Governing Capital Flows

SUNANDA SEN

Ruling Capital: Emerging Markets and the Reregulation of Cross-Border Finance
by Kevin P Gallagher; *Cornell University, 2015; pp xi +233, $29.95.*

The book under review provides a much needed analysis of the problems faced by the emerging market and developing countries (EMDs) in a world of volatile global finance, along with their responses by using a set of countervailing monetary policies to protect their interests.

The backdrop of analysis for the book relates to the global financial crisis of 2008 with volatile capital flows, the inward surges of financial flows to the EMDs thereafter, and more recently, a reversal with capital flights from the EMDs. Each of the phases were responsible for considerable disruptions in the respective economies. An analysis of these aspects, as the author points out, is largely missing in the literature.

The book is the end product of extensive research by the author, using secondary material, a follow-up of the ongoing changes in the field of global finance and trading arrangements, and personal interviews of relevant people in the concerned institutions.

The nine chapters offered in the book include titles like "Countervailing Monetary Power," "Politics of Re-regulating Cross-Border Finance," "Trading Away Financial Stability" and so on thus setting the tone of the book on issues of concern to the EMDs.

With capital flows between nations subject to frequent disruptions, the study draws attention to the need to govern capital flows. This could be achieved either through an international directive or with a process of cooperative decentralisation among individual nations.

In this context, the author recalls the recommendations of Keynes as well as White, the architects of the Bretton Woods institutions, with their advocacy for restrictions on speculative capital as a tool to control capital flows. The author also draws attention to the contradictions, as can be observed, in the moral policing exercised by the United States (US) and Europe (as well as the international financial institutions) for the removal of capital controls in the EMDs with strong advocacy for free flow of capital; contrasting their reliance during early post-war years, on regulations of capital flows for their own economies (pp 34–37).

Global flows of capital were considerably influenced at the end of the Cold War when the US and Europe emerged as global hegemons. The oligarchy, in close alliance with the Wall Street and the US Treasury, was in a position to prop up a financial architecture which rested on uneven power relations, especially between the EMDs with weak bargaining power and the rich nations of the West.

The architecture did set up the International Monetary Fund (IMF), a major Bretton Woods institution, in which the US had a veto power till recently, with voting rights linked to the share of quota the country held. The respective weight of the EMDs in terms of quota and the related voting power was rather nominal.

Macroeconomic Perceptions

Changes, however, could be observed in global macroeconomic perceptions which followed the global financial crisis of 2008. Such changes were resonating even in the IMF parlours where proposals, put up earlier in 2008 and again in 2010, were there for amendments which sought to enhance aggregate quotas as well as their distribution in terms of voting rights of member nations.

As for the EMD nations, the prevailing quota share in the IMF for many was disproportionately small in relation to their rising gross domestic product (GDP). Prominent among such countries was, of course, China, the second largest economy in the world. Long deliberations within the IMF were continuing, starting in 2008, on the possible implementation of the 14th General Review of Quotas. The latter was finally settled in January 2016 with changes in the voting pattern among IMF members. The quota revision package initiated an unprecedented 100% increase in total IMF quotas and a major realignment of quota shares to better reflect the changing relative weights of the IMF's member countries in terms of their GDP share in the global economy.

However, as per IMF sources, individual quota currently held by the US at 16.58% is still rather high, especially as compared to the share for China, the second largest economy of the world, at 6.11% and of BRICS (Brazil, Russia, India, China and South Africa) as a whole at 14.22%. The shares still indicate the persistence of disproportionate voices within the IMF.

Changes in the IMF norms include one more aspect which is no less important for the EMDs. IMF has initiated an "institutional view" which incorporates "Capital Flow Management" (CFM), thus deviating from its earlier position on free capital flows (pp 126–42), and also conceding a need to control capital both for the source and the receiving nations (p 130).

The author mentions an IMF Staff Paper (14 November 2012) titled "The Liberalization and Management of Capital Flows: An Institutional View" which admits that "there is ... no presumption that full liberalisation is an appropriate goal for all countries at all times." The paper, however, also claimed that "the appropriate policy mix depends on a variety of country-specific conditions, including macroeconomic and financial stability, financial development, and institutional capacity." The effectiveness of the CFM was thus watered down considerably, with cautions and reservations exercised by the IMF itself.

Open Capital Account Model

It, however, remains a fact that the IMF has continued to cherish, till recent years, its persistent goal of full capital account convertibility (CAC) for the member countries. Earlier, in the 1990s an official amendment was actually proposed for a change in the IMF Articles of Agreement by codifying a norm with strong international standards to guarantee CAC (p 42).

Opposition from the EMDs with their weak voting power was ineffective to counter the powerful lobbies for CAC. However, as the end of the decade witnessed the Asian crisis in 1997, alignments got weakened within the IMF itself. Outside the IMF, some key members of the US Congress as well as non-governmental organisations (NGOs) in the country opposed the proposed amendment for CAC, setting that as a precondition for sanctioning US grants to the crisis-affected countries in Asia, which already had posed a problem for US banks.

In the meantime, the powerful nations in the West had discovered options like the Trans-Pacific Partnership (TPP) as well as the bilateral trade and other regional agreements as more convenient routes to enforce liberalisation of capital in their partner EMD nations (pp 47–48). Between those, the IMF's mega project of enforcing efficient markets via full CAC was shelved aside.

Alternate theoretical positions have been used in the past to "regulating capital." Of those, the new Keynesian models were instrumental in advocating CAC to the EMDs during the 1980s and 1990s. This has been opposed in theories contesting the related policies, on grounds of failed outcomes with instability, lack of development and limits to policy autonomy faced by the developing nations.

Despite the limitations of a static general equilibrium approach, the mainstream framework of Robert Mundell and Marcus Fleming correctly pointed at the policy trilemma inherent in countries with open capital account. Responses more relevant for the EMDs include the Minskian developmentalist models, the dissent voiced by Stiglitz, and of late in a "landmark paper," as mentioned by the author, by Anton Korinel in 2007 (pp 48–74).

The orthodox CAC position of mainstream economics was met with more serious challenges as the world met with the disastrous impact of unrestricted capital flows which started with the collapse of the Lehman Brothers in 2008. By then, Korinel's "financial amplification effect" was very much prevalent, with "feedback loops among falling exchange rates, adverse balance-sheet effects (because of dollar debt which increases in value), and tightening access to credit" (p 66). As the author points out, the loop had spread the net wide along the channels of derivative trading, a device adding much fuel to the major financial crisis of countries.

Use of derivatives in the financial sector for hedging and speculation met with some responses in the EMDs, with the initiation of the "third generation cross-border financial regulations," largely to redress the disruptive effects of the foreign exchange (FX) trading in derivative markets (p 71).

The latter included the rising volumes of carry trade in foreign currency across nations, largely to profit from the sharp currency appreciations experienced by some EMDs. The appreciations resulted from the wave of excessive short-term capital inflows to the EMDs, which were in response to the Great Recession in the West following the global crisis. Capital flows were drawn to the appreciated currencies by using carry trade. This provided lucrative opportunities for using derivatives by international speculators, while adding to vulnerability for the receiving economies.

In addition, autonomy in the latter suffered a great deal, with monetary policy as well as exchange rates subject to uncertainties on the level of those flows, thus denying the countries an opportunity to use monetary as well as exchange rate policies in national interest (pp 70–98). An example can be found in the uncertainties, as at present, relating to the US Federal Reserve's decisions regarding the future of quantitative easing (QE).

Use of countervailing monetary policies by the EMDs, as the author points out, is thus useful, not only in rectifying the uneven power structure of nations in trade and finance, but also by stabilising the flows of global capital. Exercising such policies on part of the EMDs, however, have often encountered hurdles which at times proved insurmountable.

Alliances of big business and the nation states provided the political front, both domestic and international, as opponents to challenge, and even the capital flow liberalisation (CFL) endorsed by the IMF. At the same time, avenues currently open to bring back liberal capital flows by relying on the trading agreements at the levels of bilateral (BTTs), multi-national (TPP) or even the General Agreement on Trade in Services (GATS) clause of the World Trade Organization (WTO) create further obstacles for the EMDs in "regulating capital."

A modest beginning in some of these countries, of "third generation cross-border financial regulations" to control the "financial amplification" of derivative trading faced serious problems with US exemptions of FX swaps and forwards announced in November 2012 (p 164).

On a positive note, the author looks at alternate forums like the G20, the BRICS or even the WTO where representation is not always tilted in favour of the rich nations, as has been the case with the IMF and the various trading arrangements. Providing some space for what is described as "crafting coalitions," attention is drawn to attempts on part of the key executive directors of the EMD to form a coalition within the IMF which questioned the "institutional view" of the IMF (p 145).

As pointed out earlier, the latter had too many qualifying clauses, even for initiating the CFL. Simultaneously, the limited but relatively easier routes open to EMDs at level of the G20 and similar forums provided some opportunities for further manoeuvring.

Not much, however, has so far been achieved by those countries in following the G20 deliberations for regulating capital flows on an effective basis. The book ends with 10 specific policy recommendations for enhancing the power to enforce the countervailing monetary strategies by the EMD economies.

Suggestions

A few suggestions may be offered here which could have made this excellent book more readable. Most importantly, the book could be reorganised by putting together the specific issues in separate chapters.

At present, the information as well as the analysis on the relevant issues are rather dispersedly put in the book. These include the role of the IMF vis-à-vis the EMDs, the policy space for "crafting" decentralised and collaborative actions on part of the EMDs in institutions like the G20, the BRICS and even within the IMF.

Finally, the theoretical contribution of the book in developing the arguments for "countervailing monetary power" on part of the EMDs deserves more emphasis while spelling out the specifics of its functioning for "ruling capital".

The book will continue to provide useful reading to researchers and policy-makers alike, within and across national boundaries.

Sunanda Sen (*drseno@yahoo.com*) is former professor, Centre for Economic Studies and Planning, Jawaharlal Nehru University, New Delhi.