V K Sharma: Issues in capital account convertibility and lessons from the current financial crisis

Inaugural address by Shri V K Sharma, Executive Director of the Reserve Bank of India, at the Joint Reserve Bank of India-Bank of France Seminar on "Issues in Capital Account Convertibility and Lessons from the Current Financial Crisis", held at College of Agricultural Banking, Pune, 2-3 April, 2009.

The views expressed are those of the author and not of the Reserve Bank of India.

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Mr. Jean Leviol, Minister Counsellor for Economic Affairs, Embassy of France, New Delhi, Mr. Gerard Beduneau, Director, IBFI, Banque de France, Mrs. Isabelle Vaillant, Deputy Director, International and Economic Relations, Banque de France, Mr. Sanjaya Panth, Senior Resident Representative, IMF, New Delhi, Mr. Sandip Ghose, Principal, College of Agricultural Banking, Dr. R. K. Pattnaik, Advisor, Reserve Bank of India and Dear Friends,

I welcome you all to the RBI-BdF Seminar on "Issues in Capital Account Convertibility and Lessons from the Current Financial Crisis". I am indeed very privileged and honoured to be here in the midst of you all this morning. I am particularly very happy to note that the Programme is very well conceived and structured what with all the material and relevant topics germane to the subject matter of the Seminar – including, no less, the recent Report of the BIS CGFS Working Group on "Capital Flows and Emerging Market Economies" chaired by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India – having been covered with the appropriate focus.

The raison d'être of capital account convertibility, as a highly desirable policy goal, is its promise of most efficient allocation of capital and the benefits that it, as a result, brings both to capital importing and exporting countries. The classical text book and, now fairly standard, condition precedent to full capital account convertibility is sound, robust and resilient financial system on the one hand, and the broad based convergence of a country on key macro-economic parameters like inflation, nominal interest rates, current account deficit, gross fiscal deficit and outstanding debt as a percentage of GDP, on the other. However, significantly the recent financial crisis has thrown into sharp relief, as never before, the critical and important role of "asset price" inflation/asset bubbles also, as opposed to that of shop floor/products/services inflation alone, as a key variable, in monetary policy response. For what happened was unprecedented in that with monetary policy focused only on traditional CPI, interest rates were kept low in spite of exploding prices of assets like real estate/property, credit assets, equity and commodities. And this was all made possible because of the huge current account surpluses in China and other EMEs, and huge private capital inflows into EMEs in excess of their current account deficit, getting recycled back as official capital flows into government bonds of reserve currency countries, especially the USA, resulting in compression of long term yields which, in turn, translated into lower long term interest rates even for the riskier asset classes mentioned above. This chasing of yield, due to global savings glut, in turn, led to unprecedented underpricing of risk as reflected in the all-time-low risk premia with junk bond spreads becoming indistinguishable from investment grade debt! Such a low interest rate environment coupled with luxuriant supply of liquidity, created enabling environment for excessive leverage and risk taking so much so that American household debt exceeded the country's GDP! This, in turn, led to a sort of the so called "Ponzi finance culture" where, with personal savings rate at close to zero, consumption spending binge was driven through withdrawal of home equity made possible by omni-present home equity loans rather than through incomes! Thus, the entire debt binge was spent in consumption and not investment, leading to a veritable partial deindustrialization of America, as it were, with the possible exception of the services sector.

All this while, the US growth story stayed non inflationary due primarily to cheap imports from China, Asia and EMEs.

In a refreshing and instructive contrast, in an almost identical macroeconomic environment in the USA in the 1980s, the Volcker Fed resolutely tightened monetary policy to counter the potentially inflationary impact of unsustainably high fiscal and current account deficits of the USA as a result of which, and also the fact that, unlike this time, there was no savings glut, US interest rates rose almost to 18-20%! This Fed action saved the day in as much as the risk premia became very high ex ante avoiding, unlike in the recent crisis, underpricing of risk and the financial meltdown although it exacted its toll in the way of hugely mis-aligned exchange rates (with £ = $ 1, and $ 1 = ¥ 365!). But, significantly, even at these historically high interest rates, unlike now, the world became cagey about continuing to lend to the USA in US Dollars to a point that the USA almost came to issuing the so-called Reagan Bonds, i.e. US treasuries denominated in Deutschemark, Pound Sterling & Yen. Going forward, however, things were normalized as a result of the Plaza Accord between G-5 countries.

Adoption of capital account convertibility leads inevitably to the so-called "Impossible Trinity" which involves having to choose between an autonomous exchange rate policy and interest rate/monetary policy. In an increasingly open capital account context, the appropriate exchange rate regime would be a flexible exchange rate regime. This is because the flexible exchange rate would make the risk of foreign currency denominated borrowing by banks and firms explicit. This would help discourage the incurrence, and accumulation, of un-hedged foreign currency liabilities. Indeed, the low volatility of exchange rates also leads economic agents to believe that the authorities are insuring them against the exchange rate risks. Significantly, lack of volatility, and stability, also discourages the institutional development of market mechanisms such as derivatives for hedging by the economic agents. The seemingly fixed and stable exchange rates are a form of implicit guarantee of the authorities and hence a source of "moral hazard". They tend to promote unhedged foreign currency borrowing and since they are least credible at long horizons, they skew financial flows towards the short end. The recent and, not so recent, currency crises in the 1990s occurred under currency regimes where exchange rates were either fixed or kept in a narrow/tight band. This, in turn, as many research studies have shown, also inhibits the flow, over the medium to long-term, of foreign capital on a sustainable basis. Typically, the foreign capital has preferred the destinations which have well-developed, deep, liquid and efficient hedging institutional structures like forex derivatives. To revisit the more relevant experience of the recent East Asian Currency Crisis, the cases of Thailand and Indonesia stand out. In Thailand, banks were required to hedge their positions by acquiring offsetting assets in foreign currency and they did so by making foreign currency loans to Domestic Corporates which became the repositories of unhedged currency and interest rate risk exposures. In Indonesia, on the other hand, corporates borrowed off-shore directly in foreign currency and their such unhedged market exposure (both currency and interest rate), in turn, created credit risk for domestic banks that also extended from Domestic Currency Loans.

If only the above East Asian countries like Indonesia, Malaysia, Thailand and the Philippines had contended with this, they would have preferred the continuous sensitivity of flexible exchange rate regime. After all, the chief merit of flexible exchange rate regime is that it admits of monetary policy autonomy/discretion/independence/ sovereignty and insulates the domestic economy against the shocks of external/foreign disturbances. (The example of external/foreign disturbances would be the appreciation of the US dollar because of the hike in the US Interest Rates to respond to its domestic compulsions). As regards the down-side of the exchange rate volatility, the same should be allowed to be handled by institutional mechanisms such as well-developed derivatives market. (Indeed a recent study shows that there was no statistically significant negative effect of exchange rate volatility on external trade and investment after 1980s though, of course, it was found not to be so in the 1960s and 1970s. This happened due to wide-spread development and use of derivatives market in the 1980s and beyond).

Interestingly, it is significant that the recent financial crisis, caused primarily due to the huge official capital flows into the rich industrial countries, especially the USA, affected, first and foremost, the USA and other advanced industrial countries with full capital account convertibility rather than EMEs; it affected EMEs as well but only as “an effect” through the transmission channel of capital account, quite unlike the previous ones like Latin American, Russian, East Asian crisis, where these countries were originally affected because of macro economic imbalances manifesting through capital account. From the foregoing, it conclusively follows that there is a very strong organic connect between open capital account and sound, robust and resilient financial system. For after all, even if global macro-economic imbalances and accommodative monetary policy provided an enabling environment for excessive leverage and risk taking, it was still the responsibility of regulators and supervisors to have taken appropriate macro prudential measures, preemptively and proactively, rather than reactively, to prevent such an apocalyptic event.

The greatest good and the highest virtue, as it were, of an open capital account is not so much the apparent, and oft quoted, benefit of efficient allocation of capital per se, as the fact that, once it has been fully achieved, it does not permit, except in the very short term, “unearned” and “unshared” prosperity but delivers “sustainable prosperity” only if it is “earned” and “shared” prosperity! For macro economic imbalances need to be seen as sustainable, or unsustainable, with reference not only to deficits alone, but equally also, with respect to surpluses. For example, China's current account surplus is 10%+ of GDP and that of America, until recently, was 7% of GDP. Such large deficits, and surpluses, are unsustainable in the long term and capital mobility will ensure that, in due course, such imbalances are unwound by export of goods and services from the deficit reserve currency country and by import of goods and services by the surplus country.

While capital account convertibility is a highly desirable policy goal, it entails a rigorous and stringent trade off in the sense that for the benefits that it brings, it also imposes a cost/price of prudent and responsible behaviour and the very highest of governance standards on all stakeholders, especially governments, central banks and financial regulators in terms of consistent and unwavering pursuit of sound and prudent fiscal and monetary policies and effective and credible regulation and supervision of the financial system.

To sum up, capital account convertibility is about macro economic equilibrium, balance and harmony. In fact, the whole thing can be likened to cosmic balance/equilibrium/harmony where stars, suns, planets, all orbit within the inviolable discipline of their elliptical orbits which do not permit deviant behaviour beyond the shortest and the longest distance from the suns and stars of the orbiting planets! Any deviant behaviour/conduct, inconsistent with the cosmic harmonious balance and equilibrium, will invite and inflict extremely retributive backlash; the more severe and prolonged the disequilibrium and imbalance, the more wrenching and excruciating will be the resulting pain as is currently being experienced. But the sobering chastising that the world has experienced in the current financial crisis, should stand us in good stead going forward provided all the lessons have been unforgettably learnt, imbibed, assimilated and completely internalized! Perfect replication of this cosmic harmonious balance and equilibrium is, therefore, to my mind, the best way to approach sustainable capital account convertibility framework as an ideal public policy goal.

With these words, I close my inaugural address and wish the Seminar all the success it deserves. Thank you so very much!