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Vicious Circles

In the last article on IMF research on capital inflows, I had concluded by saying that what the paper omits to touch upon is even more significant. Consider, for example, the question of the growth benefits of a liberal capital account. The February 2010 paper makes no mention of the fact that there is no empirical evidence to suggest that a liberal capital account leads to faster economic growth (Financial Globalization: a Reappraisal by M. Ayhan Kose et al, IMF, August 2006; Dani Rodrik, 1998).

The second major omission is any reference to the vicious circle excessive capital inflows can trap the recipient country into. From Mexico in 1994-95 to east Asia in 1997-98, Russia and Brazil (1998), Argentina (2001) and more recently Iceland and Latvia: in each case, the crisis was the result of excessive capital inflows, appreciating domestic currencies leading to an uncompetitive tradables sector, and increasing deficits on the current account. One day “the music stops playing” resulting into a balance of payments crisis and misery for the people, particularly the relatively worse off. There is, again, no mention of the fact that, in the east Asian crisis, Malaysia managed to avoid IMF’s deflationary medicine by resorting to capital controls – unlike Thailand, Indonesia and South Korea – and, as a result, suffered far less. Equally predictably, the research fails to refer to the fact that the two fastest growing major economies of the world have not seen the need for a fully liberal capital account.

Overall, the only way to avoid getting caught in the vicious circle is to stop domestic currencies from appreciating in real effective terms, by central bank intervention (and sterilization). And, if this is considered too costly for any reason, there should be no hesitation in imposing controls on capital inflows in the form of taxes and/or reserve requirements. But, as I said last week, this goes against the primacy given to finance capital over the real economy in the IMF's approach. Indeed, one can hardly escape the conclusion that the IMF approach is driven by an ideology that has become fashionable in the Anglo Saxon economies, particularly in the last three decades (rather than a dispassionate analysis of the risks and rewards of capital flows, or consciousness of the needs of the real sector). Keynes, one of the authors of the post-war international monetary system, had apprehended the possibility and tried his best to have the Bretton Woods twins headquartered away from Washington (to reduce its ideological influence), but did not succeed. Since the IMF continues to be wedded to an ideology ignoring all evidence, the developing world needs to look at its advice on exchange rates and the virtues of unfettered capital inflows, with a big pinch of salt.

Some European countries, particularly Greece, have been entrapped in another vicious circle, starting with the global recession resulting from the crisis in financial markets originating in the U.S. sub-prime mortgage market. The existing fiscal deficits worsened, leading to difficulties in selling sovereign debt in the market at acceptable yields; a rescue package which calls for further tightening of fiscal policy through increased taxation and lower public spending had to be put in place. The deflationary package would surely worsen the growth prospects, increase unemployment and lower tax revenues, possibly failing to meet the deficit cut objective. As far as Greece itself is concerned, the big uncertainty is whether, once the existing € 110 bn package is used up in 3 years time, it would be able to return to capital markets. By then, sovereign debt as a percentage of GDP may well reach as high as 150%, but the exposure of foreign holders, particularly banks, would have come down thanks to the bonds maturing in the interim.

Other countries in Europe, including major ones like U.K. and Germany, are tightening their budgets. This makes the prospects of a double dip recession in Europe ever more likely (although the sharply lower euro should help the tradables sector). And, the problems become even more when regard is had to Europe’s demography, with an increasing proportion of retirees to the working population. This apart, since the European Union is the largest single economy in the world, what happens there would surely have repercussions for global growth.

French and German banks have huge exposures to sovereign bonds issued by Greece, Portugal and Italy, as also private sector borrowers in these countries. According to an estimate of Royal Bank of Scotland economists, the total exposure of banks outside Greece, Portugal and Spain to private and public debt of these countries, is as high as € 2 trillion! (Recently, Spain has been downgraded from its AAA rating by at least two major rating companies.) No wonder, European banks are finding it difficult to borrow at LIBOR in the market – and the gap between the 3-month LIBOR and the corresponding overnight indexed swap rate has widened in recent weeks.

The big question is whether the crisis in Greece is one of liquidity or of solvency, requiring, at some stage, restructuring of its sovereign debt.

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