

## Introduction and Conclusions

This is a report about capital inflows. But we must resist the temptation to analyse capital inflows in too simple a manner, thinking only about the determinants of the inflows themselves and their effects. One must consider capital inflows in the broader context of macroeconomic developments and analyse the inflows jointly with the appropriate policy responses to those developments.

Why might such policy interventions be desirable? Capital inflows, after all, have long been regarded as both a sign and a cause of economic success. Borrowing abroad permits investing up to the point where the marginal return equals the cost of capital, while smoothing the path of consumption over time. Yet capital inflows can give rise to serious problems

- ❖ real exchange rate appreciation, current account deficits, and falling profitability in the production of tradeable goods (endangering 'export-led growth')
- ❖ gradual accumulation of an excessive foreign currency debt burden
- ❖ sudden shocks from reversal of the inflows (volatility)

Capital inflows may cause macroeconomic instability, while domestic microeconomic distortions can both exaggerate and misdirect the flows.

This report will argue that there are three resulting sets of policy issues which are to be faced and will draw some clear conclusions:

- ❖ Macroeconomic policy responses to the inflows
  - A stable real exchange rate is important, but countries facing sustained capital inflows may have to accept a trend

appreciation, especially if the capital inflows go in parallel with rapidly increasing productivity that underpins the appreciation.

- Sterilised intervention may be useful when a capital inflow is temporary, but it is unsustainable and unwise in the face of longer-term inflows. Unsterilised intervention is likely to give real exchange rate appreciation through inflation, which is less desirable than a nominal exchange rate appreciation.
- It is usually very difficult to judge whether inflows are temporary or long-term; so avoid strictly pegged exchange rates. But this is not the fundamental choice; the basic issue is whether or not to accommodate the capital inflows – but this will depend on the assessment of their persistence. Meanwhile, a wide range of diverse policy instruments can be used, none of which is likely to be sufficient alone.
- Control budget before opening up the capital account, but in the face of large capital inflows, contractionary fiscal policy is an appropriate response only if the inflows are judged to be temporary.
- Without a nominal exchange rate 'anchor', there is an urgent need for an institutional framework that will firmly underpin monetary policy.
- Opening up capital markets requires standards of prudential regulation and supervision of financial institutions that are even higher and stronger than in open developed economies.

- There is no simple set of reliable 'early warning indicators' for financial crisis.
- ❖ Policy in respect of capital inflows themselves
  - There are convincing arguments not to try to steer foreign investment into FDI rather than portfolio equity investment.
  - Preserve freedom for the timing of liberalisation, which should wait upon whether the appropriate institutional framework is yet ready.
  - Retain or install appropriate capital controls during the process of liberalisation in other domains (several countries appear to have been successful with capital controls, most notably Chile and Malaysia).
  - Keep credit rationing in reserve during the process.

These freedoms may be transitional freedoms and may be consistent with the signing of a no-rollback clause in the forthcoming transfer of investment code measures from the OECD to the World Trade Organisation. But there are conflicting considerations: signing on to an multilateral investment code will convince investors that policy risk is less, and that will make countries less vulnerable to sudden withdrawal; yet it will also restrict freedom to use policy instruments which could ease the adjustment costs of transition to a more liberal open regime.

- ❖ Policy in respect of global systemic reform
  - The IMF should continue to improve data availability as a source of information to the markets, but should not function as a ratings agency – its confidential assessments from surveillance should remain confidential.
  - The IMF's new Emergency Financing Mechanism will require, to be effective, a significant increase in IMF quotas.
  - The GAB, even augmented, is unlikely to be much help to any but the largest developing countries.

- There may be a useful role for regional central bank cooperation to supplement multilateral arrangements; but this will not be easy to organise.
- A 'Tobin tax' seems unlikely to be an effective response to the main problems raised by capital inflows – i.e, the loss of domestic monetary control and vulnerability to financial crisis.
- The G10 recommendations for resolution of sovereign debt crises would be steps in the right direction, but mechanisms and contractual changes providing for bondholder representation, qualified majority voting, and sharing clauses in bond covenants are highly unlikely to evolve in a 'market-led' process – they will need strong official encouragement and involvement.
- The IMF Executive Board should accept without delay the G10 recommendation that 'lending into arrears' be regarded an appropriate IMF policy under stated conditions (that are not unduly restrictive) to deal with financial crises involving securitized debt.

The plan of the rest of the paper is as follows. Chapters 2 and 3 provide background; first of all a historical perspective and then an introduction to current issues and prospects. The main argument of the paper begins in Chapter 4, with a discussion of the reasons for huge increase in capital flows to the developing world which has occurred since the beginning of the 1990s. Chapter 5 discusses the appropriate macroeconomic policy responses to these flows. Chapter 6 discusses possible policies directed at limiting the flows themselves. Chapters 7 and 8 are directed towards discussing the reforms of the international monetary system which we believe are necessary, including improving crisis prevention measures, necessary measures relating to the management of illiquidity crises, and the putting in place of better procedures for the management of sovereign debt workouts.