The Other Side December 18, 2014

Seventy years of the IMF – III

The IMF's "Institutional View" on capital account was last articulated in November 2012: "*The Liberalisation and Management of Capital Flows*". The view maintains that "*capital flows can have substantial benefits .. by enhancing efficiency, promoting financial sector competitiveness, factoring greater productive investment".* While it does see the need for capital controls in certain circumstances, but not as *"substitute for warranted macroeconomic adjustment"*, there is very little analysis of the impact of capital flows on the real exchange rate and external imbalances. There are many references to member countries' obligation under Article IV of the IMF's Articles of Agreement not to "manipulate" exchange rates, but none to Article I which requires the IMF to *"facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income… as primary objectives of economic policy."*

Earlier, in its Annual Report on Exchange Arrangements and Exchange Restrictions 2011, the IMF had asserted that, "*The economic benefits of cross-border capital flows are considered to be similar to those emanating from free trade."* The subsequent 2012 Report, published in October, also emphasises the same point as a "Special Topic". It claims that on the basis of an economic analysis of 37 countries which liberalized capital flows between 1995 and 2010 (from Afghanistan to Uganda, the only two major economies in the sample being Korea and Russia), liberalization is associated with "higher real GDP growth per capita", "lower inflation rate" "higher equity returns", "lower bank capital adequacy ratios", and "higher capital inflows and outflows". There is no reference to China, for example, registering higher growth than every country in the sample without a liberal capital account. And, what about the missing variables?: oil price in the case of Russia; monetary policy; the management of the exchange rate; etc. etc. One also wonders to what extent the "sample" of 37 countries was chosen to support the desired conclusion. Interestingly, a background paper (*Liberalising Capital Flows and Managing Outflows,* March, 2012) came to different conclusions:

⇒ *The empirical evidence on the benefits of liberalizing capital flows is fairly mixed;*

⇒ *The main cost of capital flow liberalization is vulnerability to financial crises brought on by large and volatile capital flows.*

Christine Lagarde, the IMF's Managing Director, repeated the second point in an article in Finance and Development (September 2014): "*greater financial integration raises the probability and size of financial crises."*

Even more important is what the IMF said about correcting global imbalances, when the issue was hot: "*historical episodes of large and sustained imbalances and their reversal clearly suggests that **a market-led realignment of real exchange rates** can play an important complementary role to demand rebalancing across countries to facilitate a smooth unwinding of external imbalances*. ***Market-led movements of real exchange rates** …would support a broader rebalancing of domestic demand across key regions that could facilitate the unwinding of the imbalances*". (*Chapter 3: Exchange Rates and the Adjustment of External Imbalances,* IMF, World Economic Outlook, April 2007).

I have two major disagreements with this approach:

⇒ Would "managed" exchange rate movements in the desired direction not be equally effective? Why do they have to be "market-led"?

⇒ And, are market-led or determined exchange rate movements necessarily, or even usually, in the direction of the equilibrium rate of exchange? Particularly when capital flows, and not exports and imports, determine them, often moving the rate away from its equilibrium value over extended periods of time?

As for the first point, and the Article IV obligation of member countries, Joseph Gagnon of the Peterson Institute, has argued ("*Combating Widespread Currency Manipulation",* 2012) that, "***Currency manipulation occurs when a government buys or sells foreign currency to push the exchange rate of its currency away from its equilibrium value** or to prevent the exchange rate from moving toward its equilibrium value. The equilibrium value of a currency is that which is sustainable over the long run.… An exchange rate is sustainable if the current account balance is not generating* *an explosive path for net foreign assets relative to both domestic and foreign wealth. Sustainability generally implies* ***a small value of the current account balance****,* ***but fast-growing economies can maintain moderate current account deficits as long as the associated liabilities do not grow faster than their economic output*****".** (In our case, they have grown much faster than the GDP.)

To elaborate the second point, market-determined prices often move away from their equilibrium levels for a long time, indeed years: whatever the conclusions of the efficient market theory. This is all the more so in a market where trading volumes are a hundred times more than the global trade in goods and services, to serve which the market was born. There could be two different reasons for the IMF's failure to analyse properly the impact of capital movements, their impact on exchange rates, and hence on output and employment:

- ⇒ The academic background of most IMF economists: "***in a number doctoral programs*** (in the US) ***a student can specialize in macroeconomics without knowing what an exchange rate is, much less an emerging market economy***" (Olivier Blanchard, IMF's Economic Counselor and head of its Research Department, in *Finance and Development*, September, 2014);

- ⇒ Market fundamentalism in Washington. As John Kenneth Galbraith has argued in his *History of Economics* (1987), economic theories often reflect the ideology of the dominant power.

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