CAC and Financial Crises

In the last article (May 21st), I had taken an overview of the policy choices made in three different eras, given the Impossible Trinity: a liberal capital account, an independent monetary policy and a fixed/managed exchange rate. In the gold standard era, countries gave up independent monetary policies; in the Bretton Woods fixed exchange rate system, members maintained capital controls; and over the last 40 years, the preferred choice of many countries – and of the IMF – has been floating exchange rates. In the context of India going for full capital account convertibility in a few years, as Governor Rajan expects, it will be useful to look at the implications for financial stability; growth; and cross border trade.

The number of financial crises in the three eras are summarised in the following table:

Period	Number of Crises
1875-1939	109
1945-1971	17
1973-2007	399

Source: Reinhart and Rogoff (2008).

(Note that the last number does not include the financial crises of 2008-09, nor the subsequent sovereign debt crisis in the euro zone.)

In *"This Time is Different: Eight Centuries of Financial Folly"*, Carmen Reinhart and Kenneth Rogoff, the latter a former Chief Economist of the IMF, emphasise "*the striking correlation between freer capital mobility and the incidence of banking crises……One common feature of the run-up to banking crises is a sustained surge in capital inflows,..a "capital flow bonanza" roughly involving several percent of GDP inflow on a multiyear basis …. The probability of a banking crisis conditional on a* *capital flow bonanza is higher than the unconditional probability"*. While I am aware that correlation is not necessarily cause and effect, in this particular case, there is enough supporting evidence to suggest that there is a cause and effect relationship between capital account convertibility and financial crises: it is difficult to believe that the relatively few crises in the middle period had nothing to do with the foregone policy choice out of the impossible trinity of monetary policy choices, viz. capital account convertibility. Even the IMF's Institutional View now envisages that capital controls may not be heresy in certain circumstances (more on this in a subsequent article). They could also make a comeback in the form of "macro-prudential" measures, as in South Korea a few years back, *"to prevent excessive 'hot money' inflows"* (Gillian Tett, Financial times, May 23, 2014).

But to revert to crises and a liberal capital account, the standard justification for deregulation of financial markets is that they allocate capital where it will fetch the highest returns to the global economy -- or at least to the owners of finance capital. The rationale used to justify huge loans to Latin American countries in the 1970s to finance external deficits resulting from increased oil prices, is best exemplified by the famous belief of Walter Wriston, the then chairman of Citibank, that *"companies can go bankrupt, countries do not"*. But they can default on external debt service and, starting with Mexico, country after country defaulted in the 1980s: the countries faced a decade of slow to negative growth, and the banks had to write off huge amounts: so much for the allocative efficiency of global finance capital!

In the 1990s too, many countries underwent crises thanks to liberal capital accounts. The first to default was, once again, Mexico which had pegged the peso to the USD, to help bring inflation down. It could sustain this despite external deficits, because of strong capital inflows in the domestic currency debt market, which had higher interest rates. As USD interest rates went up in 1994, the flows stopped, and Mexico faced a balance of payments crisis.

The boom in East Asian economies attracted a huge amount of capital inflows in the 1990s – FDI; portfolio investments in both debt and equity markets; foreign currency loans, both short term and long term; etc. The result was overvalued currencies, increasing deficits on the current account, and dependence on capital inflows to finance them.

When the Thai central bank could no longer maintain the parity of the currency, the baht fell sharply triggering a crisis which quickly reverberated into neighbouring countries: a classic case of the herd instinct amongst lenders/investors. As Prof Jagdish Bhagwati wrote in his *In Defence of Globalisation* (2004):

"Starting in Thailand in the summer of 1997, the Asian financial crisis swept through Indonesia, Malaysia, and South Korea, turning the region's economic miracle into a debacle. Capital, which had been flowing in, flew out in huge amounts. Where these four economies and the Philippines had attracted inflows of over $ 65 billion in 1996, the annual outflows during 1997 and 1998 were almost $ 20 billion, amounting to an annual resource crunch of over $ 85 billion – a staggering amount indeed! This caused currencies to collapse, stock prices to crash, and economies to go into a tailspin………Per capita incomes tumbled to almost one-third their 1996 level in Indonesia, with the other crisis-stricken Asian countries showing declines ranging from a quarter to nearly half of the 1996 levels.

"The East Asian crisis in 1998 had been a result of this unwarranted extrapolation from free trade, resulting in freed international capital flows".[i]

In *The Asian Crisis,* Robert Wade and Frank Veneroso quote Nobel Laureate James Tobin: ***'South Koreans and other Asian countries—like Mexico in 1994-95 – are . . . victims of a flawed international exchange rate system that, under US leadership, gives the mobility of capital priority .. over all other considerations'.***

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