Reserve Bank of India Occasional Papers
Vol. 40, No. 1, 2019

Taming the Tide of Capital Flows: A Policy Guide by Atish R. Ghosh, Jonathan D. Ostry and Mahvash S. Qureshi, 472 pp., MIT Press (2018), US$ 45.

Financial globalisation has generally been argued as a means to greater economic prosperity for Emerging Markets and Developing Economies (EMDEs), subject to the effectiveness of their policy framework for enhancing resilience to vulnerabilities associated with surges and sudden stops in capital flows. Financial crises, however, have often exposed the limitations of policy frameworks, and the search for a more robust optimal framework continues. In this context, the book titled *Taming the Tide of Capital Flows*: *A Policy Guide* by three leading experts on the subject — Atish R. Ghosh, Jonathan D. Ostry and Mahvash S. Qureshi — provides a comprehensive perspective on opportunities and challenges associated with capital flows. It lucidly blends findings from exciting theoretical and empirical literature, as well as varied country-specific experiences with rich analytical insights. The book extensively deliberates upon policy measures intended to help EMDEs to contend with large and volatile capital flows in this age of financial globalisation.

Financial globalisation entails the flow of capital from capital rich nations to capital scarce ones, at times accompanied by technical know-how, leading to enhanced productivity, profitability and growth. Nonetheless, empirical evidences fail to unequivocally support these outcomes in Emerging Market Economies (EMEs). Large swings in capital flows can lead to macroeconomic imbalances and often impose serious costs on the real economy in the form of real exchange rate misalignment, credit and asset price booms, inflationary pressures, overheating and financial imbalances culminating in financial crises and large capital outflows. Such oscillations (large inflows and subsequent outflows) have also been highly unpredictable.

The macroeconomic impact of convolutions in capital flows to emerging markets, have thus become a topic of major academic and policy debate in both the group of countries- at the receiving end as well as the originating end. The authors of the book not only explain the causes and consequences of booms and busts created by surges in capital flows, but also outline the ways through which such cycles could be moderated using the right mix of instruments available with the policymakers.

The book is divided into four parts and has twelve chapters. Part I sets out the basic facts and figures about capital flows to EMEs along with a comprehensive review of the available literature on capital account liberalisation and capital controls. It also lays out the broad structure of capital flows to EMEs since the late nineteenth century. Part II takes us through a range of possible explanations for the large capital inflows to EMEs and also investigates the consequences in terms of macro-financial imbalances and balance sheet vulnerabilities. The use of different policies to cope with large capital flows in EMEs is discussed in part III. The final part provides various pragmatic choices on policy implementation for manoeuvring capital flows so as to obtain maximum benefits from capital account liberalisation.

Part I, comprising two chapters, provides a detailed introduction to the topic and a historical perspective of capital flows regulation. Following the Washington Consensus, policy prescriptions articulated by international financial institutions overwhelmingly encouraged capital account liberalisation to EMEs. The thinking on capital flows has evolved over time, taking into account opportunities and challenges under different economic conditions and different country-specific contexts, without laying down any rigid consensus. While trade in goods has been widely accepted as a tool to attain pareto optimal outcomes universally, views on trade in financial securities have become progressively more diverse. The authors have analysed capital flows in five distinct phases: pre-World War I; the interwar period; the Bretton Woods era; the adoption of generalised floating; and the aftermath of the Global Financial Crisis (GFC) of 2008. The authors emphasise that volatility in capital flows is not a new phenomenon and that it has existed as an integral part of the late nineteenth century's financial globalisation. Over time, what has changed, however, is the outlook regarding the management of capital flows. The perspective of policymakers has undergone refinements according to the needs of time. The late nineteenth century witnessed the *laissez-faire* approach, followed by structural controls contemplated at Bretton Woods, then came the free market principles and the Washington Consensus of the 1980s and 1990s. Lately, a re-examination of free market principles has started with lingering imprints of the GFC of 2008. The authors conclude that though capital flows may lead to multiple benefits to EMEs, unrestrained flows of capital could be problematic.

The authors identify US interest rates and global market uncertainty as key push factors for capital flow to EMEs and country-specific conditions such as external financing needs, growth performance, exchange rate regime, financial openness and institutional quality as the main pull factors. Capital surges have often resulted in crashes due to overheating of the economy, propelling credit booms, asset price bubbles, excessive appreciation of currency leading to loss of competitiveness and increased vulnerability of balance sheets. The authors empirically establish that the chances of some sort of financial crisis after an episode of capital surge are three to five times higher compared with a normal year in terms of size of capital flows. They suggest that such crash-landings could be avoided by timely calibration of policy tools to limit domestic credit expansion and currency overvaluation, as these factors primarily result in financial crisis. With a view to address balance sheet vulnerabilities, policies should be directed towards promoting safer types of capital inflows like Foreign Direct Investment (FDI), while capping risky inflows like other investment flows from banks and portfolio debt flows. Thus, the overall policy framework will require effective management that could ensure the right mix of capital flows as well as dampen the boom-bust cycles through the use of cyclically varying macroeconomic policies, prudential measures and capital controls.

The book moves on to discuss in detail the relevant policy framework required to deal with the consequences of large capital flows. It provides a theoretical framework that proposes rational mapping between various macroeconomic imbalances and potential policy instruments: policy interest rate for maintaining price stability; foreign exchange intervention for limiting appreciation of domestic currency; and macro-prudential measures to ensure financial stability. Since each instrument may have implications for other targets, there is a need to exercise caution while using them. Importantly, the use of one policy instrument to attain a desired target can have the potential to destabilise another macroeconomic dimension and thereby create a situation of confusion and uncertainty. The authors sensitise policymakers to be cautious in using policy instruments according to suggested mapping and suggest the use of capital controls in certain cases to manage large inflows.

The book attempts to address a more contentious issue, *i.e.,* whether policymakers in an inflation targeting (IT) framework should intervene in the

foreign exchange (FX) market, and whether FX intervention is compatible with IT framework. Multiple objectives can sometimes crosscut each other, which might affect the credibility of a central bank's inflation target, as its ability to anchor expectations might be undermined. The authors, however, argue that there is no incompatibility between inflation targeting and pursuing an exchange rate objective. They show that out of three macroeconomic imbalances caused by capital flows, namely inflation, currency appreciation and credit growth, if central banks prioritise managing inflation, first using policy interest rate, and then pursue a second objective with a second tool, such an objective may not be inconsistent with inflation targeting. A careful use of multiple instruments can lead to increased welfare gains and enhanced central bank credibility as well.

Balance sheet vulnerabilities, the other kind of crisis triggered by unbridled outpouring of capital flows, may involve the piling up of an unsustainable level of liabilities leading to maturity and/or currency mismatches. The authors use a formal model to show that private agents often under-price salient risks associated with debt and borrow excessively choosing a risky liability structure, and also fail to internalise the externalities caused by them on the real exchange rate and collateral constraint for other borrowers. That is why they suggest a kind of Pigouvian tax to channelise capital inflows towards a less risky form of liability such as FDI, which can help avoid crash-landing. In practice, policymakers use both capital controls and macroprudential measures to manage large capital inflows, with country-specific approaches getting customised to historical, economic, and institutional characteristics.

The last part of the book provides an overview of the debate on the effectiveness of various policy tools in macroeconomic management and deliberates upon international spillovers, scope of international cooperation to tackle the same and, finally, offers some concrete policy advice. The authors argue that sterilised intervention can be used to alleviate the currency appreciation pressure, whereas both FX market intervention and macroprudential measures can be used to dampen excessive credit growth. Capital controls and currency-based prudential measures can be effectively employed to shift the composition of inflows towards more stable liabilities. Therefore, policymakers in EMEs should use all tools available with them to manage capital inflows. Furthermore, since capital inflows involve at least two

parties across borders, there is a need for greater international coordination. Coordination between source and recipient countries aimed at containing flows could involve an 'exchange rate test' where countries, in the event of large inflows, could be expected to let their exchange rate appreciate to its multilaterally consistent equilibrium level before taking measures to curb appreciation.

The book uses rigorous theoretical, analytical and practical approaches to analyse how EMEs can reap the benefits of globalisation without facing the associated risks of financial crises, growth collapses and hurdles for the IT framework in inflation targeting economies. The authors have documented how a balanced deployment of monetary, exchange rate, macroprudential, and capital control policies can mitigate macroeconomic and balance sheet imbalances. Notwithstanding the comprehensive coverage of issues, certain aspects could have been given greater attention in the book to enhance its appeal to readers, such as threshold degree of openness, optimal level of capital flows, optimal sequencing of liberalisation of capital controls, importance of pre-conditions to liberalisation, and a matrix of factors that could determine the success or failure of any policy instrument. The suggested mapping of available policy tools to targeted macroeconomic variables, which may appear as a broad framework, needs to be tested in varied crisis events, even as countries may in practice deploy their own preferred policy mix depending on the nature of the problem capital flows pose for their macro-financial environment at any point of time. In the current context of global discussions on de-globalisation and rising trade tensions, and also considering that the outlook for both push and pull factors driving capital flows remains highly uncertain, this book is a must read for policymakers and economists to better understand the complex dynamics of capital flows and trade-offs associated with an alternative mix of policy responses.

Himani Shekhar*

* Himani Shekhar is a Manager in the Department of Economic and Policy Research, Reserve Bank of India.