Yannis Stournaras: Open and orderly capital movements - does global co-operation matter?

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the OECD High-level policy seminar on "Open and orderly capital movements: does global co-operation matter?", Paris, 25 October 2016.

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Thank you for inviting me to participate in this seminar and to share some thoughts on capital movements with you. The issue of open and orderly capital movements is particularly topical and one for which an exchange of views among policy makers across various economies is essential. Discussion, communication and debate are, after all, the first steps towards multilateral co-operation.

It appears to me that the crisis has placed us at a crossroads with regard to many areas of policy-making. Confronted with unprecedented circumstances, we were forced to reassess our policy frameworks in order to better guard our economies against risks. I believe that, for the most part, we have managed to do so collectively and in a spirit of multilateral co-operation, a spirit that, I would suggest, is necessary in our globalised world.

Policies with regard to capital movements fall into this category. We are called upon to decide how to find ways to harness the benefits from global capital flows, so as to avoid slipping back into protectionism and financial retrenchment, with potentially detrimental effects on global recovery.

Benefits and risks of financial openness

The benefits of free capital movements are well-known:

- efficient global allocation of resources;
- reduced cost of capital in capital-scarce countries;
- greater and more efficient investment;
- normalisation of consumption fluctuations in response to temporary shocks;
- international risk-sharing[1];
- support for the transfer of technology and managerial knowhow;
- promotion of financial development and sound macroeconomic policies in recipient countries[2].

Nevertheless, the extent to which countries can realise these benefits presupposes certain conditions[3]:

- a developed financial system;
- sound institutions;
- prudent macroeconomic policies and sufficient macroprudential supervision;

Additionally, the benefits will depend on the level and composition of capital flows.

Absence of these conditions raises the risks associated with capital flow liberalisation, especially in the event of a negative shock, creating significant challenges for policy makers[4].

Managing capital flows

In the face of risks, countries have at their disposal a range of policy tools for managing capital flows: exchange rate flexibility, foreign reserves accumulation, monetary policy action, macroprudential measures and, in some instances, even capital flow management measures[5].

These policies also come with their challenges and can have multilateral spillover effects on global economic and financial stability[6]. Policy co-operation is thus an important complementary tool for capital flow management. Multilateral co-operation can mitigate the cross-border effects of capital flows management measures and can provide economies with a useful framework for gradual capital flow liberalisation in line with their financial and institutional development.

It is precisely in this way that the OECD Code of Liberalisation of Capital Movements makes its contribution. Through the Code, countries are provided guidance on the sequencing of liberalisation and the appropriateness of policy response to shocks. By fostering transparency, dialogue and accountability, adherence to the Code ensures non-discriminatory treatment of countries, provides reassurance to markets as to the scope and duration of measures and catalyses policy support for reforms and adjustments.

Overall, the ever more interconnected international environment makes policy co-operation more necessary. To illustrate this point, I would like to draw on two examples: First, can coordination help moderate volatility in response to specific shocks, especially those emanating from global players? Second, can it prevent the emergence of global imbalances?

Diverging monetary policies

One pertinent example of the need for policy co-operation to avert large and volatile capital flows is in dealing with the effect of divergent monetary policies on global financial markets.

It is broadly agreed that the impact of US monetary policy can have global repercussions, influencing exchange rates, risk premia and asset prices and causing valuation effects of US dollar-denominated liabilities. Thus, changes of stance can be associated with significant capital flows especially to/from emerging market economies. The taper tantrum that affected global financial markets in 2013 is one example[7].

Over the near future, it is widely expected that the US interest rate will be gradually raised, while those in the euro area and other advanced economies remain low. This divergence is likely to impact on global capital flows. Uncertainty about the pace is judged to be a source of volatility in financial markets. Thus, informal discussions between policy makers, if not closer co-operation, along with clear and coordinated communication and execution of policies, can be a useful tool for dampening volatility and preventing undue financial market turbulence.

Euro area imbalances

My second example which supports the case for greater co-operation is the lessons that emerge from the build-up of structural imbalances in the euro area before the crisis.

A corollary of monetary integration is the elimination of exchange rate risk, which reduces transaction costs and increases the elasticity of substitution between financial assets issued by member states of the monetary union. In the euro area, financial linkages were greatly facilitated by the introduction of the single currency.

A distinct feature of these linkages was the build-up of current account imbalances. Deficits accumulated in the periphery were mirrored by a build-up of surpluses in core countries. The financial account counterpart involved significant capital flows from the core to the periphery, with its counterpart in the accumulation of debt – whether public or private. These flows were directed mainly to non-tradable sectors (public consumption and residential investment). The crisis brought with it a “sudden stop” to these capital flows, resulting in sharp adjustment, largely in deficit countries[8].

Subsequently, much has been done to address what we now recognise as deficiencies in the design of the Economic and Monetary Union – the European Financial Stability Facility and subsequently the European Stability Mechanism; the banking union and its components. But more importantly for imbalances, the surveillance framework of EU Member States has been strengthened through new rules and procedures, among them, the Macroeconomic Imbalances Procedure. In short, co-operation is important also at the regional level. These changes are also supporting the reform process in Greece.

Conclusions

The course and magnitude of global financial flows and our own perceptions of financial openness are being continually reshaped in the 21st century. A period of relative abundance was rapidly brought to a halt with the international financial crisis of 2008. Our experience with free capital flows can help us ensure that in the future we harness their benefits and multilateral co-operation is key to achieving that.

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1 (1) See Obstfeld, Maurice. Risk-taking, global diversification, and growth. No. w4093. National Bureau of Economic Research, 1992, Van Wincoop, Eric. “How big are potential welfare gains from international risksharing?.” Journal of International Economics 47, no. 1 (1999): 109–135 and Agénor, Pierre‐Richard. “Benefits and costs of international financial integration: theory and facts.” The World Economy 26, no. 8 (2003): 1089–1118.

2 (2) See Kose, M. Ayhan, Eswar S. Prasad, and Ashley D. Taylor. “Thresholds in the process of international financial integration.” Journal of International Money and Finance 30, no. 1 (2011): 147–179.

3 (3) See for instance, Kose, M. Ayhan, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei. “Financial globalization: A reappraisal.” IMF Staff Papers 56, no. 1 (2009): 8-62 and Prasad, Eswar S., and Raghuram G. Rajan. “A pragmatic approach to capital account liberalization.” The Journal of Economic Perspectives 22, no. 3 (2008): 149–172.

4 (4) See Rogoff, Mr Kenneth, Mr Eswar Prasad, Mr M. Ayhan Kose, and Shang-Jin Wei. Effects on financial globalization on developing countries: Some empirical evidence. No. 220. International Monetary Fund, 2004.

5 (5) Ostry, Jonathan D. “Managing Capital Flows: What Tools to Use?.” Asian Development Review 29, no. 1 (2012): 82.

6 (6) See Beck, R., Beirne, J., Paternò, F., Peeters, J., Ramos-Tallada, J., Rebillard, C., Reinhardt, D., Weissenseel, L. and Wörz, J., 2015. The side effects of national financial sector policies: framing the debate on financial protectionism. ECB Occasional Paper 166.

7 (7) See Fratzscher Marcel, Marco Lo Duca and Rolad Straub. “A global monetary tsunami? On the spillovers of US quantitative easing”. CEPR Discussion paper No 9195, October 2012, Miranda-Agrippino, Silvia, and Hélène Rey. World asset markets and the global financial cycle. No. w21722. National Bureau of Economic Research, 2015 and Lim, Jamus Jerome, Sanket Mohapatra, and Marc Stocker. “Tinker, Taper, QE, Bye? The effect of quantitative easing on financial flows to developing countries.” World Bank Policy Research Working Paper 6820 (2014).

8 (8) See Lane, Philip R. “Capital Flows in the Euro Area.” Economic papers 497 (2013): 1-54 and Hobza, Alexandr, and Stefan Zeugner. “The ‘imbalanced balance’ and its unravelling: current accounts and bilateral financial flows in the euro area.” European Economy, Economic papers 520 (2014): 1-32.