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IMF Research on Capital Flows

I had earlier commented in this column on how fickle the views of the IMF researches, over the issue of exchange rates, have been over the years. The February 2010 IMF Research Department paper titled “Capital Flows: The role of controls” seems equally to skirt around the basics, never touching, for instance on the experience of the balance of payments crises over the last two decades. True, the paper has a disclaimer that “the views…… should not be attributed to the IMF”: but the Global Financial Stability Report, April 2010, which surely represents IMF’s views, also makes some curious points to which I will come back in a later article.

The paper starts with asserting that “*These flows, and capital mobility more generally, allow countries with limited savings to attract financing for productive investment projects, foster the diversification of investment risk, promote intertemporal trade, and contribute to the development of financial markets*”. Shorn of jargon, the first part makes the utterly obvious point that capital inflows can finance the savings: investment gap, i.e. the deficit on current account. How promoting “intertemporal trade” becomes a different gain is difficult to appreciate. Some explanation about the expression “intertemporal trade” is in order. In IMF-speak, it means “*importing goods today (running a current account deficit) and, in return, exporting goods in the future (running a current account surplus then)”* – (Do Current Account Deficits Matter?” Atish Ghosh and Uma Ramakrishnan, Finance and Development, December 2006). Once again, this means inflows finance current account deficits.

The second gain is “diversification of investment risk”; but surely this is a gain for the investor, and not to the recipient of inflows? As for the development of financial markets, for many western commentators, the root cause of the 1997-98 crisis in East Asia, in countries with a liberal capital account regime, was the weaknesses of their financial markets (and crony capitalism) – so the liberal capital account regime had obviously not done much to improve financial markets. Indeed, even the supposedly mature and developed financial markets in the United States found it difficult to manage the huge capital inflows. Ben Bernanke himself has been quoted by the Financial Times (October 20, 2009) as saying that the recent US-centred financial crisis had many similarities with past emerging market crises -- fuelled by giant capital inflows that overwhelmed both market discipline and regulatory safeguards. Again, as Carmen Reinhart and Kenneth Rogoff argue in their recent book *This Time is Different*, "*The U.S. conceit that its financial and regulatory system could withstand massive capital inflows on a sustained basis ….. arguably laid the foundations for the global financial crisis of the 2000s.* And, the U.S. has always had the "benefit" of a liberal capital account." (Mr. Rogoff was earlier the Chief Economist of the IMF)

The paper then goes on to assert that "*the benefits from a free flow of capital across borders are similar to the benefits from free trade…, and imposing restrictions on capital mobility means foregoing, at least in part, these benefits, owing to the distortions and resource misallocation that controls give rise to"*. This is an extremely dubious proposition: the gains from free trade in goods and services stem from the principle of comparative advantage, specialization and economies of scale. Such is not the case in respect of capital flows: in the very next paragraph, the paper concedes that "*policymakers are again reconsidering the view that … that all financial flows are the result of rational investing/borrowing/lending decisions. Concerns that foreign investors may be subject to herd behavior, and suffer from excessive optimism, have grown stronger; and even when flows are fundamentally sound, it is recognized that they may contribute to collateral damage, including bubbles and asset booms and busts*". It is truly amazing that the IMF seems to have learnt about market psychology only in the 21st century! Keynes made the point a long time back, comparing market psychology to a beauty contest: *"It is not the case of choosing those which, to the best of one's judgement are really the prettiest, nor even those which average opinion genuinely thinks is the prettiest ... we devote out intelligences to anticipating what average opinion expects the average opinion to be".* Too much of investment activity in the domestic or cross border markets is driven, not by a rational analysis of the risks and rewards, but by trying to anticipate "what average opinion expects the average opinion to be" – in other words, the herd instinct.

Later, the paper goes on to accept, with a lot of “if”s and “but”s that “*if the economy is operating near potential, if the level of reserves is adequate, if the exchange rate is not undervalued, and if the flows are likely to be transitory, then use of capital controls — in addition to both prudential and macroeconomic policy—is justified as part of the policy toolkit to manage inflows*”. In simple English, I suppose they mean that if capital inflows are leading to on overvalued currency, control them!

There are many others myths which the paper propagates; I would revert next week.

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