The Other Side April 7, 2016

"The Global Monetary Non-System"

In his articles and speeches, Dr. Raghuram Rajan has been arguing for policymakers in advanced economies to give greater weight to the repercussions their Unconventional Monetary Policies (UMPs) can have on the global economy. He emphasised the issue in two recent speeches in Delhi also. His worry is that UMPs can lead to global instability. The solution according to him is that "*multilateral institutions like the International Monetary Fund should exercise their responsibility for maintaining the stability of the global system by analysing and passing careful judgement on unconventional monetary policies (including sustained exchange-rate intervention). The current non-system is pushing the world towards competitive monetary easing, to no one's ultimate benefit."* (Project Syndicate article on "*The Global Monetary Non-System*", 1st January). In a more recent article (Project Syndicate March 21st) he has argued that "*As matters stand, central banks in developed countries find all sorts of ways to justify their policies, without acknowledging the unmentionable – that the exchange rate may be the primary channel of transmission."*

The issues raised are important, and need to be looked at carefully and dispassionately, in the light of empirical evidence. For one thing, the IMF itself, as an arbiter of macro-economic policies, is not free from ideological biases, some examples of which I had quoted in my last article. The second point is whether the exchange rate is the primary channel of monetary transmission. Arguably, the actual channel is not so much the exchange rate per se, but the impact of monetary policy on cross-border capital flows, which then influence the exchange rate. Therefore, if the monetary transmission of UMPs is to be curbed, the correct solution may be controls on capital flows. Dr. Rajan has not touched upon this issue. In fact, in his book *Saving Capitalism from the Capitalists* (2003) he has argued that a liberal capital account is an anti-dote to crony capitalism and budgetary indiscipline.

The other side is whether propagation of a liberal capital account by the IMF since the 1980s is itself the outcome of "crony capitalism". Many economists think so – and it was also the root cause of several financial crises. Dr. Jagdish Bhagwati has alleged that foisting a liberal capital account on developing/emerging economies was an example of Wall Street influencing the IMF in that direction with the help of the US Treasury. So has

Dr. Khairy Tourk, Professor of Economics, Stewart School of Business, Chicago, in a letter to the Financial Times (March 10, 2012): "*The 1997 crisis* (in East Asia)*, on the other hand, was a result of an International Monetary Fund policy that reflected Wall Street interests. The US Treasury, in the 1980s, prodded the IMF to push for the immediate liberalisation of the capital account in emerging economies."* (It was precisely to mitigate the influence of the U.S. Treasury on IMF that Keynes wanted the IMF headquartered away from Washington: he failed.) The crises in Mexico (1994-95), Brazil and Russia (1998), Argentina (2000-01), etc. have the same root cause. As William R. White, Chairman of the Economic and Development Review Committee of the Organisation for Economic Co-operation and Development, has recently argued, "*hot money, funds that flow from one country to another from investors seeking the highest returns, can wreak havoc – both on the way in and out"* (Finance & Development March 2015). Martin Wolf seems to agree: to quote from *"The Shifts and the Shocks",* his recent book on the financial crisis, *"No sensible economist would today – after so much painful experience -- advise* (emerging) *countries to simply open their capital accounts to the world and ignore the risks of excessive inflows… falling incentives for the production of tradeable goods and services, and severe financial and economic crises"*.

Back in 1962, Robert Mundell had propounded the "Impossible Trinity": a fixed/managed exchange rate, the free movement of capital and an independent monetary policy cannot be simultaneously maintained. Since then the scale of cross-border capital flows has increased so enormously that, in the view of Helene Rey, Professor of Economics, London Business School, this needs to be revised to a dilemma: the belief that *"a flexible exchange rate can insulate you from financial shock"* as argued by inflation targeters, is not realistic; *"independent monetary policies are possible if and only if the capital account is managed."* (Finance and Development, June 2015).

The third issue following from Dr. Rajan's view is whether the relationship between interest and exchange rates is consistent, a point I will revert to in the next article.

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