WORLD MONEY May 31, 2010

IMF Research on Capital Inflows - II

In the last week's article, I had commented on the February 2010 IMF research paper titled *Capital inflows: The Role of Controls*. To continue, the paper also advances some other questionable propositions. For example, discussing the sterilisation of an increase in money supply resulting from central bank intervention in the market, it claims that "sterilization means that domestic interest rates continue to be relatively high, perpetuating inflows." The assertion is less than sound on both the points:

⇒ To the extent sterilization is limited to the money pumped in the system through intervention, the market liquidity and interest rates should remain *where they would have been in the absence of intervention and sterlisation*. The rates will remain "relatively high" only if they were so before the intervention and sterilization, for reasons of monetary policy.

⇒ Equally questionable is the proposition that higher interest rates may perpetuate inflows. The assertion is certainly wrong in relation to equity markets, as high interest rates reduce growth and have a bear influence on equity prices. Even in the case of debt markets, it could be argued that prospects of higher rates through sterilization, if apprehended, may well lead to capital outflows with existing foreign investors liquidating their investments in anticipation of a price fall, and taking money away.

The paper goes on to argue that controls on capital inflows "may form a useful part of the policy toolkit. This is particularly true of transitory surges, because the currency appreciation is likely to be temporary, whereas damage to the tradable sector (through hysteresis effects) may be more permanent." (Like the term "intertemporal" referred to in the last article, I also needed to look up the word "hysteresis". It merely means "the lagging of an effect behind its cause": why not the simpler word "lagged"?) While one has no quarrel with the point made, the following argument has some extremely serious implications: "if the increase in flows is expected to be more persistent, by contrast, the economy should adjust to the (permanently) higher real exchange rate". The IMF's Global Financial Stability Report, April 2010, articulates the same point slightly differently saying that "more permanent increases in inflows tend to stem from more fundamental factors, and will require more fundamental economic adjustment" (The GFSB makes arguments similar to those in the research paper on capital controls in general.) So the suggestion is that some kinds of capital controls are tolerable if inflows are transitory, but not if they are of a more permanent nature. Even assuming that one can foresee whether inflows are transitory or permanent, what exactly are the "more fundamental" economic adjustments "to the (permanently) higher real exchange rate" the wise men are referring to?

One could be productivity growth in the tradables sector to make the economy competitive at the high exchange rate: but this surely is a slow, gradual process; the exchange rate can appreciate much faster and do permanent damage to the tradables sector as the paper acknowledges, well before productivity catches up with the exchange rate. The second is deflation of the domestic economy, through tight monetary and fiscal policy, lower consumption and price levels to make domestic costs in the tradable sector competitive at the higher exchange rate. Even assuming that the higher interest rates resulting from a tight monetary policy do not lead to even larger capital flows as the IMF researchers seem to believe, surely a fall in domestic prices would require a cut in wages: is that a feasible proposition? This is not as fanciful an argument as it may sound. The British actually did this in the 1920s while restoring the pound's gold parity to prewar levels, succumbing to the arguments of the City that this was needed to maintain London's position as the global financial capital. It led to a general strike by the unions, a deep depression inflicting huge misery on the people, before the foolish policy was abandoned.

Another fundamental economic adjustment could be that, if a country like India is attracting huge capital inflows in the equity market because it is one of the two fastest growing major economies in the world, it should reduce growth rather than resorting to capital controls!

Is there any other “adjustment” which I am missing? What is truly astounding about the IMF line of thinking in both the staff paper and even the Global Financial Stability Report is the unstated assumption that the real economy must adjust to whatever exchange rate the financial economy produces; that the real economy must remain a servant of the financial economy. The article of faith is that the freedom of unregulated finance capital must have priority over the needs of the real economy! It is truly amazing that such implications are integral to the line being advocated less than two years after the excesses of the financial economy brought the world to the brink of a global depression.

What the paper does not discuss about other basic issues relating to capital inflows is equally interesting: more on this in a later article.

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