

# **Rethinking Global Finance:**

## **The Importance of Active Capital Account Management**

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Almost 30 years of financial deregulation in the US led to a dominant thinking that what is good for Wall Street is good for Main Street.

Many were convinced that “Finance is good, more finance is better and unfettered finance across the borders is the best.”

Not just the Wall Street, politicians of both sides, regulators, think tanks and financial media were also convinced by this thinking.

US witnessed rapid financialization of its economy. Before the onset of global financial crisis, finance sector used to account for 40 percent of total corporate profits in the US.

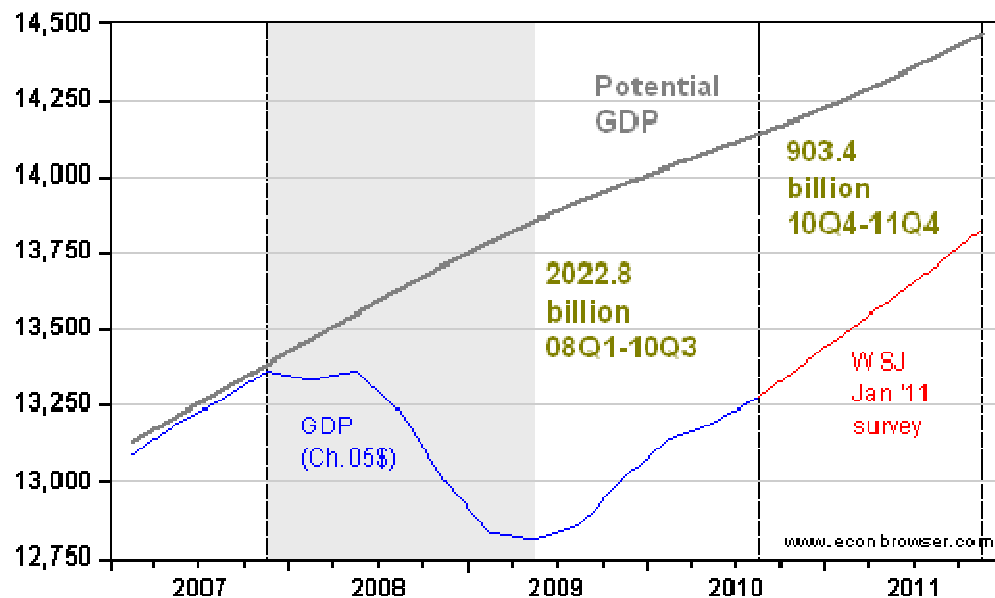
Financial sector attracted the best talent from universities because of higher salaries and huge bonuses. In 2007, employees at Goldman Sachs received US\$ 5,75,000 on average. Before the financial crisis, Wall Street bonuses were rarely questioned by financial industry, rather celebrated.

Even many developing countries also believed that if we follow a liberal and open financial system, it will lead to higher economic growth, more prosperity, and poverty would be removed. Since Asian countries benefited from trade liberalization in the 80s and 90s, many countries believed that they could also benefit from FL in the same manner. Financial openness, if not properly managed, can destroy not just the financial sector but also the real economy.

One of the biggest lessons of the global financial crisis is that more sophisticated financial systems need more (not less) regulation.

The social and economic costs of financial crisis are huge. “Lost Decade” was about Japan in the 1990s. Now the US economy is facing the prospects of a “lost decade” in terms of output loss under recession.

In their forthcoming book, Menzie and Jeffrey Frieden has estimated that the cumulative GDP loss (relative to potential GDP) from 2007-2014 is at US\$3.53 trillion, about \$12604 per person. The prospects of recovery are still very weak in US as well as in Europe and Japan.



Source: Menzie Chinn and Jeffrey Frieden, *Lost Decades*, 2011 (forthcoming).

It is the ordinary citizen, pensioners and unskilled workers who are losing their jobs, houses and pensions. More than eight million jobs have been lost in the US since December 2007. These people did not cause the financial crisis. But they are paying the price for it.

The Social Europe model based on generous wages, pensions, welfare benefits and collective bargaining is under serious attack.

Since the world can't afford another crisis of this magnitude, there is a renewed debate on how to build a stable and robust global financial system.

In my recent book, I have listed several guiding principles.

1. Finance is a means to an end, not an end in itself. The financial sector exists to serve the real economy, not the other way around.
2. Financial stability is an important public good. Financial stability should be pursued even if there are some tradeoffs in terms of economic growth.

**3.** The market fundamentalist view that markets are efficient and self-correcting is a faulty proposition. Particularly financial markets are inherently unstable and prone to failure due to asymmetric information, herd behavior and moral hazard. Therefore, they should be strictly regulated.

Once we have regulation, we should make sure that regulations are strictly enforced. If the quality of supervision is poor, then good regulation on paper cannot save the financial system. So we need both effective regulation and better supervision if we wish to have a sophisticated market-led financial system.

**4.** Policymakers need to recognize financial markets are different from other markets. Banks are different from bakeries. If a bakery fails, it won't have macro economic impacts. If one bank fails, other banks in the country (and outside) can also fail because of inter-bank lending and global interconnectedness.

**5.** No single policy instrument alone can fix global finance. We need a combination of policy measures at various levels (national, regional and international). Therefore, there is a greater need for international cooperation and coordination.

## Post-crisis Policy Responses

**G20:** India and France played a key role in the revival of G20. The G20 is better than G8. But only the big developing economies are members of it. South Africa represents the entire sub-Saharan Africa. If the membership can't be expanded, at least there should be mechanisms to consult and seek views of 130 + countries who also have a stake in global financial stability.

On trade finance and liquidity support it has done good coordination but on global financial reforms, there is very little progress.

Still the agenda setting of G20 is largely done by developed countries.

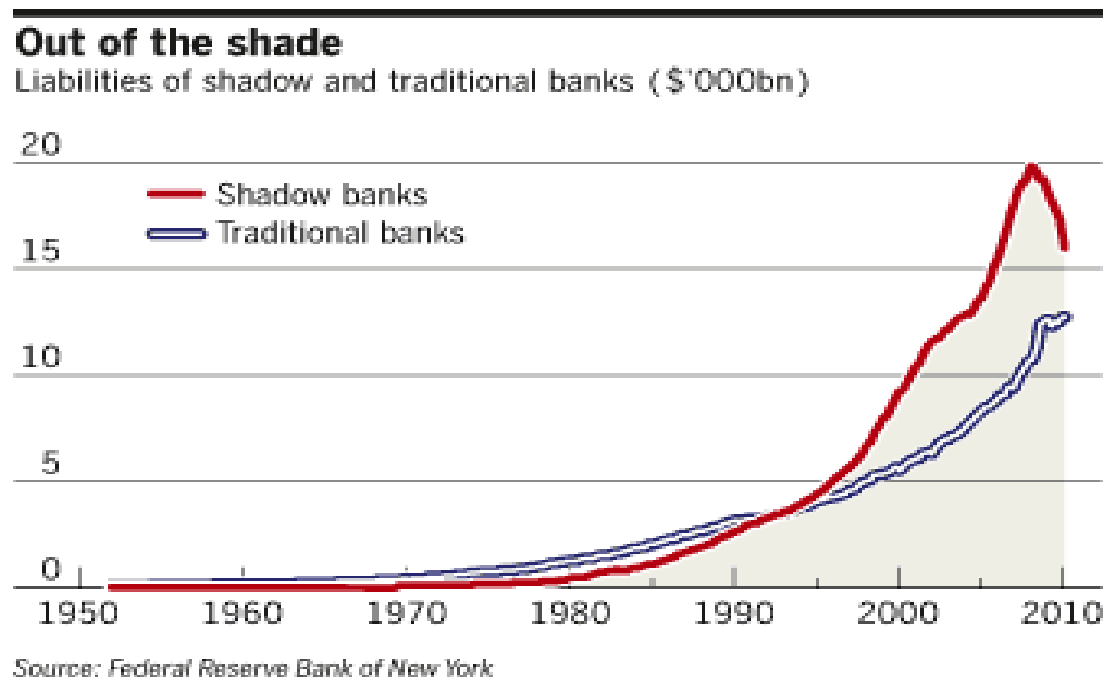
Very little achieved on IMF reforms despite the growing share of emerging markets in the world economy. India's quota share will increase from **2.44 percent to 2.75 percent**. But this 0.30 percent increase is largely technical, not significant in strategic terms.

The G20 is silent on policy issues such as regulating volatile capital flows, financial liberalization and capital controls.

Maybe this year we could see discussions at G20 on transaction taxes and IMS because France and Germany are pushing for it.

**US:** Reforms are narrow and patchy. Post-crisis, big banks are getting bigger and bigger. 4 US banks account for 55 percent of total banking assets. The crisis has already shown that massive banks fail massively. The US Fed has admitted only one major bank was safe during the crisis.

The “shadow” banking system (SBS) which played a major role in the financial crisis is still not on the radar of US regulators. Despite the crisis, SBS (\$16 trillion) is bigger than traditional BS (13 trillion). Still there are no clear rules to regulate the activities of opaque SBS.



**Basel Accord III:** Better than Basel II but some questions still remain.

**Derivatives:** CDS Trading has moved to CCPs to improve transparency and risk management but large dealers banks still dominate the trading.

**Europe:** Many proposals are on the table but there is too much divergence and very little cooperation. Much of political energy is spent on dealing with ongoing debt crises. European Banking Authority (became operational on 1 January 2011) is a positive development but its governance and accountability structures remain weak.

EU directive on hedge funds/PE is strongly resisted by UK.

German ban on naked short-selling is a welcome move but other EU members are not endorsing it. So it could be easily circumvented.

**Within Asia,** I see a greater role for regional mechanisms and institutions which are relatively easier to develop and manage than international ones. Post-Asian crisis, the Chiang Mai Initiative is a positive move. It should be expanded to include countries like India and Australia. Its surveillance processes should be strengthened.

Asian Monetary Fund is also worth exploring.



## Capital Controls

Capital controls are imposed to restrict both inflows and outflows of capital.

Experience suggests controls on inflows are more effective than outflows.

Some controls are market-friendly (e.g., Chilean) than others (e.g., Malaysia).

### Why Capital Controls?

1. To protect the domestic economy from volatile capital flows and external shocks. Volatile capital flows are a bigger source of systemic risk for developing countries. Post-crisis, Brazil, Taiwan, Korea, Indonesia and Thailand have introduced capital controls. Many more countries are going to deploy capital controls because at present there is no global coordination on managing volatile capital flows.
2. To alter the composition of capital flows in favor of longer-term flows.
3. Controls help countries to operate monetary policy with some independence.
4. To save foreign exchange (e.g., India).
5. To check capital flight (e.g., Malaysia).
6. To retain domestic savings and use them for productive investments.

In the last 60 years, capital controls of various types have been used by all types of governments.

Several successful economies have used capital controls in the past. This includes South Korea, Japan, Brazil, France, Italy, and many more.

South Korea used controls on both inflows and outflows. It achieved higher economic growth with the help of capital controls, credit controls and government planning.

Capital controls helped Malaysia to recover faster than other economies.

China and India, two recent “success stories,” still use various forms of capital controls today. A restricted capital account protected both economies from the contagion effects of Asian financial crisis.

Several economists who are votaries of free trade do not support free capital movements across borders.

Post-crisis, IMF is also endorsing the use of capital controls with conditions.

Dr. Reddy has recently suggested that even developed countries should impose capital controls to restrict “hot money” outflows.

However, one should not view capital controls as a panacea. Capital controls alone can't fix the financial system. They are not a substitute to other policy tools such as better risk management and regulation of domestic banking system. They should be a part of broader policy measures.

You also need a robust administrative machinery for implementation of capital controls to make sure that controls are not abused.

The policy space to deploy capital controls should not be curbed. Last week, several economists signed a statement asking US not to push for removal of capital controls under FTAs/BITs.

One of the biggest lessons of financial crisis is that policymakers should reject orthodoxies and dogmas. They should be more open to diversity of policy tools.

Policymakers should not hesitate to deploy capital controls and other measures just because controls are contrary to free market ideology.

One-size-fits-all approach on CAL could be damaging. As suggested by authors, the “institutional embeddedness” is a pre-condition for effective capital account management and financial sector reforms.

We live in a real world where no policy framework is perfect. We need a much <sup>11</sup> more nuanced thinking in capital account management.

India was able to protect its financial system during the Asian and global financial crisis because of various reasons.

One major reason was our calibrated approach towards opening up of banking sector and CAL. The credit should go to RBI because New Delhi was pushing for CAL way back in 1997 when even the real economy was not liberalized. At that time, New Delhi paid no attention to the sequencing of reforms.

Pre-crisis, India's regulatory regime was criticized as "conservative" and "inward looking."

But the so-called "conservative" approach by RBI has given us 7-8% growth, higher domestic savings, profitable domestic banks and not a single rupee of public money has been spent to bailout banks.

This is not to say that the management of India's financial system is perfect but the Indian experience has so much to offer to the world in the policy arena of CAM and opening up of banking sector.

**Thank You**

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