Central Banks and Capital Flows

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Summary

Capital flows were at the heart of the Asian Crisis of 1997-8. The inflows were too large before the crisis, and the reversals were hugely damaging. Now, ten years after the crisis and with international capital flows greater than before and likely to increase significantly, we still don't have a clear analytical framework, or a practical operational set of policy guidance, on how to handle these flows. The usual economic tools – the Mundell-Fleming model, uncovered interest parity and the Impossible Trinity - are analytically unhelpful and focus on the wrong issues.

Large inflows will appreciate the exchange rate and are quite likely to cause asset price pressures. These capital flows reflect an on-going structural disequilibrium: the emerging countries have intrinsically better profit opportunities, as they move to the technological frontier. During the decades that they will take to get to the frontier, foreign capital will be attracted by the higher returns and the prospect of currency appreciation. In this environment, the exchange rate will be poorly anchored by fundamentals, and the resultant wide swings may well trigger sharp capital reversals, which in turn threaten stability in the financial system. Thus "twin crises" seem a real possibility.

There is a range of possible policy responses, although none of them seems to provide an easy, complete or fool-proof answer. "Sand in the wheels", hedging, fiscal

surpluses, intervention using foreign exchange reserves, domestic taxes, taxes on inflows (unremunerated reserve requirements), better bankruptcy arrangements, and stronger prudential measures may make some contribution, but each will be limited by institutional constraints and administrative capabilities.

Nevertheless, this is the world in which the emerging countries find themselves, and to turn their backs on global financial integration is not the answer. This paper attempts to set out the problems and to provide a tentative and partial exploration of how these imperfect policy responses might be used to smooth the impact of global capital.