Comment on "Globalised Financial Markets and Financial Crises," by Charles Wyplosz

Mukhtar Nabi Qureshi

Listening to the masterly presentation of Charles Wyplosz on globalisation of financial markets and financial crises has been very educative and indeed enlightening. He gives an analytical insight into the dimension of problems that have arisen as a result of a violation of what he calls an iron law of open macroeconomics, namely the inconsistency of a fixed exchange rate, full capital mobility and monetary policy independence. While any pair of the three is possible, an attempt at achieving all three would inevitably result in a currency crisis which, in his view, lesson-wise is not a new phenomenon but a rediscovery of what has already happened in Europe or Mexico. Seen in the suggested healthy order of sequencing, the lesson is that full capital liberalisation should be undertaken after consolidation of the banking system on a sound footing, the removal of other weaknesses in the external and domestics side of the macroeconomic framework, and the selection of an appropriate exchange rate mechanism.

I have a few comments to make in this regard. From the point of view of developing countries, it is sometimes argued that while capital liberalisation is a desirable objective, it would not be proper to base it on the strength of efficiency of resource allocation alone. Other factors of production including labour are equally essential for resource allocation and global welfare. However, in a situation where first-best conditions in the use of all factors of production are not available, other combination of policies may be considered. Thus, balance of payment needs of developing countries would justify capital account convertibility which, in turn, helps financing their needs of current account deficits for achieving a desirable level of investment and growth. Developing countries need private capital inflows because of low national savings, large investment requirements, increasing debt servicing, and a declining trend in net official capital inflows. Grants and long-term concessionary loans from multilateral agencies and bilateral sources are no more available to finance current account deficits. While developing countries have benefited from private capital inflows, they have also faced crises as funds were withdrawn, even when they already had strong fundamentals like high growth and saving rates,

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low budget deficits, low inflation, diversified exports and high levels of reserves. It is, therefore, appropriate for other developing countries with weaker economic fundamentals to pause for a while along with these emerging economies to take a fresh look at the costs and benefits of capital account convertibility.

In developing countries the current account deficit is mostly generated by ambitious growth targets and speedy liberalisation of the current account itself. Paradoxically trade liberalisation and market-based economic management make it necessary for them to carry forward the process of reform and opening up of their capital account transactions as well.

The difficult issue to decide is whether capital account liberalisation should be extended to short-term funds and if so whether it be optional or compulsory. One may argue that certain preconditions should be put so as to hedge against disruptive or destabilising effects of cross-border movement of short-term funds. Several countries including Pakistan have moved toward a *de facto* liberalisation of short-term capital and the question is whether to make them adopt it *de jure* forcefully or voluntarily. It seems a consensus is developing in favour of a mandatory approach and extension of the IMF jurisdiction to the capital account to promote an orderly liberalisation through proper watch, advices and assistance. It could provide rather more resources to sterilise speculation efforts and to meet systemic problems. To make the process of capital account convertibility less painful, a reform of the banking system is a *sine qua non*. Regulators should provide for acceptable international standards of capital adequacy, lending, early warning and preventive mechanisms, transparency and disclosure, as well as a proper reporting system to the cental bank. This should include information on capital flows in and out of the country. Good governance, containing favouritism and corruption is necessary. Again, a strong and autonomous central bank capable of enforcing desirable monetary policy is also necessary. Fiscal prudence and avoidance of quasi-fiscal deficits coupled with proper coordination with monetary policy objectives would add to the strength of the economy and would facilitate meeting preconditions for moving toward capital account convertibility.

It might be appropriate to say that the financial mess of Asian countries was of its own making. For years, banks were treated as tools of state industrial policy, ordering them to make loans to uncreditworthy companies and industries. Central banks were subservient to the wishes of extraneous elements and did not enjoy proper autonomy. New lessons learned through the Asian crisis, incisively articulated by Professor Wyplosz, will go a long way in generating new research besides forcing the monetary authorities to reduce their objectives and follow a cautious blend of interventionist and market-based approach.

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