The Other Side December 4, 2014

Seventy years of the IMF – II

In the last article I had referred to the IMF changing from being the administrator of the fixed exchange rate system to propagator of a liberal capital account and floating exchange rates, in the second half of its life. (Interestingly, the change of heart occurred with the Reagan presidency in the US, and its market fundamentalist ideology.) Before discussing the pros and cons of this issue, it will be useful to look at how monetary policy has undergone changes over the last 150 years.

In terms of Robert Mundell's Impossible Trinity, a liberal capital account, managed exchange rate, and an independent monetary policy cannot co-exist (at least in "corner", or extreme, circumstances). In the Gold Standard era, central banks gave up an independent monetary policy as money supply was determined by the gold reserves of the central bank; in the Bretton Woods fixed exchange rate system most countries eschewed a liberal capital account; and over the second half of its life, the IMF's policy stance has advocated eschewal of managed exchange rates. Interestingly, as Carmen Reinhart and Kenneth Rogoff find, the number of financial crises in the world economy was 109 between 1875 to 1935; 17 between 1945 to 1971; and as high as 399 between 1973 to 2007. Since monetary policy is concerned with financial stability, the evidence seems to suggest strongly that the Bretton Woods system resulted into the least number of crises. Earlier, IMF research (Study on Advanced Country Experiences with Capital Account Liberalization (2001)) had also concluded that "*A number of advanced economies suffered financial sector crises following capital account liberalization and financial sector reform (including Japan and some Nordic countries*)…… ***sound macroeconomic policies are important but not sufficient to avoid exchange rate volatility and potentially problematic capital flows***" (emphasis mine).

What about developing/emerging economies, many of whom have suffered financial crises after liberalizing capital flows? An IMF research paper concluded that "*the process of capital account liberalization appears to have been accompanied in some*

cases by increased vulnerability to crises". As for growth, "*if financial integration has a positive effect on growth, there is as yet no clear and robust empirical proof that the effect is quantitatively significant*" (*Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, March 17, 2003).

Turning now to market-determined exchange rates, one of the objectives of the IMF is to ***"****facilitate the expansion and balanced growth of international trade."* It is as well to remember that the foreign exchange market was born to facilitate trade between different currency regimes. The real exchange rate is extremely important for the expansion and balanced growth of international trade, particularly in the case of economies producing non-differentiated goods and services. Do market-determined exchange rates facilitate the movement of the real exchange rate to its equilibrium level, the level necessary for balanced growth of international trade, in an era of liberal capital account?

I can do no better than to quote from an article by Kenneth Rogoff, former Economic Counsellor and Director of IMF's Research Department, Finance and Development, (2002), "… *there is some tendency for a country's real exchange rate (the nominal exchange rate adjusted for differences in relative national price levels) to return to its historical value. But* ***the adjustment is very slow indeed. All empirical evidence suggests that one must think in terms of several years, not several months, for the pull of purchasing power parity to kick in."*** And, purchasing power parity in the tradeables sector is the economic fundamental that should determine exchange rate. Again, markets lost during those "several years" (domestic markets to imports, and export markets to other countries) are difficult to regain.

Flassbeck and Marca, economists with the United Nations Conference on Trade and Development, have argued (2007) that **the most important price for exports and imports is the real exchange rate. If it moves in the "wrong" direction, i.e.**

appreciating when the current account is in deficit, then there is no *"easy way out of a protracted imbalance. … such 'false' price movements should be avoided at all costs"*; *that "exchange-rate flexibility does not discourage portfolio and currency speculation unless interest rate differentials could be offset by the risk of depreciation, in periods of extreme volatility. In particular, if the herd behaviour of speculators is sufficient to appreciate the target currency, the appeal of large returns is sufficient to generate them."* It goes on to argue that "(Capital) ***flows moving from low-yielding, low-inflation countries to high-yielding, high-inflation countries would cause the currencies of the latter to appreciate, and provoke the paradoxical and dangerous combination of surplus economies experiencing pressures to depreciate, and deficit countries facing a correspondent pressure to appreciate.***

"floating currencies under various monetary policy regimes, rather than being immune to speculative operations actually stimulate them if the amounts available to investors are big enough to drive the market in a certain direction."

Promoting a liberal capital account is not part of the IMF's Articles of Agreement. There was an attempt to amend the Articles to include this as an objective – but it was abandoned after the crisis in East Asia. And yet, the IMF has continued to propagate the virtues of a liberal capital account and market-determined exchange rates. Its "Institutional View" on capital flows is supposed to have undergone a change in 2012, an issue I will come back to.

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