## Duvvuri Subbarao: Strengthening IMF surveillance

Talking points of Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at a seminar on “Strengthening IMF surveillance”, IMF Spring Meetings, Washington DC, 16 April 2013.

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**Question 1: Over the next three to five years, what do you see as the critical issues for IMF Surveillance?**

***Response***

There are several critical issues for IMF Surveillance over the next three to five years. I want to focus on two of them.

(i) Is the IMF able to analyze and understand the growing complexity of global linkages?

(ii) Does the IMF have an objective, unbiased and contestable view on various aspects of Capital Account Management!

I will look at these issues from an Emerging Market (EM) perspective.

(i) ***Growing Complexity of Global Linkages***

- We are all agreed that global interlinkages have become stronger, more complex and potentially more disruptive. The IMF needs to be ahead of the intellectual curve in understanding these linkages.

*Models used by IMF* – Could not predict spillovers before crisis

- So far research within and outside IMF has been focussed on trying to understand linkages ***through trade, finance and confidence channels***. It is not clear that we have a clear understanding of the spillovers through these channels. The spillovers predicted by the models that we use are small relative to the reality of the large and pervasive spillovers that we saw during the global financial crisis and are seeing through the ongoing eurozone crisis. This clearly suggests that the assumptions underlying these models are incomplete if not flawed. Greece, Cyprus, Spain have had much greater impact on EMEs than we thought possible.
- Among large emerging economies, India was by far the least integrated into the global economy. Even so, India too was affected by the crisis by much more than we thought.

*Impact of QE on EMs*

- First, we all understand and admit that the extraordinary accommodative monetary conditions in AEs is transmitting to EMs through capital flows, exchange rates and global commodity prices.
- The question is: Has this transmission channel become stronger now than before because of: (i) the greater openness of EMs; (ii) the extent of monetary easing in the AEs; (iii) the duration of QE; (iv) forward guidance that QE will stay for an extended period. The question is, do our models reflect this new reality or are we still working with the old assumptions and coefficients? If we have not changed our models, are we not likely to underestimate the impact of the spillover?

*Non-tradeable Sector*

- Second, do we understand transmission of spillovers which originate in the non-tradeable sector? After all, the global financial crisis had origins in the housing sector, a quintessentially non-tradeable sector.

*Global Supply Chains*

- Third, do we understand the working of the global supply chains sufficiently? In an interconnected world, global supply chains can be conduits for negative spillovers as in the case of the Japanese tsunami.
- Does the IMF understand how global supply chains operate?

*Deleveraging by Eurozone Banks*

- Fourth, financial developments in the euro area have given rise to concerns that euro area banks could deleverage by reducing their lending to emerging market economies. The recapitalization needs of various euro area banking systems may also have an impact on credit flows to EMEs. BIS data show that the cross-border bank lending to emerging markets has dropped sharply since the second half of 2011 as the euro area crisis intensified. Spillovers from both unwinding of QE and amplification of euro area uncertainties, if they occur together, would take on the dimension of a perfect storm for almost all members of the IMF.
- All these illustrations suggest that there is need to refine our understanding of the interlinkages and spillovers.

(ii) ***Capital Flows***

- The change in our world view on capital account management is by far one of the most remarkable intellectual shifts brought on by the crisis.

***Consensus Dissolved***

- In the pre-crisis period, there was consensus on several issues surrounding capital account. Those consensus views have now dissolved.

(a) ***Opening up of Capital Account***

- Pre-crisis: Consensus was that every country should move towards a fully free capital account. The only questions were about timing and sequencing.
- Now we are not so sure.
    - Argument: Capital Controls protected EMEs from adopting some of the financial products that proved toxic in AEs.
    - But there is the old argument that if countries are integrated economically, can they remain separate financially?
    - There are also questions on whether capital controls can ever be effective permanently as interested parties can circumvent them.

(b) ***Pre-crisis: Consensus was that capital controls are bad always and everywhere.***

- Now we are not so sure.
- New consensus: Capital controls are not only appropriate, but also necessary.
- But what type of controls and under what circumstances?
- Are they a substitute for or a complement to macroprudential policies?
- Price based or quantity based?

- Asymmetric as between controlling inflows or outflows?

(c) ***Pre-crisis: Consensus that foreign exchange intervention is sub-optimal.***

- Now we are not so sure with some AEs defending their currencies from the safe haven impact.
- New orthodoxy: There may be circumstances when foreign exchange intervention is warranted.
- When is intervention appropriate?
- Is intervention symmetric between fighting currency appreciation and fighting currency depreciation?

***I believe the IMF management has issued a guidance note to its staff on capital account issues. Whether IMF will be even handed, as between source and recipient countries, on capital flows will be an important issue for surveillance on the way forward.***

**Question 2: How well do you think the IMF is now handling linkages and spillovers in today's interconnected world, above all the Eurozone, but also in relation to global imbalances?**

***Response***

- The IMF needs to put in greater effort at being even handed in both its policy advice and in working towards its acceptance. This has to be done both at country and global levels.
- Let me cite two examples to illustrate this.

***Currency wars***

- Near consensus that one of the root causes for the global financial crisis was the unsustainable build up of global imbalances. Concern that currency wars, by preventing market based adjustment of exchange rates, may be aiding build up of global imbalances.
- Moscow G-20: "We will refrain from competitive devaluation. We will not target our exchange rates for competitive purposes, will resist all forms of protectionism and keep our markets open".
- Useful to summarize the arguments of both sides on the currency wars.

***Arguments of Emerging Markets (EMs)***

(i) Extraordinary surge in global liquidity because of quantitative easing by advanced economies.

   - This liquidity not absorbed in AEs. Spilling over into EMs.
   - This is money looking for quick returns. Hence inherently volatile.

(ii) In the face of capital flows, we do not have any benign solution.

   - If we don't intervene, appreciation of currencies unrelated to fundamentals.
   - If we intervene to stem appreciation, but do not sterilize, resultant liquidity will lead to inflation and asset price bubbles which can disrupt financial stability.

- If we sterilize the liquidity, interest rates go up attracting more flows. A classic case of Dutch Disease.
- There is really no benign option.

(iii) Contrary to popular stereotype view, real effective exchange rates of EMEs have indeed appreciated since the 2008 crisis.

(iv) AEs must be more sensitive to the spillover impact of their policies.

- The burden of adjustment must be shared.

***Arguments of Advanced Economies***

(i) QE is driven by entirely domestic macroeconomic consideration of stimulating demand.

- Currency depreciation is not an objective of easy monetary policy.
- If any depreciation of AE currencies has occurred, it is an incidental by product of the policy.

(ii) There is no evidence that trade weighted exchange rates of EMEs, with some exceptions, have appreciated relative to their values before the crisis.

(iii) EMs are attracting capital flows because of pull factors, not push factors.

(iv) Spillover of QE is in fact positive because if AE growth recovers, it will provide a boost to EM exports and more than offset the impact of currency appreciation. The net impact of QE is +ve for EMs.

- ***Where does IMF Stand on currency wars?***

(i) Does the IMF have an unbiased understanding of "currency wars"?

(ii) Is the IMF being even handed in its evaluation of countries' forex intervention and capital control policies?

(iii) Is the IMF's job done just by bringing out the spillover reports? Should it not go beyond that to more assertively sensitize AEs to the spillover impact of their policies? Should it not be more proactive in dissemination of its findings and in urging action?

***IMF needs to be more consultative***

- There has been a lot said and written about how the IMF economists must be more open minded, less ideological, be bold enough to question orthodoxies and brave enough to differ from established wisdom.
- One important condition for this to happen is that IMF economists should talk to people beyond governments and policy institutions.
- In federal systems, they must talk to state governments.
- They must talk to non-state actors such as NGOs, self help groups, chambers of commerce.

***Cyprus bail out***

- In particular, they must understand how financial market participants will react to their views and their policy advice. The initial Cyprus bail out was an example. Media reported that the IMF was against the tax on "insured depositors" but yet IMF let that go forward with damaging consequences as we now know.

- IMF should talk more to financial market participants – not just large banks but other players – hedge funds, PE firms, AMCs etc.

**Question 3: How should the IMF tailor its advice to different economies across the world? Is it doing a good job of this?**

***Response***

- I would like to emphasize two points here. First, how far is IMF advice based on country-specific factors? Second, is the Fund's surveillance even handed?
- Viewed from these two standpoints, there is a lot of scope for improvement. According to the IEO survey, authorities of many large emerging market economies found that the surveillance process added little value and offered very limited perspectives and that their advice failed to take into account country-specific factors.
- Advice by the Fund should stem from a complete understanding of not only macroeconomic, but also social and political settings of a country.
- Advice should be founded on hard evidence and driven by facts. Ideology should not play any role in analysis of facts. The Fund also needs to exercise extreme caution when it gives advice based on models. This is because in many cases even small changes in model specifications, definitions of variables used, and time periods used in estimation can lead to significant differences in the results. At times, models are also not amenable to country-specific factors.
- The impact of IMF surveillance works primarily through debate with country authorities and public dissemination of its findings that is expected to condition market and public response to IMF advice, and thereby work indirectly on policy making. More transparent and wider dissemination of balanced surveillance analysis may be an important means to enhance the effectiveness of surveillance. The IMF must be open to criticism and advice.
- Now let me come to the issue of even handedness, which, I believe, is necessary to enhance the IMF's legitimacy in its role as a trusted advisor. Surveillance is often believed to have less impact on large member countries relative to smaller ones (in terms of size of GDP or population). It is necessary to evaluate how this issue has been addressed since the 2011 TSR so as to ensure even handedness. In a recent IEO report on "Role of IMF as a Trusted Advisor", it has been brought out that there is a perception among some country authorities that the IMF is dominated by the interests of its largest shareholders. Surveys have shown that about a third of country authorities and half of the mission chiefs did not believe that the IMF has become more even handed since the onset of the global crisis. Lack of even handedness can undermine the IMF's ability to perform both its global watchdog and trusted advisor roles. There is a need to strike an optimum balance between these two objectives which will give a boost to the IMF's credibility.
- The issue of even handedness is inextricably woven into the IMF's governance structure. Modernizing surveillance must flow from and cannot precede reforms in governance. As governance reforms progressively reflect the changing global economic realities, so also will the IMF's surveillance gain legitimacy, incisiveness and traction. It is only by this that the IMF's surveillance will remain meaningful and responsive to the rapidly evolving needs of an integrated global economy.