang-Jin Wei (2003, 2006)
- Raghuram Rajan (2005, 2008)
- Raghuram Rajan and Arvind Subramanian (2007)

Benefits of Financial Integration: Theory

- Efficient international allocation of capital
- Consumption smoothing via international risk sharing
- Large welfare effects for developing economies

Figure 4. GDP (per capita, PPP weighted): 1970-2004

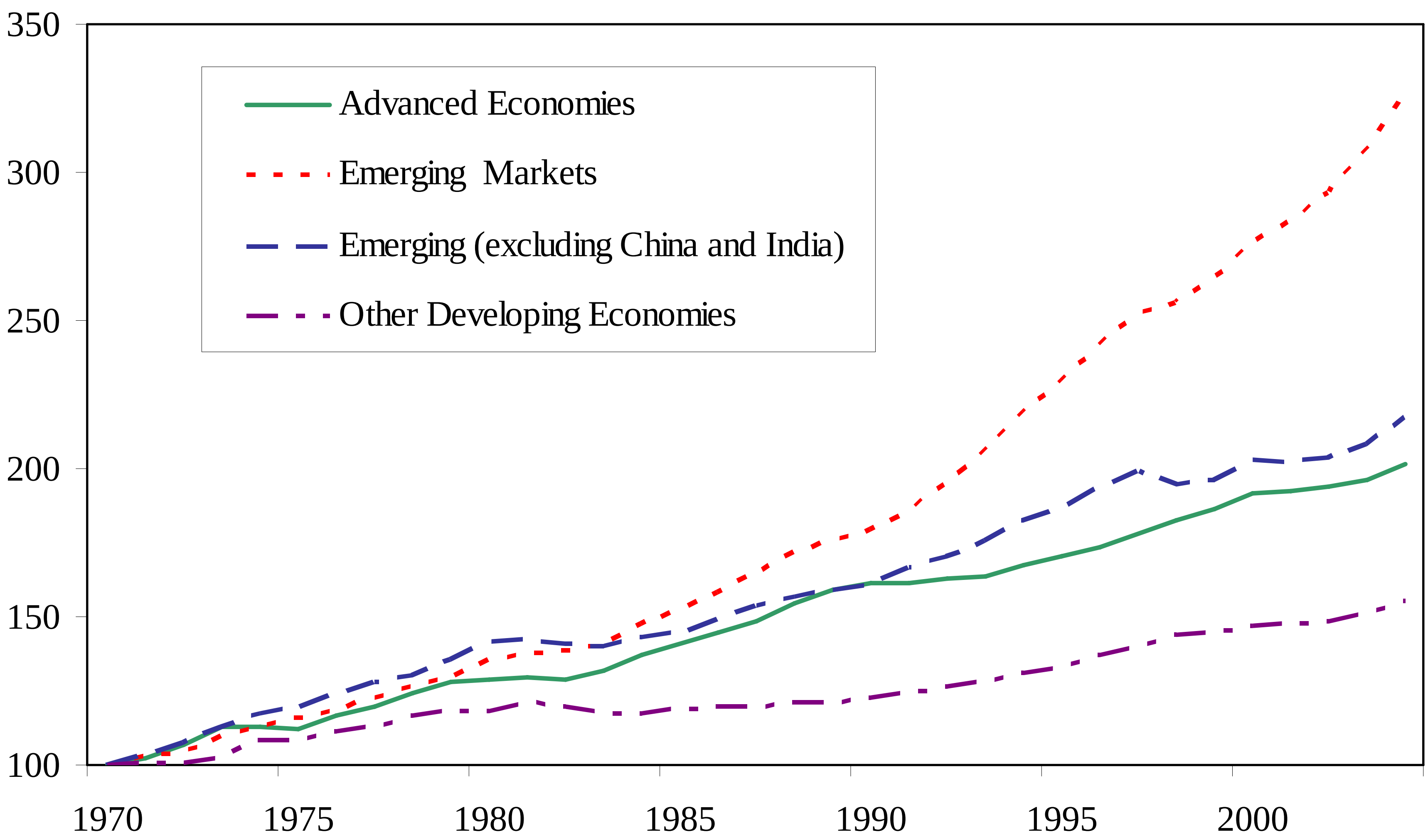
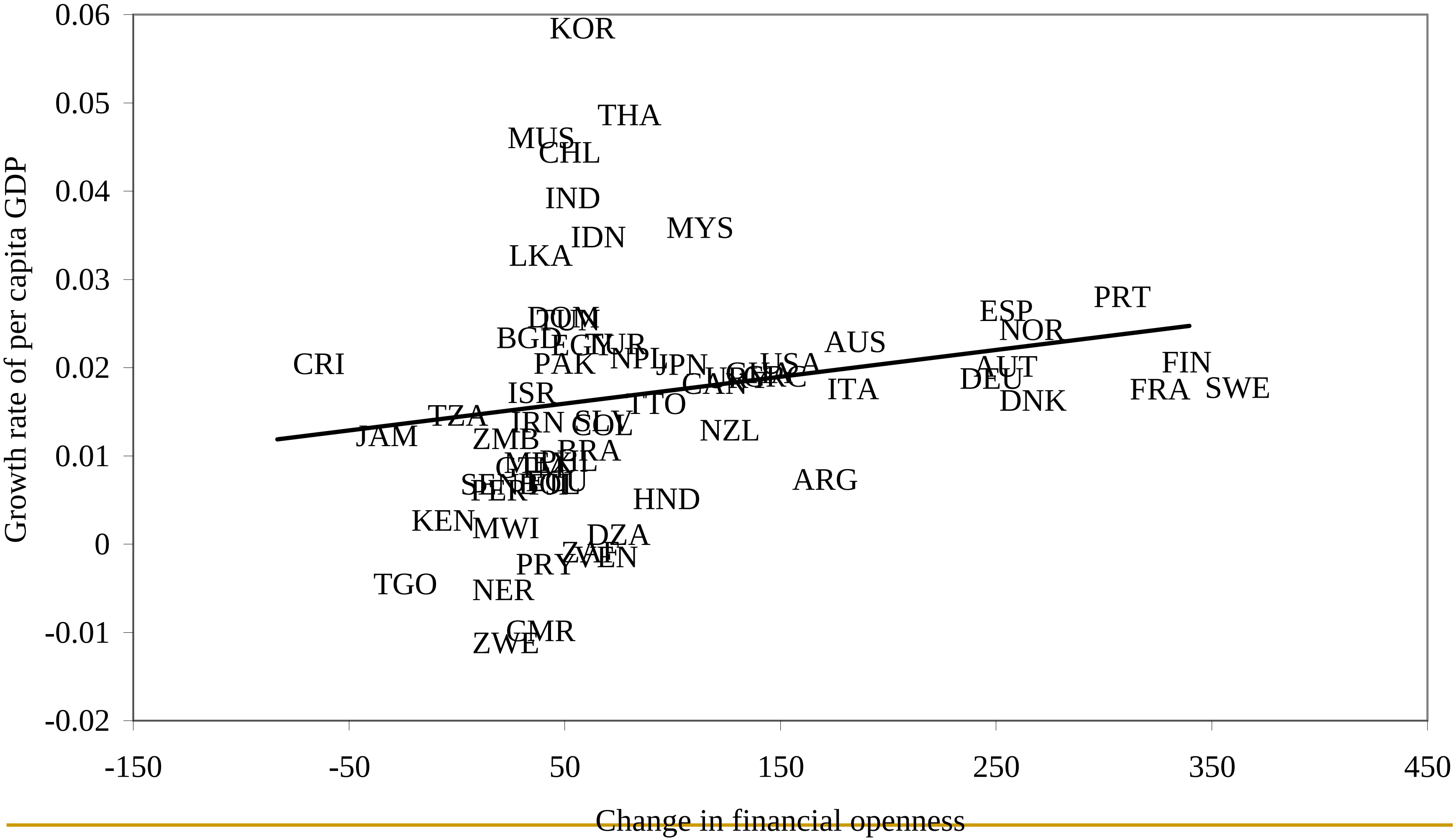


Figure 5B. Change in Financial Openness and GDP Growth, 1985-2004
Unconditional Relationship



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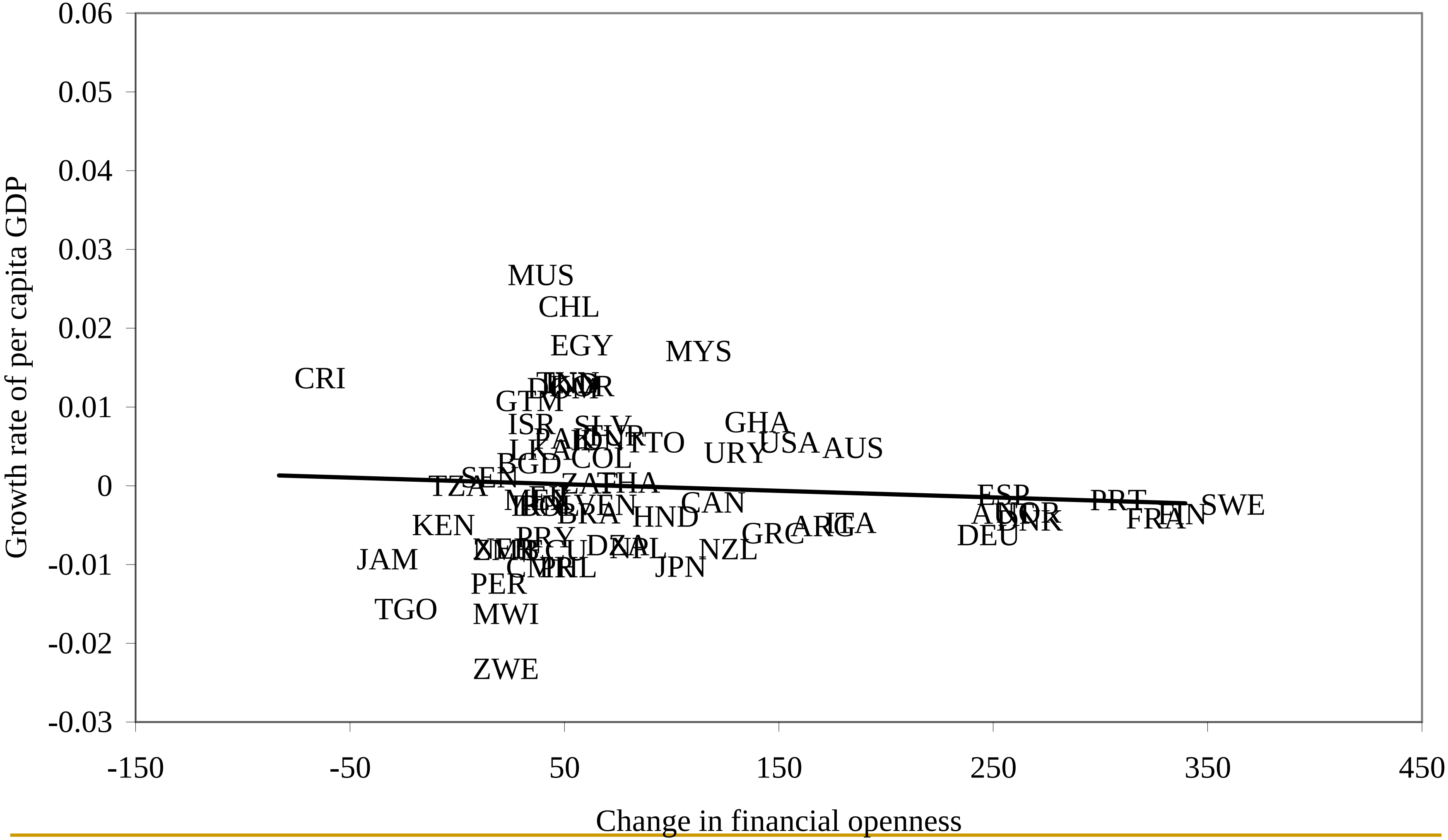


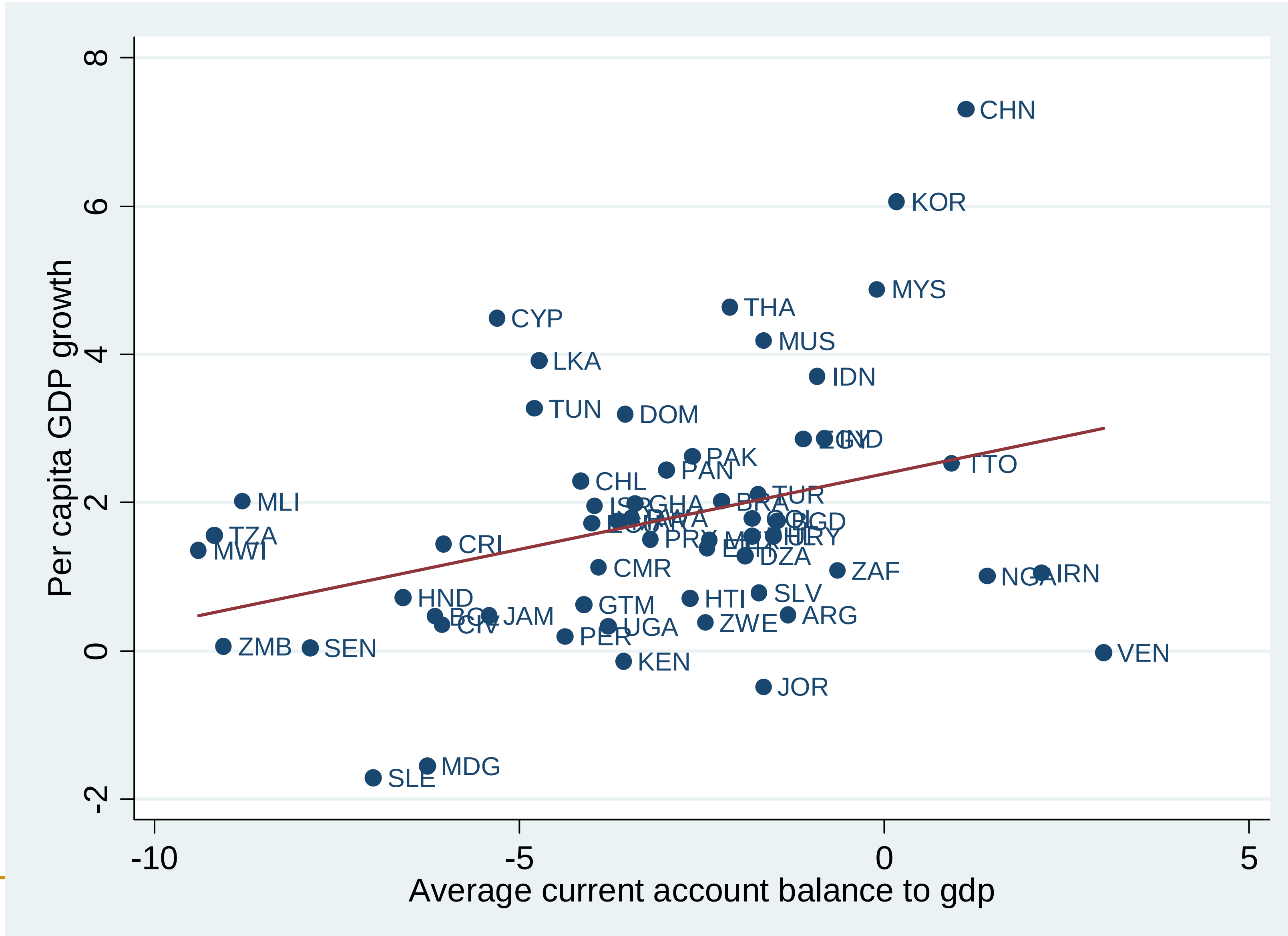
Growth Benefits of Financial Integration: Evidence

About 25 studies of growth effects

No effect:	4
Mixed:	18
Positive:	3

No robust macroeconomic evidence of growth benefits

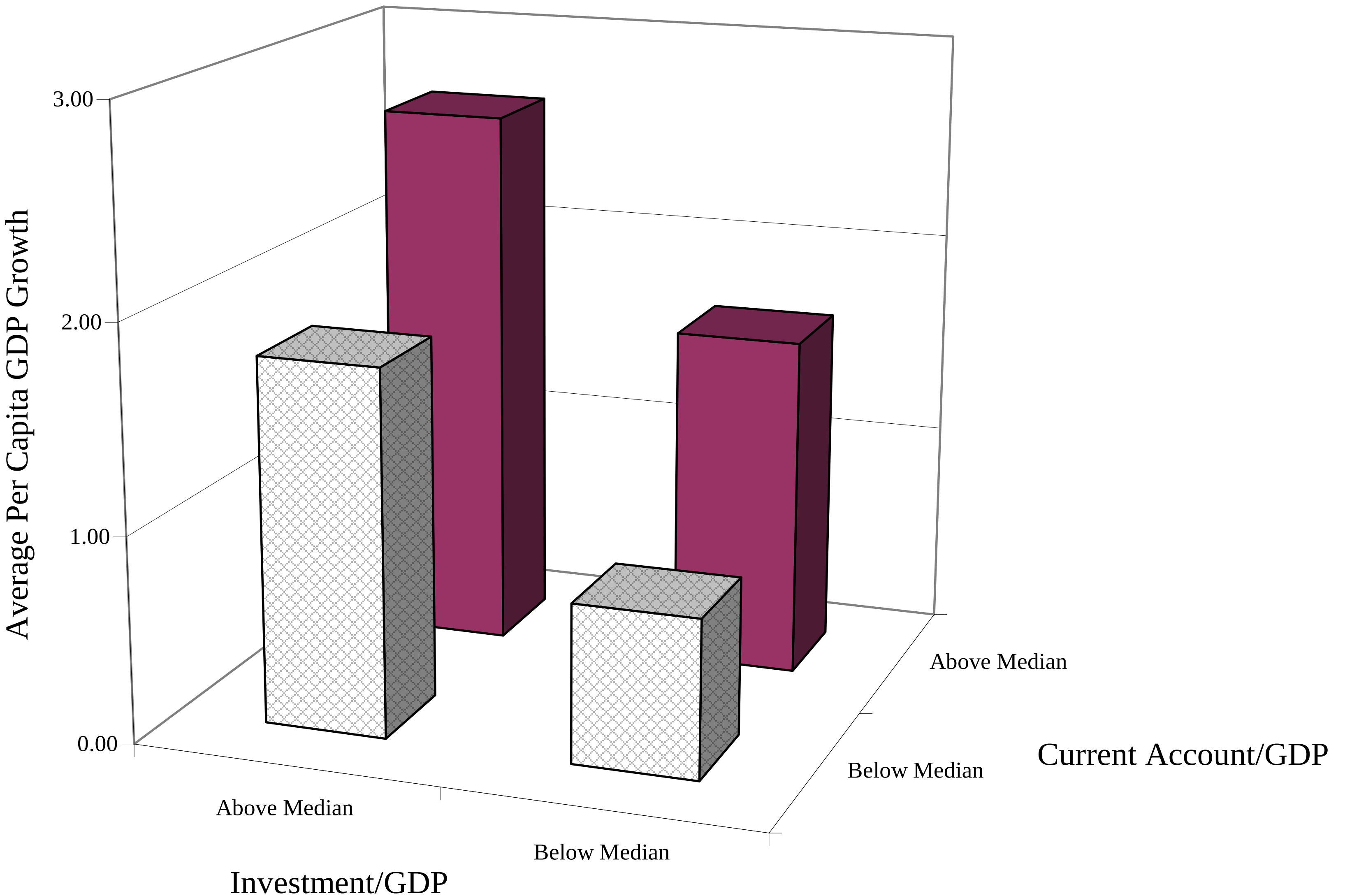
Correlation between Growth and Current Account Balances
Non-industrial Countries, 1970-2004



Why Doesn't Foreign Capital Boost Growth?

1. Domestic financial system cannot effectively intermediate foreign capital

Figure 6. Current Accounts, Investment and Growth in Developing Countries

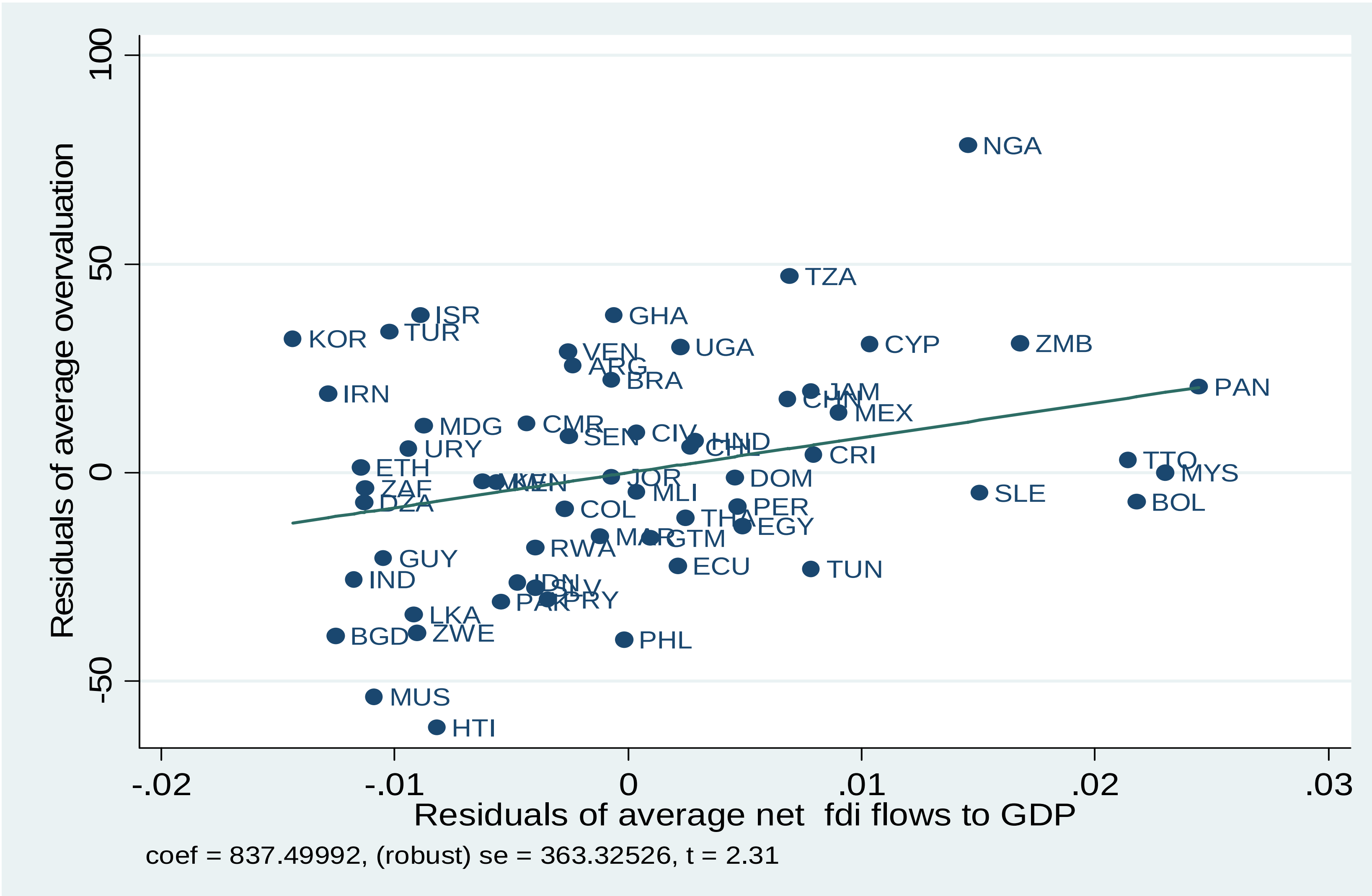


Why Doesn't Foreign Capital Boost Growth?

2. Foreign capital leads to exchange rate appreciation (overvaluation)

=> Lower exports, returns to investment, and overall growth

Foreign Capital and Overvaluation, 1970-2004



Financial Integration and Volatility: Evidence

- Capital mobility does not increase probability of crises
- Banking crises are most disruptive and occur frequently in closed economies

No evidence that financial integration by itself is proximate determinant of financial crises

But Two Issues on Volatility

- Relative volatility of consumption growth increases at low and intermediate levels of integration
- Developing economies, including emerging markets, have not attained better risk sharing

Other Ways of Looking at the Data

- Effects of different types of private capital flows:

  > Equity flows
  > FDI
  > Debt

- Macroeconomic vs. microeconomic evidence

Summary of New Evidence

- Equity market liberalization seems to work
- FDI benefits becoming more apparent
- Benefits more evident in micro data
- More risk-sharing benefits from FDI, portfolio equity flows; debt not good for risk-sharing

The Traditional View

Financial Globalization ⇒

More efficient international allocation of capital

Capital deepening

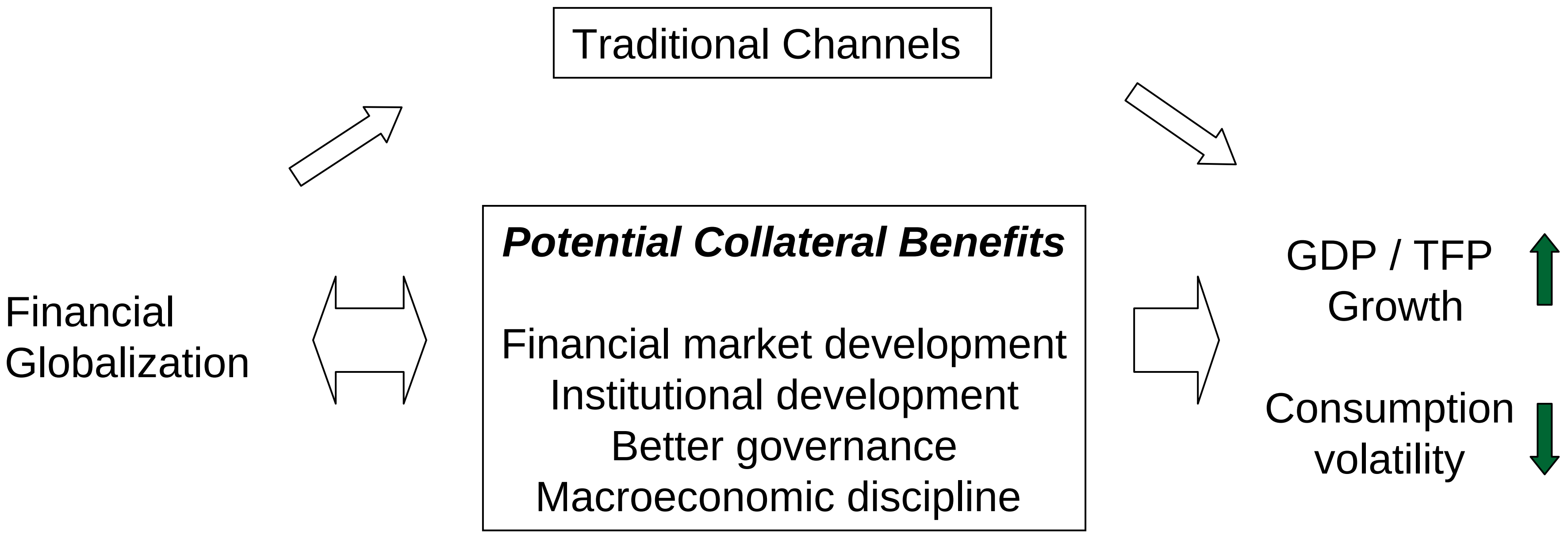
International risk-sharing

⇒

GDP growth ↑

Consumption volatility ↓

A Different Perspective



FG and Financial Development

- Foreign ownership of banks improves efficiency of domestic banking system
- Inflows add to depth of equity markets
- Financial sector FDI has benefits

Figure 6A. Financial Openness and Financial Development: 1985-2004
Private Credit/ GDP

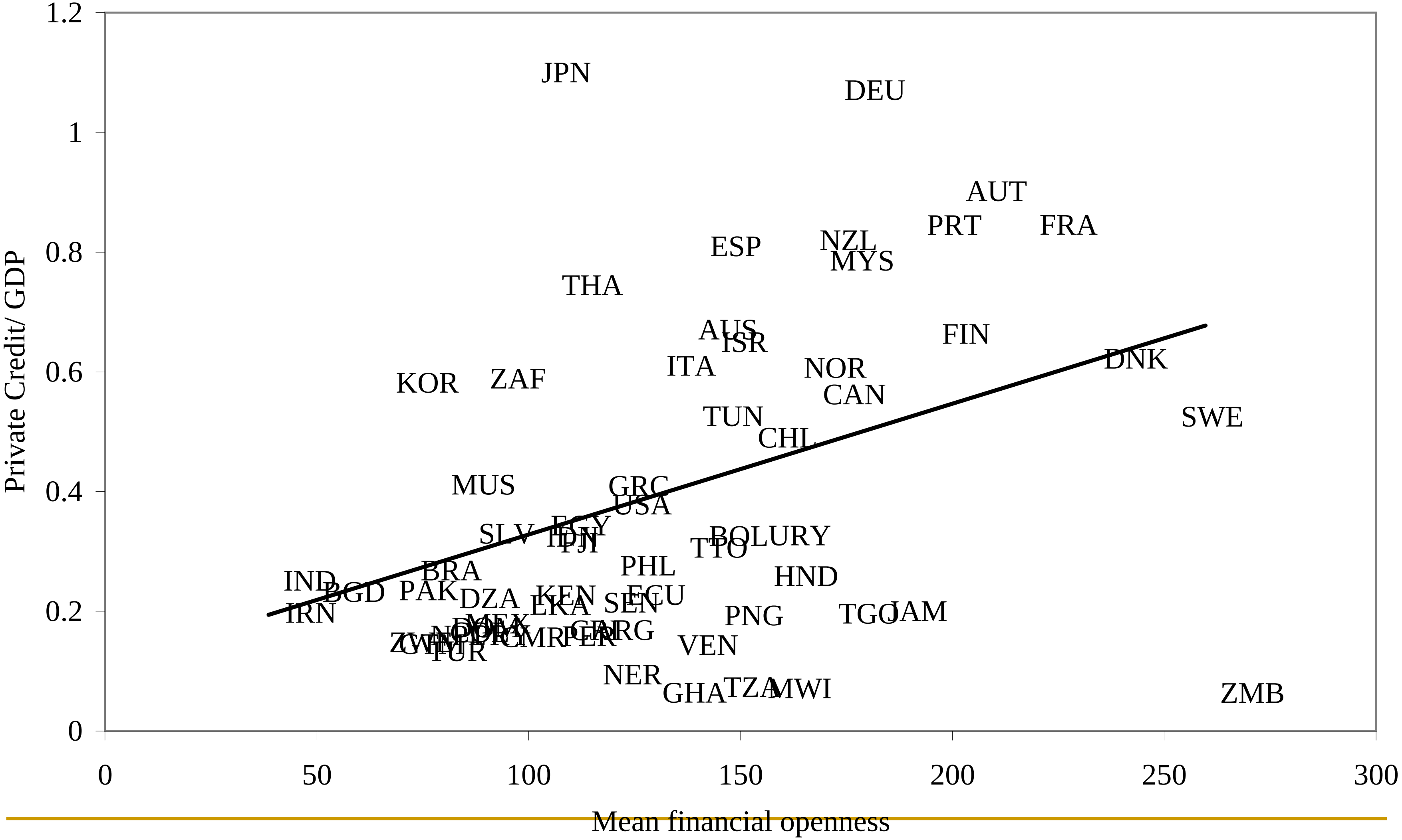
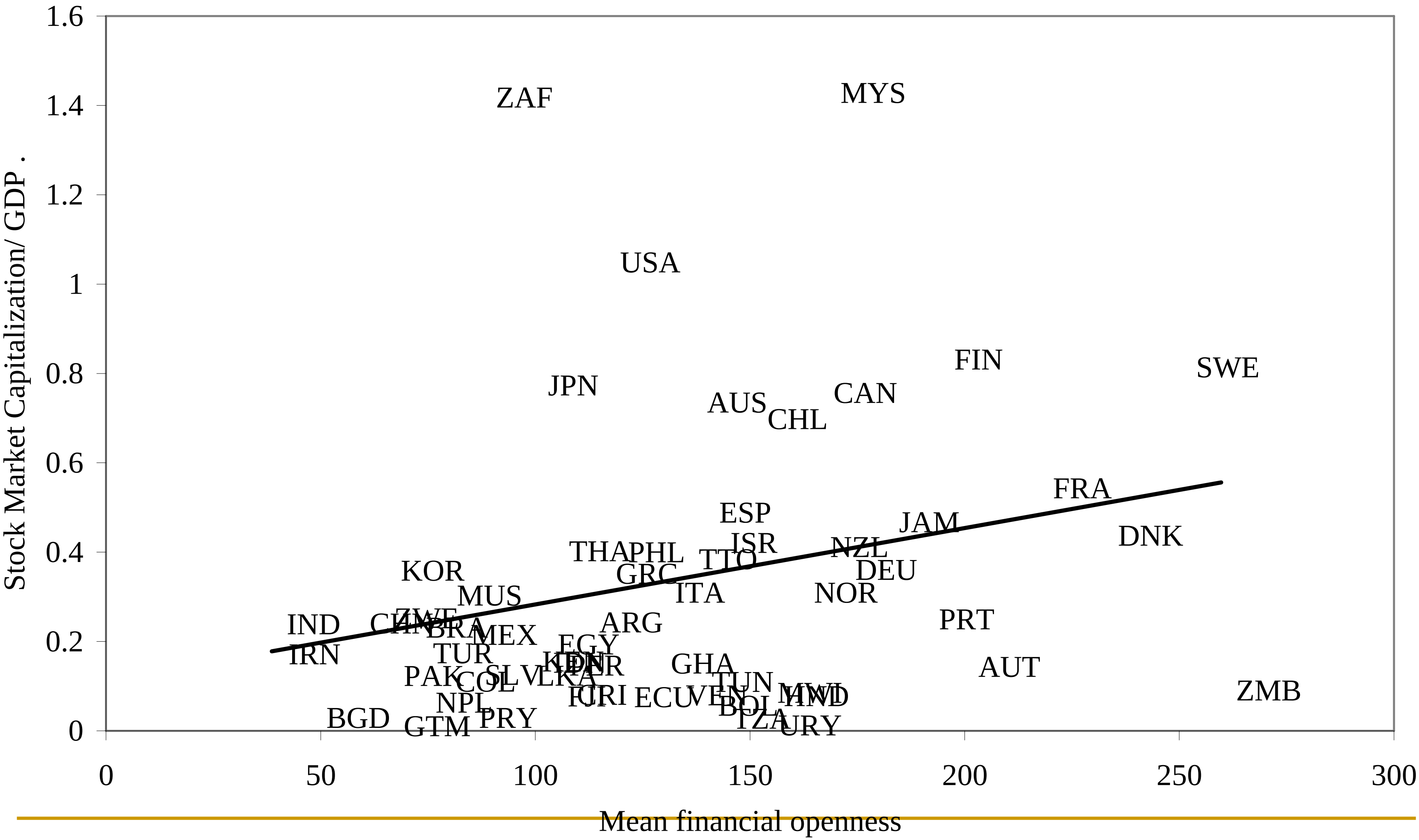


Figure 6A. Financial Openness and Financial Development: 1985-2004
Stock Market Capitalization/ GDP



FG and Quality of Institutions, Governance

- Openness to foreign capital provides incentives for improving corporate governance
- Corruption, lack of transparency discourage FDI, portfolio flows =>

incentives for improving public governance

Figure 6B. Financial Openness and Quality of Institutions: 1985-2004
Institutional Quality

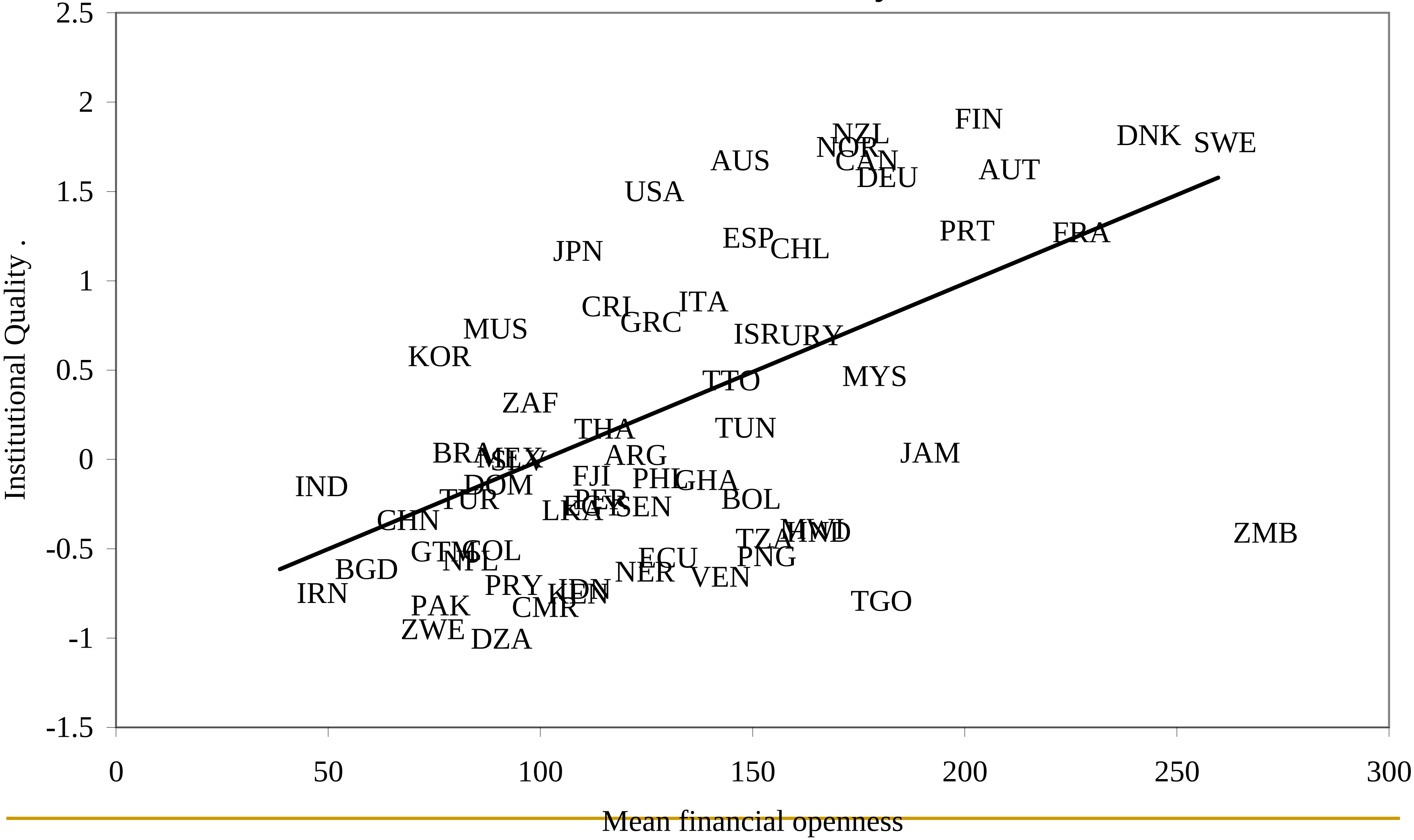
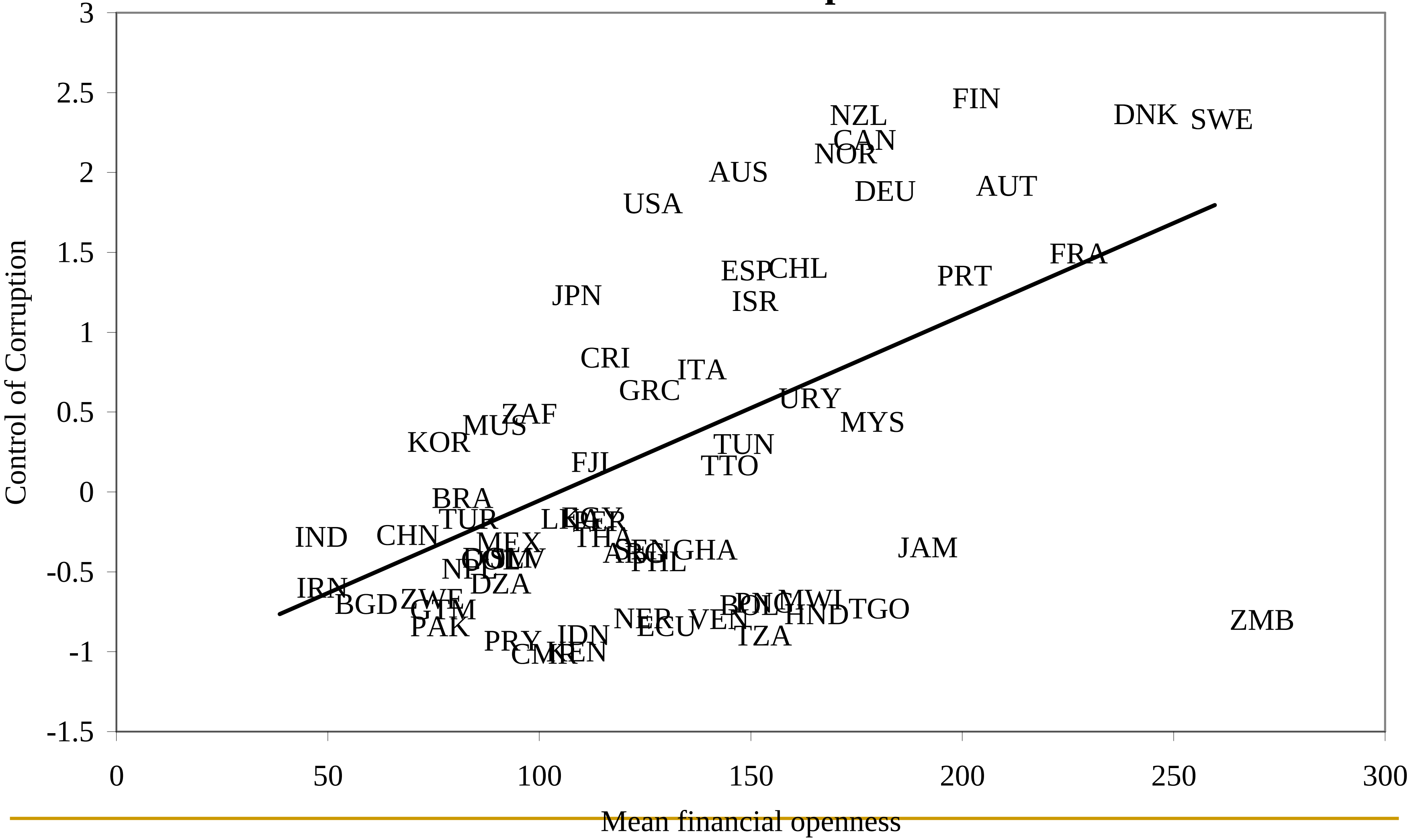


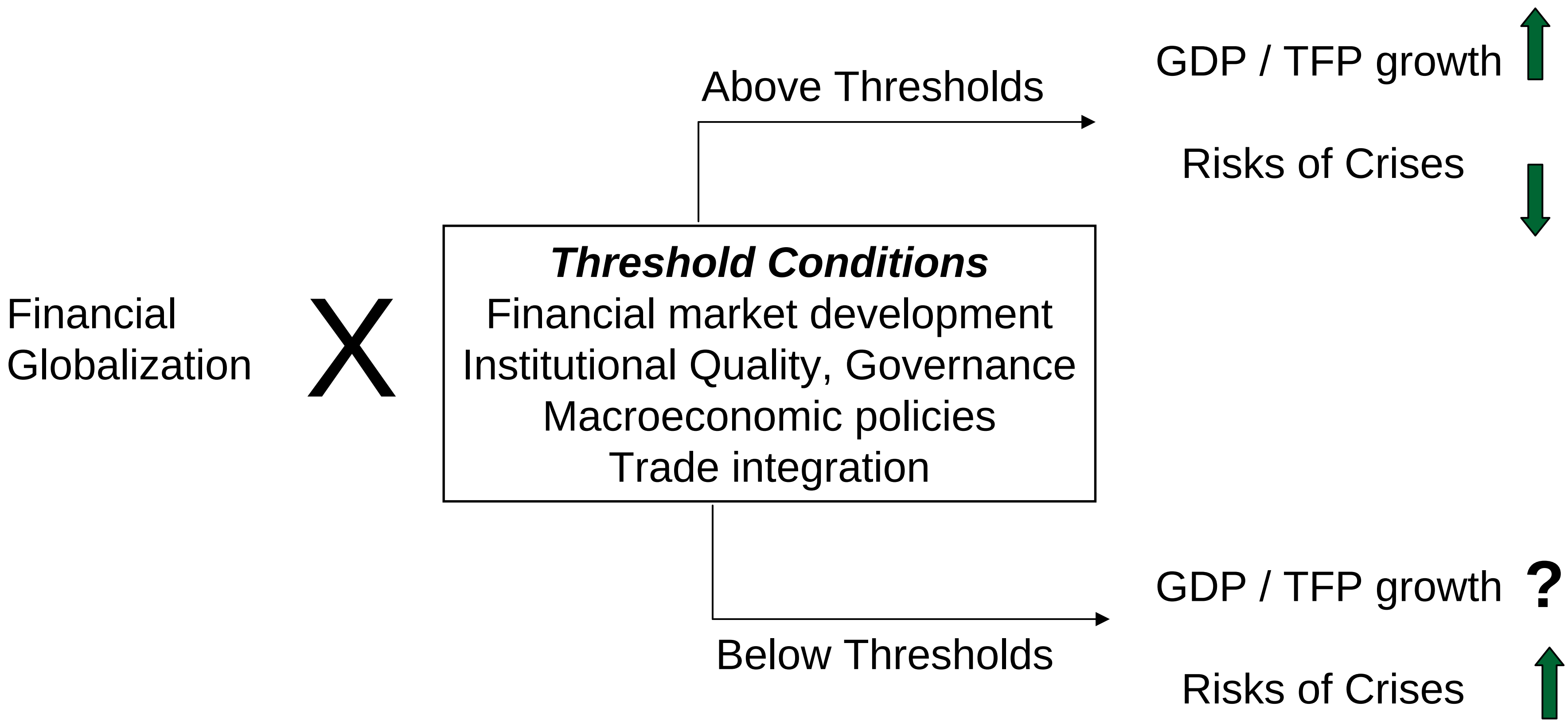
Figure 6B. Financial Openness and Quality of Institutions: 1985-2004
Control of Corruption



FG and Macroeconomic Policy Discipline

- Capital account liberalization as commitment device
- Even Stiglitz is on board!
- Sadly, limited evidence

Complication: Threshold Effects



Why Do Thresholds Matter?

- Financial Market Development

  - Allocates financial flows efficiently

  - Enhances macroeconomic stability

- Institutional Quality

  - Affects the volume and stability of financial flows

  - Shifts the composition of flows towards FDI and equity

- Trade Openness

  - Makes less vulnerable to sudden stops

  - Mitigates the adverse effects of financial crises

TENSION !!

- Financial integration can catalyze financial development, improve governance, impose discipline on macro policies...
- But, in the absence of a basic pre-existing level of these supporting conditions, financial integration can wreak havoc

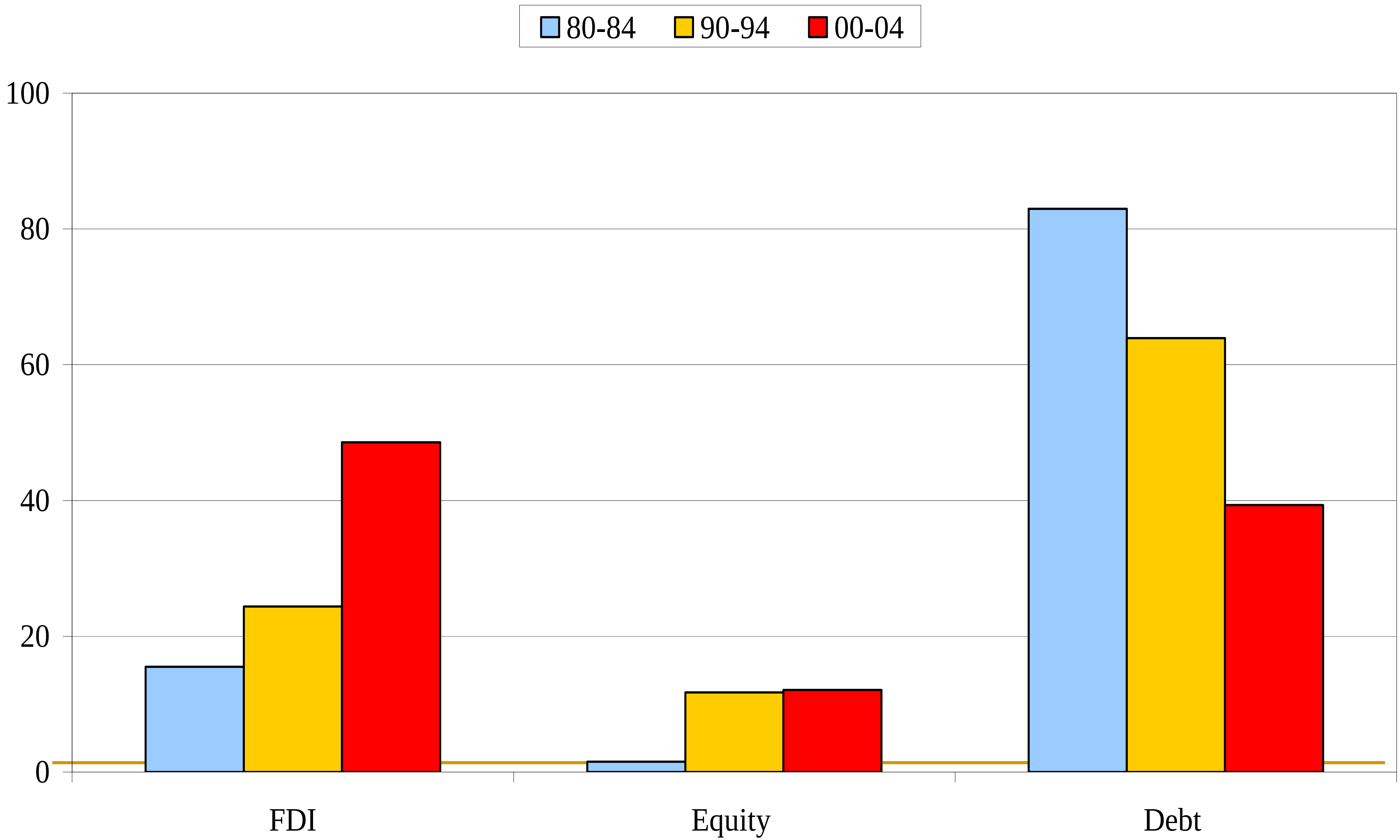
Collateral Benefits Framework May Help Make Progress

- Unified conceptual framework
- Country-specific requirements, initial conditions can be taken into account
- Selective approach to liberalization based on prioritization of collateral benefits
- Can manage risks during transition to thresholds, but can not eliminate them

Has the Benefit-Cost Tradeoff Improved?

- **Composition of inflows and stocks of external liabilities has become more favorable**

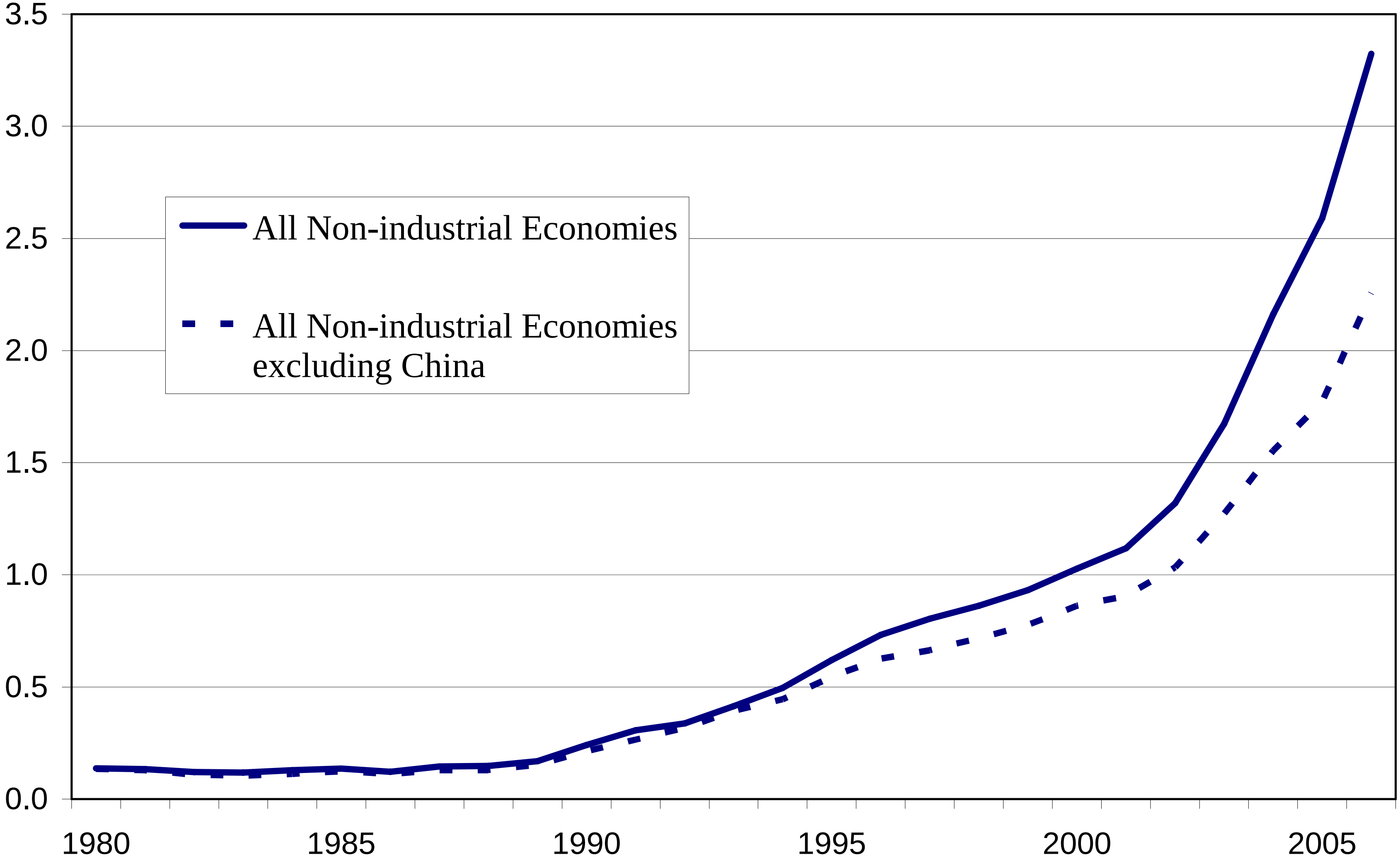
International Financial Integration:Distribution of Gross Inflows (% of Total)
Emerging Markets



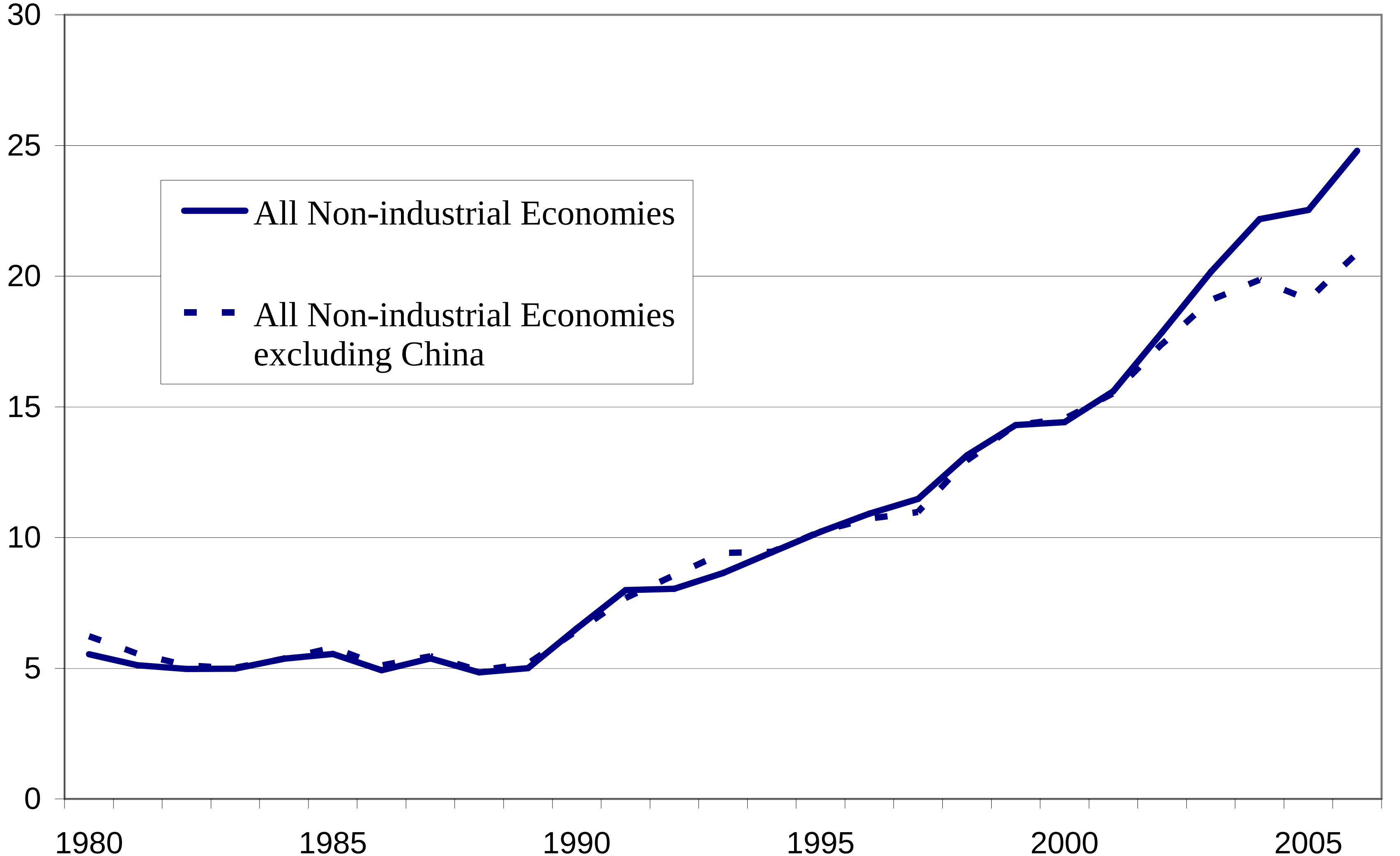
Has the Benefit-Cost Tradeoff Improved?

- Composition of inflows and stocks of external liabilities has become more favorable
- **High levels of foreign exchange reserves**

Foreign Exchange Reserves Held by Non-industrial Economies (in trillions of US dollars)



Foreign Exchange Reserves Held by Non-industrial Economies (as percent of nominal GDP)

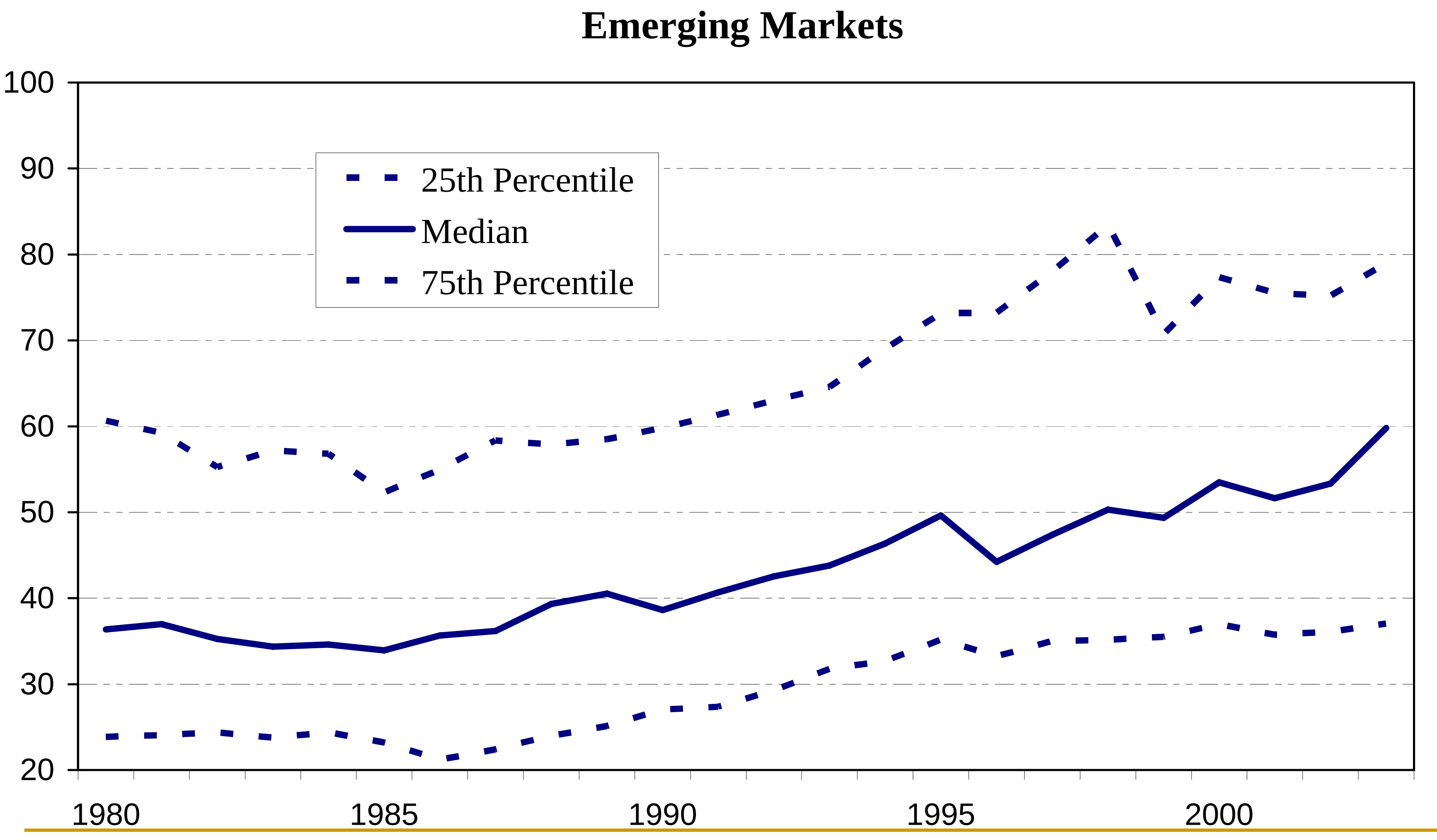


Has the Benefit-Cost Tradeoff Improved?

- Composition of inflows and stocks of external liabilities has become more favorable
- High levels of foreign exchange reserves
- Greater exchange rate flexibility, with inflation targeting
- **Rising trade openness**

Trade Openness

(the sum of imports and exports as a ratio to GDP, in 2000 constant prices)



Has the Benefit-Cost Tradeoff Improved?

- Composition of inflows and stocks of external liabilities has become more favorable
- High levels of foreign exchange reserves
- Greater exchange rate flexibility, with inflation targeting
- Rising trade openness
- New players, new instruments have made international financial markets deeper and more efficient

But …

- Many developing economies still below threshold levels of financial, institutional development
- Still de facto fixed or tightly-managed exchange rates
- Real exchange rate appreciations hurts poor and undeveloped economies
- Herding behavior of unregulated investors such as hedge funds + risks in system harder to trace

CAL: The Reality on the Ground

- Capital account becoming de facto more open
- De jure controls increasingly ineffective as channels for capital to flow in and out expand
    - Rising trade flows
    - Increasing sophistication of international and domestic investors
    - Other aspects of financial globalization

Implications of Rising Financial Openness

- Controls not very effective, especially beyond short horizons
- Controls on inflows have large distortionary costs
- Government constantly playing catch-up, which makes policy environment unpredictable
- Maintaining de jure controls despite rising de facto openness => economy has to deal with complications of open capital account but doesn't get full indirect benefits

Dealing with the Reality of CAL

- Key problem is mismatch between level of de facto openness and other policy settings
- Synchronize other policies to deal with open capital account:
  - ➢ monetary policy that can respond nimbly to shocks and focus on domestic objectives
  - ➢ well regulated and supervised financial markets
  - ➢ broadening of financial markets to reduce effects of capital flow and exchange rate volatility
  - ➢ fiscal discipline
  - ➢ trade openness

Pragmatic Approach to CAL

- Manage rather than resist CAL (latter futile in any case)
- Opportunistically liberalizing outflows makes sense in present circumstances
- But need to remove fetters on financial markets to promote vehicles for international portfolio diversification
- Increasing de jure openness can generate positive spillovers for financial market development--e.g., removing restrictions on participation of foreign investors in domestic bond markets
- Level of reserves makes CAL safer (but not riskless)

Complications from an Open Capital Account

- Monetary policy has to cope with domestic liquidity consequences of capital inflows
- Exchange rate management harder, both in terms of level and volatility
- Risks to financial system (if underdeveloped and/or weakly supervised) -- inflows could feed into asset price bubbles
- Regulatory and supervisory capacity may not be sufficient to keep up with foreign firms and financial innovations that they introduce (transitional risks)

Implications for Macro Policies

- Policy objective of tightly managed exchange rate could be counterproductive if capital account is de facto open
- Rising sterilization costs make exchange rate objective untenable
- Monetary stability essential to deal with volatile inflows
- Need a new nominal anchor to take place of exchange rate objective and to manage inflation expectations
- Reducing fiscal deficits and level of government debt is key medium-term objective, esp. to support monetary policy

Implications for Financial Market Regulation

- Financial market regulation must adapt to allow broad range of markets (e.g., currency derivatives) to develop and deepen
- This would provide a buffer against external shocks, and take some of the pressure off monetary policy as a short-term stabilization tool

Broader Policy Messages

- Financial integration can support and catalyze other reforms, especially financial development
- Best to actively *manage* the process of capital account liberalization rather than fight the inevitable
- Seize windows of opportunity when benefit-risk tradeoff improves; but coast is never completely clear.
- Capital account liberalization not an end in itself; needs to be put in the context of a more complete policy/reform agenda