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## **Remarks by Governor Edward M. Gramlich**

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### World Capital Flows: Let's Fix the System, Not Abandon It

For many years it has been clear that free trade is generally more efficient economically than protection. There are still huge political fights within countries about trade policies, and there may be occasions when countries are better off deviating from free trade, but free trade normally wins the economic high ground in most policy arguments.

But that is not true, or not as true, for international capital flows. Large increases in world debt levels combined with inadequate management of foreign currency risks have led to a collapse of banking systems in country after country, massive changes in exchange rates, and a recession or depression in much of the world economy. In view of these provocations, many observers are now reexamining their preconceptions that free international capital flows are optimal. Particular countries such as Malaysia are clamping on exchange controls, free trade economists such as Paul Krugman are suggesting currency controls as a least bad option, a good many others are recommending distortionary taxes on some capital flows, and almost everybody is at least reexamining their preconceptions.

But before this process goes too far, I would like to enter a contrary plea. There are clear problems with the present system of international lending and borrowing. But there are clear and important benefits as well. We know what the problems are. Let's fix them as soon as possible, and try to preserve the important benefits of international capital flows.

#### **The Benefits of World Capital Flows**

Let me start with the benefits of world capital flows. Much of this is standard neoclassical economics, but it bears repeating in these troubled times. Countries' saving and investment propensities can differ markedly around the world. If economies were closed to capital flows, domestic interest rates would equilibrate saving and investment in each country. These interest rates would vary widely, which means that capital would have a different marginal value in each country.

Suppose now the world were to be opened up to capital flows. Capital would flow out of those countries with low interest rates, where investment prospects are scarce compared to domestic saving, and towards countries where interest rates are high, where investment prospects are abundant relative to domestic saving. Countries that import capital would benefit from a greater stock of high productivity investments. Countries that export capital would put their saving to better use. Both countries would gain, and the world economy would also gain because scarce saving is better allocated to capital markets around the world.

This all may sound a bit academic, but the process has been very important in the world's economic development. Countries undergoing development can sometimes squeeze the requisite saving out of their poor economies, as the United Kingdom did in the 19th century and Japan did in the 20th century. Or they can import capital to supplement domestic saving, as the United States, Canada, and Australia did in the 19th century and several countries in Eastern Europe and Asia have done in the 20th century. This imported capital has been very important in the world's development process, and it has often brought with it other benefits, such as the international spreading of technological improvements. Without world capital flows, the general level of development in the world would be far less.

## **Problems**

If that's the story, what's the problem? Why do world capital markets seem to be causing such anguish, in country after country? Why are countries turning away from open capital markets? It turns out that there is some fine print that goes with the neoclassical model, and the world economy has had some trouble with the fine print. Here are some of the ways.

- Exchange rate volatility. Countries trade in different currencies, and exchange rates are necessary to make the conversions. But in addition to being the devices for converting currencies, exchange rates play another important role in the world economy - they also represent the mechanisms for bringing countries price structures in line in international trade. Suppose one country's prices are too high for it to compete in world trade, either because it has suffered an adverse trade shock, has had too much inflation, has too rigid labor contracts, or for some other reason. The country can suffer a painful recession to get its prices back in line. Or it can let its currency depreciate. Depreciations are not absolutely necessary, as is asserted by advocates of fixed exchange rates. But depreciations, or currency fluctuations in general, are often far less costly ways to make international adjustments. The next time you hear someone complain about exchange rate changes, ask them what else they had in mind to restore international equilibrium.

While exchange rate changes have this potentially stabilizing effect, they can also be destabilizing. When exchange rates are allowed to fluctuate, they are set in currency markets according to the demands and supplies of forward-looking traders, and they can be very volatile, often overshooting long term values. This volatility can destabilize trade and impart significant uncertainty to international lending. Borrowers may borrow in international markets expecting to repay at one exchange rate, and when the bill comes due, the exchange rate may differ, by a lot. Lenders and borrowers can both hedge, but hedging is costly, and institutions providing this hedge can go broke.

- Financial institutions. Financial institutions engage in what is known as maturity transformation. They take deposits from you and me, which deposits can be redeemed any time we take out our check book, and make long term loans to mortgage borrowers and businesses. There are fantastic efficiencies in this process - consumers can get higher returns on their saving, and business can borrow and invest in productive equipment. Indeed, banks and other financial institutions play the same role in allocating domestic saving to its best uses that the international capital market plays for international capital.

But as with capital flows, there are risks. If the banks' loans go bad, the institution is

in trouble and may not be able to redeem deposits. Within a country's borders there are often institutions such as deposit insurance to protect savers, but internationally the risks can be greater.

Given that banks are involved in the domestic saving, investment process, it is not surprising that they have become heavily involved in the international saving, investment process. In general this process too has led to worldwide efficiencies, but here too there are risks. In Japan, for example, the banks have been hurt by a massive decline in real estate and other values, which have put many nonperforming loans on their books. In Korea and Indonesia, the banks were hurt by the foreign currency exposure of their borrowers.

- Incentive effects. Incentive effects are always important in economics, generally complicating the analysis of policy measures. Nowhere is this as true as with international capital flows.

One incentive problem involves what is known as moral hazard. Suppose national governments do intervene to protect the safety and soundness of banks. That intervention might seem sensible, but it could inspire more risky lending by the banks, to let the government pick up the tab if things go bad. A second problem involves unilateral default on loan payments or currency obligations. Defaults would appear to benefit debtors, but in the long run these debtors will have trouble getting new credit. Or contagion effects. Even if one borrower is perfectly sound, if other borrowers like it go under, lenders will be reluctant to lend to similarly classified borrowers. Discussions of international capital flows abound with these incentive effects.

- Transparency. A last issue involves transparency. For the international capital market to work well, lenders must know the risks and rewards. They must know the aggregate debt of a country, the exchange rate risks they are taking, and the on and off-balance sheet liabilities of all relevant banks. When they do not have a good picture of these risks, they can get into serious trouble.

While the world financial crisis has hit with uneven force in various countries, and while local situations have differed, the interaction between these four elements has almost always been critical. Sometimes big changes in exchange rates precipitated a crisis, sometimes big changes in asset values put the banks in trouble, sometimes moral hazard issues generated unsound loans, and almost everywhere there was a lack of transparency. Once a crisis got going, unilateral defaults and contagion effects spread it to other countries. The result was a broadscale financial collapse, which then fed over to the real sector and caused bankruptcies, credit restraints, and recessions. These real income losses in turn magnified the financial problems.

### **Solutions**

Are there any solutions to this mess? Many are calling for an end to open capital markets, as if the benefits are not worth the costs. Others are calling for distortionary taxes, to protect countries from too much openness. Should we go part or all of the way back to closed economies?

I remain an optimist and I think not. There may be occasional instances where some restrictions are necessary to control extreme capital flows not justified by economic

fundamentals. Moreover, the world capital system clearly is in need of repair. But I hope we can repair it and get back to a world where saving in whatever country goes to the country that needs it most, and that can pay the most to the saver. And to a world where international capital flows are an important vehicle for world economic development. Let me discuss some remedies that should help in that process.

- Financial institutions. Two types of corrections are necessary. A first is tantamount to preventive medicine - what should be done when institutions are not in crisis? The basic need here is for better bank supervision. Supervision must be improved to insure that proper risk management techniques are put in place and followed. Previous practices where banks, or those to whom banks made loans, loaded up on short term hard currency denominated liabilities must be curbed. Market discipline can also be used to control risk, by exposing financial institutions to as much market discipline as possible and by limiting moral hazard problems.

But even with all the preventive medicine in the world, the patient sometimes gets sick, and banks in Japan and a number of other countries surely are. What is to be done then?

Examination of a number of historical episodes suggests that there are three important elements to dealing with a banking collapse. First, the bank regulators must go through the balance sheets, determine the problem loans, take them off the banks' balance sheets, sell them, and have the public take whatever losses were entailed. Second, the troubled institutions must be closed down with the management replaced and shareholders suffering losses. Third, the healthy institutions must then be recapitalized, preferably by new equity sales in capital markets. The sooner these steps are taken, the better. The longer they are not taken, the longer troubled banks will continue incurring losses, engaging in risky practices, threatening the safe institutions, generating contagion effects, and not performing the banks' all-important maturity transformation function. Indeed, here is a way foreign capital flows can be part of the solution to the problem, because new foreign-owned banks that can perform this maturity transformation function can be invited to participate in credit-starved economies.

- Maturity transformation. While financial institutions perform maturity transformation, there is no reason to unduly burden the system. Countries have often gotten into trouble when they have done too much maturity transformation - that is, borrowed from abroad at short maturities to finance long term investment. Steps could be taken to limit such borrowing, either nationally or through bank supervision. Some economists have used this idea to propose taxes on short term borrowing, though the tax rates necessary to do the job could be very high and it might be more effective to use orthodox principles of bank supervision.
- Transparency. A further set of corrective mechanisms involves greater transparency. It must be clearer to lenders and borrowers alike what risks they are taking. This requires better reporting by financial institutions, and it also requires better aggregate statistics on the uncommitted foreign reserve balances of individual countries. Transparency alone cannot do the job of good bank regulation, but it is hard to imagine a solution to the international lending problems of the day without more transparent accounting.

- The IMF. Last but not least I discuss the IMF. Frankly, my own feeling is that if an institution like the IMF did not exist, we would want to invent something like it. Here is an international institution that, at least in principle, can supervise the finances of different countries without the accusations of big brother that would come about if the United States alone tried to put itself in this role. Moreover, it can organize other lending countries to bring support to countries in need of liquidity assistance, as opposed to having the bill fall entirely on the United States.

Supporting the existence of something like the IMF does not suggest agreement with its exact structure or with all of its policies. The present crisis indicates that international preventive medicine provisions are weak. It may be difficult for the IMF to perform this warning system role, but there is clearly a need for better warnings about the risks of lending to certain countries, to prevent currency vulnerabilities from building up as much as they did. The IMF's "one size fits all" recommendations of fiscal austerity should also be reexamined, because in many Asian countries expansionary fiscal policies were clearly called for - indeed, still are called for - while the IMF initially recommended the reverse.

But the two biggest criticisms of the IMF involve the moral hazard issue and exchange rate flexibility. On moral hazard, the criticism is more or less inevitable. Any time there is any governmental attempt to increase safety and soundness, moral hazard questions can be raised. In the case of the IMF, if it is there to bail out countries in a liquidity crisis, countries will be more likely to end up in liquidity crises. The answer, it seems to me, is for the IMF to attach tight conditions on its lending, so that countries will certainly not look forward to getting into debtor status. In terms of underlying structural change, this is one of the few leverage points the international lending community has on borrowing countries, and it is important for the IMF to use its tool well.

On exchange rate flexibility, the problem with the critics is that they are not saying the same thing. Some say the IMF is too quick to let the exchange rate fall, some say it is not quick enough. Both cannot be right at the same time.

As a general rule, the exchange rate flexibility issue is a hard one and it is hard to make broad recommendations. Sometimes a country's cost structure is clearly out of line, or its inflation rate is clearly too high, and exchange rate flexibility seems to be the least costly way to bring prices and wages back into line. But exchange rate flexibility will cause capital losses and will raise the cost and risk of future capital transactions. That does not mean that the exchange rate must be preserved at all costs, but it does mean that capital flows themselves put some constraints on the normal international adjustment mechanisms. Given all this, it is hard for me to take a firm policy on exchange flexibility, and I have some sympathy for the apparent open-mindedness of the IMF on the issue.

Will these solutions be enough? Who knows. But I think we all have a stake in making the world capital system work better. Before we initiate more artificial restrictions on capital flows, we should try to improve the system to take advantage of its very large benefits.

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