

POLICY AREA:
Financial Resilience

Beyond financial regulation: the need for a broader and more coordinated capital flow management strategy

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February 27, 2017

Abstract

To foster a smooth functioning of the international financial system, the G20 should lead the international effort not only to complete the financial regulation reform program, but also to stabilize the regulatory framework, avoiding uncertainty which hampers the supply of credit to the real economy. Financial resilience cannot be achieved by regulation alone, though. The G20 should endorse a broader approach to promote a more effective international strategy of capital flow management, orienting global financial markets towards monetary and financial stability.

Challenge

In the current configuration of the International Monetary System (IMS), global financial markets determine the creation and distribution of international liquidity and the level of exchange rates. It is, in other words, a market-led IMS. With globalization, markets tend to react in a uniform way to changes in the economic situation and the policy stance of key countries, both advanced and emerging economies.

In this context, capital flows move periodically in and out of major countries and regions of the global economy, causing excessive credit creation followed by sudden credit contraction, volatility in financial asset prices and exchange rates, often overshooting equilibrium levels. Changes in the monetary policy stance, actual or expected, of major advanced countries have been a key factor in orienting capital flows and exchange rate movements worldwide.

These features of the market-led IMS have become more visible in the current economic juncture characterized by slow growth, low inflation and by interest rates in major countries close to the zero lower bound. The widespread recourse to quantitative easing monetary measures has magnified the impact of monetary spillovers on exchange rates, in turn influencing global capital flows. The prospect of a reversal in the monetary stance of the US has led in the past to a frantic search for safe assets which has caused disproportionate changes in exchange rates and asset prices in Emerging Market Economies (EMEs). More tensions could materialize as US monetary is gradually tightened.

Monetary spillovers, currency wars and cycles of financial boom and bust have thus become the main issues of contention in the fora of international cooperation. The policy response to the current situation of financial instability has in fact been quite differentiated within the G20. On the one hand, the G7 countries have reaffirmed their conviction that monetary policy should be oriented towards meeting domestic objectives, that exchange rates should not be targeted and that greater transparency and better communication of policy stances should be sufficient to prevent excessive volatility and disorderly movements of exchange rates. This implies that each country should aim at keeping its own "house in order", allowing floating exchange rates and free capital mobility to play their role in the adjustment of payment imbalances. In addition, more effective regulation and macroprudential policies should limit the risk of financial instability. On the other hand, EMEs have in general taken a more "interventionist" approach. While aiming at keeping the "house in order", they have resorted to capital controls and foreign exchange market interventions to limit capital inflows and the appreciation/depreciation of their currencies. In this way, they have accumulated large holdings of official reserves as a precautionary buffer against sudden capital outflows.

Proposal

1. The divergence of approaches followed by the most important members of the G20 does not ensure an efficient management of the IMS and entails significant risks of trade and financial protectionism. Large exchange market intervention or exchange rate movements have led to reciprocal accusations of "currency manipulation" or "competitive monetary easing" with the risk of paving the way to retaliatory actions or countervailing measures of all kinds. Even macroprudential policies have been implemented in ways that tend to "ring fence" domestic banking and financial sectors.

The G20 has so far been unable to reconcile these different approaches. In its pronouncements, the G20 has so far attempted to paper over the differences, blending language from the two positions. In the work conducted so far under the aegis of the G20 by the IMF, the OECD and the BIS the emphasis has been placed on the need for individual countries to adapt their economies to strengthen their resilience and their capacity to absorb and quickly recover from adverse shocks, both real and financial. The contributions of these institutions, however, reveal significant differences of approach. The OECD believes that the benefits of free capital mobility outweigh the cost of financial instability and puts the emphasis on structural reforms to increase the resilience of productivity, jobs, financial structures and institutions. The BIS stresses the need to manage the financial cycle in order to counter the built-up of financial imbalances and currency mismatches and suggests that countries establish a macro-financial stability framework, encompassing prudential, monetary and fiscal policies, together

with structural policies to foster the flexibility of labor and product markets. The IMF shares most of these policy prescriptions, but underlines the need to strengthen the international monetary system in order to manage the risks confronting the global economy; this implies multilaterally coordinated efforts to enhance the effectiveness of national policies and to build a more coherent global financial safety net.

2. A new, unified, approach to these issues is required. The G20, as the "premier forum for international cooperation" should not limit its role to giving advice to individual member countries or to promoting a strengthening of financial regulation.

The G20 should give a mandate to the three institutions to devise a unified approach to monitor potential sources of international financial instability and to promote coordinated policy responses to forestall the outburst of major financial crises. The coordinated strategy may involve the use of macroprudential, monetary and fiscal policies and capital flow management measures. The G20 should in this way perform the task of providing a "multilateral forward guidance" to financial markets, signalling the determination to counter unwarranted changes in market interest rates and exchange rates, which may give rise to destabilizing capital movements.

Further proposals expressed by the Task force to improve financial resilience are:

- Establishing a star-shaped currency swap system based on five currencies (US dollar, euro, renmibi, sterling and yen) in the SDR basket centered around the IMF. This would help to build a more multiple IMS, preventing global liquidity risk and enhancing the global financial stability (Liu Dongmin).
- Developing some indicators of optimum sterilization rate to be targeted by Central Banks. In a context of strong capital inflows, countries may use sterilization as a tool to prevent domestic currency appreciation. If not used in a sustainable economic policy's prudential framework, this tool could mask economic imbalances and generate bubbles. To prevent these risks, the IMF should develop indicators such as a Reserve Adequacy Ratio (RAR), to be published monthly or quarterly. This ratio could be elaborated in each country following a common method indicated by the IMF or it could be calculated directly by the IMF for all countries. More ambitiously, national governments could use this kind of indicators to limit the use of sterilization policies by Central Banks. (Alfredo Gutierrez Girault).
- Enhancing the role of IMF as a lender of last resort by increasing significantly its resources, which are no longer adequate despite the recent reform (José Siaba Serrate).
- Establish a joint study group to analyse whether the current fractional banking system, in which commercial banks create money endogenously, is a sustainable arrangement, or prone to generate periodic credit-fuelled and therefore debt-based growth cycles that are inherently unstable. If the latter were found to be the case, this joint group should come with recommendations on how to tackle this source of instability, which has national origins but international effects, in the form of the aforementioned destabilizing capital flows (Miguel Otero-Iglesias).

References

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3. Wolf, M. (2015) *The Shifts and the Shocks: What we've learned – and have to learn – from the financial crisis*, Penguin.
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Implementation Overview

The G20 should give a mandate to the three institutions to devise a unified approach to monitor potential sources of international financial instability and to promote coordinated policy responses to forestall the outburst of major financial crises. The coordinated strategy may involve the use of macroprudential, monetary and fiscal policies and capital flow management measures. The G20 should in this way perform the task of providing a "multilateral forward guidance" to financial markets, signalling the determination to counter unwarranted changes in market interest rates and exchange rates, which may give rise to destabilizing capital movements.
