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Conference of the German Development Institute / Deutsches Institut für Entwickllungspolitik (DIE) on

Managing International Capital Flows for Sustainable Development

Berlin, 17 December 2012

- Conference Report -

Keynote Speech: “Managing Global Capital Flows”

José Antonio Ocampo, Columbia University

In his keynote **José Antonio Ocampo** gave an overview on the complex macroeconomic policy choices developing country governments are confronted with due to the volatile nature of capital flows. The monetary policy of advanced countries in the aftermath of the international financial crisis poses severe challenges to emerging and developing countries which recently prompted the IMF to change its “institutional view” regarding the management of the capital account in developing countries. As a result of the financial crisis the capital account determines macroeconomic dilemmas in many developing countries. Fiscal policy has to be countercyclical but cannot become hostage to capital inflows. Monetary policy also has to be countercyclical but this leads to high interest rates which attract even higher capital inflows. These and other potential economic costs of capital inflows – due to prevalent currency and maturity mismatches between capital inflows and domestic demand for capital – contribute to the necessity of capital account regulation in developing countries.

On a global dimension the low interest rates in advanced countries lead to a redistribution of capital to emerging and developing countries with potential negative externalities. However, nobody asks surplus countries – including the surplus countries within the Eurozone – to regulate capital outflows, despite cross-border flows being part of the problem of global imbalances. Destabilising capital flows put an undue pressure on emerging and developing countries and demand costly macroprudential measures and capital account regulation which have to be regarded as negative spillovers of the policies of advanced countries affecting the real economy in developing countries. The global economy needs a better segmentation of capital markets in order to avoid the high welfare costs of policy coordination failures in the global financial system.

Session 1: Dealing with Global Liquidity and Volatile Capital Flows

Chair: Ulrich Volz, SOAS, University of London and DIE

Presenters:
Jae Young Lee, ASEAN+3 Macroeconomic Research Office
Heiner Flassbeck, UNCTAD
Ingo Bordon, DIE

Jae Young Lee (ASEAN+3 Macroeconomic Research Office) showed evidence that capital flows to the East Asian region became recently more volatile and this increase has its roots in volatile portfolio and bank lending flows, while FDI remained a rather stable source of capital. Risks from macroeconomic policies in advanced economies affect emerging Asia through two channels: the trade channel and the finance channel. In particular, risks to financial stability by volatile capital flows are created by excessive credit growth, rapid appreciation of the currency, an increase in asset price inflation, and investment in local debt instruments. Jae Young Lee presented macroprudential measures taken by Korea, a small, very open economy with large external debt and a strong preference of borrowing in foreign liquidity markets. Korea implemented three instruments, among these a limit on foreign exchange forward positions and a macroprudential stability levy. Both instruments are chosen to mitigate risks in the banking sector stemming from wholesale borrowing in foreign currency. Implementing these instruments the Korean macroprudential policymaker made sure not to impose direct controls but affecting the cost structure of refinancing in the banking sector. Moreover, the policymaker installed a flexible system to be able to adjust the instruments to the effective needs of the policymaker. Overall the macroprudential policy appears to be quite effective.

Heiner Flassbeck (UNCTAD) underlined the strong correlation between financial markets, in particular the equity, commodity and foreign currency markets, during the 2005-2008 period. Especially the exchange rates of emerging economies appear to be mispriced due to short term capital flows. Carry-trades seem to be a driving force behind large deviations of nominal exchange rates from purchasing power parity. These are induced by high differences in interest rate levels between advanced and emerging economies and a market situation which allows herding of market participants. He suggests that foreign currency interventions and the accumulation of foreign reserves may be a short term solution but in the longer run he advocates a fixed exchange rate system that sets exchange rates in relation to effective purchasing power parity.

Ingo Bordon (DIE) presented empirical evidence that the increase in global liquidity led to strong increases in commodity prices and, even more important, in much higher volatility of commodity prices. This empirical evidence suggests that commodities have become a financial asset class, so that a co-movement of liquidity and commodity and food prices can be expected for the coming years. This new development became evident from 2007 on, when a clear structural break in the data series can be detected. Potential policy measures should focus on balancing supply with demand and on containing excessive speculation in commodity and in particular food markets, for example through position limits for market participants. Any measure should be evaluated by analyzing its impact, feasibility and market friendliness.

The discussion emphasized that although the strong increase in global liquidity and the following volatile capital flows are a consequence of the easing of monetary policies in advanced economies, it is not a solution to refocus monetary policy at this point in time since it is the only instrument available to stimulate the world economy which is still rather weak. To avoid excessive price inflation and volatility in commodity, but especially in food markets, these need to be regulated more tightly with respect to speculative investments, although care has to be taken to design effective regulation. Regarding the accumulation of foreign reserves and foreign exchange intervention as a measure to dampen overvalued exchange rates, it was noted that both instruments also entail high costs.

Session 2: Role of the IFIs in Providing Liquidity and Long-term financing beyond the Crisis

Chair: Peter Wolff, DIE

Panelists:
James Roaf, International Monetary Fund
José Antonio Ocampo, Columbia University
Margret Thalwitz, Centre for Global Cooperation Research & University of Oxford
Jürgen Zattler, BMZ

This session offered an institutional perspective to the discussion on managing capital flows for sustainable development. It discussed the IFI's responses to the global financial crisis and the appropriate division of labor among the IFIs.

Panelists agreed that during and in the aftermath of the global financial crisis Multilateral Development Banks (MDBs) and other International Financial Institutions (IFIs), including the Regional Development Banks, have provided important counter-cyclical support to crisis-affected countries by supplying financial resources. The MDBs saw substantial capital increases which allowed them to expand their lending, particularly to middle-income-countries. The IMF has been spending a large part of its additional resources to over-indebted countries in Europe and also revamped its lending toolkit. The provision of liquidity provided positive signals to international capital markets. Signaling helped to boost confidence and increased the policy space for some crisis-hit countries by reducing their refinancing costs in international capital markets.

However, some aspects of the crisis response of IFIs were more problematic: For instance, there is a need to improve the IMF's existing tools as residual stigma, limited automaticity and predictability of contingent credit lines remain challenging. There is also a need to introduce new tools and approaches such as secondary market bond purchases and the strengthening of relationships with the regional firewall architecture. In addition, the crisis response of the World Bank came with a lag as considerable time passed between approval and disbursement of funds. The crisis also exposed severe imbalances and debt problems which are much more difficult to resolve and the IMF is now still struggling with these questions.

The crisis has demonstrated that the envisaged division of labor – with MDBs focusing on long-term lending and the IMF on short-term lending in times of crisis – is flawed and there are overlaps. In particular, MDBs have played an important role in crisis prevention and containing contagion by playing a counter-cyclical role. This warrants reviewing the mandates of MDBs with respect to their role in crisis prevention, eventually strengthening crisis response instruments and the mandate in monitoring financial sector weaknesses. Despite the overlaps between the roles of MDBs and IMF, panelists agreed that they should play complementary roles. Liquidity management and provision

as well as surveillance are considered the IMF's core roles. However, it was noted, that the IMF is likely to face challenges in playing its surveillance role effectively vis-à-vis powerful countries. Panelists agreed that MDBs' crisis lending will remain limited because of several limitations. In particular, the MDBs capital base remains inadequate for the provision of liquidity at a large scale in times of crises, despite MDBs' currently greater headroom through capital increases. However, given fiscal pressures in many industrialized countries, contributions from emerging powers are crucial for further capital increases of MDBs. These countries in turn are reluctant to provide more capital without changes in the governance structure and their representation in MDBs. Moreover, mandates for prudent lending pose limits to the extent to which MDBs can play a counter-cyclical role during crises.

The discussion highlighted that for the World Bank, as a key institution for long-term financing, it is crucial to review its governance structure and scale-up long-term financing for infrastructure, inclusive green growth and global challenges. Otherwise emerging powers, which are particularly interested in increasing infrastructure financing and their representation in IFIs and whose financial contributions to MDBs are crucial are unlikely to provide more capital to the World Bank. Moreover, proposals for new MDBs like the BRICs Bank underline the need for changes in the mandates and governance structures of MDBs, in particular of the World Bank, to increase both their liquidity and avoid fragmentation.

Session 3: Global Debt Management

Chair: Erika Renneke, Deutsche Bundesbank

Presenters:
Yuefen Li, UNCTAD
Jürgen Kaiser, Erlassjahr.de
Dagmar Linder, Deutsche Bank (tbc)
Kathrin Berensmann, DIE

Kathrin Berensmann (DIE) started by presenting an overview of instruments in the Global Debt Governance system, distinguishing between instruments for crisis prevention (e.g. IFI's Debt Monitoring and Assessment Frameworks, Principles, debt management, development of local currency bond markets) and crisis resolution (e.g. Heavily Indebted Poor Countries Initiative, Multilateral Debt Relief Initiative, Paris and London Club restructurings, Principles, debt swaps, insolvency procedure). In a next step, she discussed the role of general Principles for sovereign lending and borrowing and how principles might address the four deficiencies of the current global debt governance system. First, the lack of linkage of instruments should be tackled by making use of complementary instruments. Second, the difficulty to implement the Principles should be addressed by introducing measures to enhance effective implementation and incentives for adherence to the principles. These measures are: (i) include the Principles in debt contracts (bonds, loans); (ii) publish lists of countries adhering to Principles; (iii) monitor adherence to the Principles; (iv) promote the inclusion of the Principles into the international policy dialogue and (v) encourage rating agencies to include the adherence to the Principles in their assessments. Third, the tendency to conduct ad hoc debt restructuring should be addressed by installing permanent instruments for predictable and timely restructuring. Last but not least, the Principles can contribute to solving collective action problems of creditors. In the conclusion Kathrin Berensmann stressed the need for a toolkit of crisis prevention and resolution instruments being combined in a complementary manner.

Yuefen Li (UNCTAD) stressed that public debt has increased immensely and that over-lending and over-borrowing have become easier, e.g. due to the deregulation of the financial market. She also emphasized that borrowers and lenders are two side of the same coin and that the focus should not only be on borrowers but also on lenders. She introduced the three tracks for debt management that UNCTAD focuses on. First, UNCTAD conducts debt validation, which entails the tracking of debt and the provision of relevant technical assistance. Secondly, UNCTAD has facilitated work on Principles for creditors and borrowers on the basis of an inclusive process involving all stakeholders. The new Principles were launched in April 2012. Yuefen Li stressed the need for Principles which govern all countries and all instruments and which enshrine a co-responsibility of creditors and borrowers. Thirdly, UNCTAD is examining debt restructuring mechanisms. Such mechanisms are controversial and many stakeholders fear accepting them because it might erode the willingness to pay and uncertainty could spread to other countries. While debt restructuring does not solve all relevant problems, more and more stakeholders believe that we need debt restructuring mechanisms, especially in light of the cases of Greece and Argentina.

Dagmar Linder (Deutsche Bank) introduced the "Principles for Stable Capital Flows and Fair Debt Restructuring". These Principles were developed in the early 2000s and launched in 2004. She stressed that they have been agreed between debtors and creditors, are based on experience in the past and entail a governance system in place. The main aim is to prevent crises but they are also meant to resolve crises once there is one. The Principles have been developed for emerging markets but have recently been extended to developed countries. The guidelines are voluntary and flexible with respect to the economic and political situation. In particular, they have been successful in improving data transparency. These Principles have not been used in the case of Argentina but have often been referred to in the case of Greece.

Jürgen Kaiser (NGO Erlassjahr.de) emphasized that it is good to have Principles – but expressed doubts how far they can reach. He underlined two weaknesses that all Principles share. Firstly, they tend to be highly vague (and even if they were more specific, there seem to be cases in which it is not possible to get the needed information in order to apply them). Secondly, the effectiveness of Principles is limited since it is unclear how they match with reality. For example, when would have been the intervention point in Greece and how would the Principles have helped in that case? For the way forward, he stressed that it is key to solve the crucial issues first, above all, the question who will be in a position to enforce the implementation of the Principles. He also called for defining crucial terms like debt sustainability and debt illegitimacy and liaising with the broader process of debt management reform and welcomed UNCTAD's enhanced mandate. In his view, an ex-post approach is more practical and promising than an ex-ante approach: the clearer the rules are, the more chance we have to get to a fair solution for all.

In the Q&A session, it was highlighted that there is a need to push for a predictable debt structuring mechanism that should not be a taboo and that such a mechanism would be beneficial both for debtors and creditors. It was also underlined that we currently have a non-system and that Principles are good but not the solution because there is no enforcer. Yuefen Li stressed that Principles may seem nitty-gritty but that they are important for law and order and cohesion of societies and that the lack of such rules in the context of debt governance should be tackled. In her view, there would be fewer crises if such Principles existed. Dagmar Linder also underlined the importance of Principles and that they are always meant to be general. Kathrin Berensmann emphasised that the two sets of instruments for crisis prevention and crisis resolution should be deployed in a complementary manner, not as substitutes for one another. For this reason, the

Principles need to be linked to other instruments forming part of the Global Debt Governance framework. Finally, Jürgen Kaiser stressed that if Greece had gone for debt restructuring, everyone would have won except those that have escaped.