FRONTIERS OF GROWTH

The Case for Re-Regulating Capital Accounts

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NEW YORK – Today's debates over "currency wars" reveal two paradoxical features of the global economy. The first is that there is no mechanism linking world trade rules to exchange-rate movements. Countries spend years negotiating trade rules, but exchange-rate movements can, within days, have a greater impact on trade than those painstaking deals. Furthermore, exchange-rate movements are essentially determined by financial flows and may have no effects in terms of correcting global trade imbalances.

The second paradox is that monetary expansion may be largely ineffective in the country that undertakes it, but can generate large negative externalities on others. This is particularly true of the quantitative easing now underway in the United States, because the American dollar is the major global reserve currency.

So far during the financial crisis and ensuing recession, the US has been incapable of kick-starting credit growth, the major transmission mechanism by which monetary expansion feeds through to domestic economic activity. But it is inducing massive capital flows to emerging markets, where they are generating asset-price bubbles. If this leads to a weakening of the dollar, it would also have negative effects on trading partners. (The same can be said of recent Japanese monetary-policy decisions.)

Some proposals would resolve the first of these paradoxes by allowing countries to use the World Trade Organization's dispute-resolution mechanism in cases of exchange-rate manipulation. But this is the wrong way to go, for it might serve only to erode one of the few effective mechanisms in place to make multilateral agreements binding.

Unilateral countervailing duties against countries that are hypothetically manipulating their exchange rates are equally bad. This does not mean, of course, that China should take no action to correct the undervaluation of its currency, though some recognition should be given to the way in which it is already contributing to solving this problem by allowing domestic wages to rise.

A much better way forward is to rethink seriously the role of cross-border capital-account regulations. One of the major areas of agreement during the recent crisis has been that deregulated financial activities can be a source of major macroeconomic disruptions.

The G-20, however, has largely focused on re-regulating domestic finance, whereas cross-border finance has been left entirely off its agenda, as if it required no regulation –and indeed as if it were not part of global finance. A particular linguistic twist is also involved here: domestic financial regulations are called by that name, but if they involve cross-border flows, they are called "controls."

A serious discussion of global capital-account regulations would benefit both advanced and emerging-market economies. The effectiveness of monetary expansion could be enhanced in advanced countries by reducing the leakages generated by the carry trade and other short-term capital outflows.

Actually, this would imply a return to the IMF's founding principle: it is in the best interest of all members to allow countries to pursue their own full-employment macroeconomic policies, even if this requires regulating capital flows. This is why capital-account regulations are allowed under IMF rules, and why the attempt to introduce capital-account convertibility into the IMF's Articles of Agreement was defeated in 1997.

For emerging markets, the best way forward is to correct the incentives for interest-rate arbitrage at the source of capital flows. Such a reform would also serve as a mechanism of coordination at the international level, since coordinated capital-account regulations by recipient countries would be difficult to achieve. In the absence of such coordination, the unilateral approaches now in place could generate further distortions.

This type of correction would also allow emerging markets to pursue more restrictive monetary policies, which they now need, given their greater macroeconomic strength. Indeed, the world will be characterized for several years by the asymmetry generated by advanced countries' weakness and emerging economies' strength, which calls for asymmetry in these two groups of countries' monetary policies. That would be very difficult to manage without some form of capital-account regulation.

Many regulations make sense, as the IMF has recognized in several cases. A reserve requirement on cross-border flows is one of them. Mutual and other private-sector funds require minimum terms for investments, and such mandatory lock-up periods should be applied to capital inflows as well. High capital and provision requirements for certain transactions, or prohibition of such transactions, should also be introduced for prudential reasons. This is particularly true with respect to lending in foreign currencies to economic agents that do not have revenues in those currencies.

At the source, capital requirements for currency mismatches in portfolios, together with margin requirements on foreign-exchange derivatives, make sense. Non-deliverable forward contracts should be subject to close regulation and supervision in both source and destination countries. In fact, a tax on foreign-exchange transactions – the so-called "Tobin tax," advocated by the late Nobel laureate economist James Tobin – might be the simplest way to go.

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