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The Capital-Flow Conundrum

ITHACA – In recent months, emerging economies have experienced capital-flow whiplash. Indications that the US Federal Reserve might "taper" its quantitative easing (QE) drove investors to reduce their exposure to emerging markets, sharply weakening their currencies and causing their equity prices to tumble. Now that the taper has been postponed, capital is flowing back in some cases. But, with little influence, much less control, over what comes next, emerging economies are still struggling to figure out how to protect themselves from the impact of a Fed policy reversal.

When the Fed initially hinted at its intention to taper QE, policymakers in some emerging economies cried foul, but were dismissed by advanced-economy officials as chronic complainers. After all, they initially rejected the very policies that they are now fighting to preserve.

But emerging-market policymakers' criticisms do not reflect an inconsistent stance; in both cases, the crux of their complaint has been volatility. They have already attempted to erect defenses against the potentially destabilizing effects of advanced-country monetary policy by accumulating foreign-exchange reserves and establishing capital controls. Now they are calling on their central banks to ensure stability by, for example, raising short-term lending rates.

But this approach fails to address the underlying issue – and misdiagnosing the problem could have far-reaching consequences, not only leading to ineffective solutions, but also possibly causing severe distortions for specific economies and the global financial system as a whole. In order to design effective remedies, it is useful to distinguish among three types of failures that impede financial-market functioning.

First, there are market failures, which occur when, for example, investors display herd behavior, information asymmetries exist, or the structure of incentives for investment managers encourages excessive risk-taking. Second, there are policy failures, which occur when undisciplined macroeconomic policies and inconsistent or ineffective financial regulatory policies heighten the risks associated with volatile capital flows.

The third – and currently most problematic – failure is one of national or international institutions. Domestic monetary policy has become the first and last line of defense against growth slowdowns and financial panics, enabling policymakers to avoid pursuing other important, but far more difficult measures. Using monetary policy to compensate for deficiencies in other policy areas constitutes an institutional breakdown: monetary policymakers are not necessarily getting it wrong, but they are constrained by the configuration of other policies.

The inadequacy of the current framework for global governance compounds the problem. The grim reality is that, with financial markets becoming increasingly interconnected, monetary-policy measures taken by any of the major economies have international spillover effects. An effective governance mechanism or reliable institution is needed to help emerging markets cope with these effects.

The lack of effective global economic governance has important implications for capital flows. Emerging-market policymakers believe that they lack recourse to safety nets that would cushion the impact of volatile flows. Their efforts to "self-insure," by, say, building up their foreign-exchange reserves, perpetuate global economic imbalances.

So how can policymakers address these failures? There has been some progress at the international level on regulatory reforms aimed at addressing market failures, though such efforts have been limited by strident resistance from financial institutions.

Solutions for policy failures are not difficult to discern. Flexible currencies, more transparent monetary frameworks, and sound long-term fiscal policies can serve as buffers against capital-flow volatility. Moreover, the functioning of emerging-economy financial markets should be improved, with policies aimed at institutional development and improved regulatory capacity. While the right policies cannot eliminate risk, they can ameliorate the cost-benefit tradeoff from capital flows.

Fixing institutional failures is the most important – and the most difficult – step. Successful reform requires, first and foremost, finding the right mix of domestic policies. In the advanced economies, in particular, a sharper focus on long-term debt reduction, rather than short-term fiscal austerity, is needed, along with structural reforms to labor, product, or financial markets, depending on the country.

In many of the troubled emerging economies, however, monetary policy has shouldered the burden of controlling inflation, managing the local currency's value, and supporting growth. This balancing act is difficult to maintain, leaving these economies vulnerable when the external environment turns unfavorable.

In India, for example, increasing productivity and long-term growth require fiscal discipline and a raft of financial- and labor-market reforms. But the central bank is being asked to do all the heavy lifting. In other emerging markets, too, the main challenge is to ensure that all macroeconomic and structural policies advance common goals.

At the same time, the governance structure of multilateral institutions like the International Monetary Fund must be reformed, in order to bolster their legitimacy in emerging markets. Otherwise, these institutions will remain ineffective in confronting collective problems related to macroeconomic-policy spillovers, and in providing insurance against crises.

Policymakers in advanced and emerging countries alike should focus on the underlying failures that destabilize their economies and impede growth, rather than trying to treat the symptoms by manipulating monetary policy or capital controls. Unless they are supported by strong institutional structures at all levels, such measures will prove futile in managing capital flows.

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