

“Political Economy of Financial Stability and Equitable Growth”

Transcript of the comments by Nemat Shafik, Deputy Managing Director, International Monetary Fund

I thank CAFRAL and IPD for organizing this event. You have made me think hard and feel like I need to go away and think harder. I am thanking you for that, actually. It's a real gift to be here with so many talented, and capable and thoughtful people.

I thought I'd start by just saying a few words about some of the stylized facts that I think have emerged in the course of today, which are the three wider lessons from the crisis. The first lesson is that price stability does not guarantee macroeconomic stability. Second, financial intermediation has huge consequences for propagating and sometimes amplifying shocks and risks, both nationally and globally. Third, is that disruptive capital flows can create significant policy challenges for countries. But under the right circumstances, capital flows can support growth. To take up a little bit from where Adair let off, there is quite a lot of evidence that foreign direct investment and equity flows contribute to growth. There is a pretty big literature that shows that that is the case through a variety of mechanism, transfer of technology, more efficient resource allocation, etc. The evidence on debt flows is much more mixed and I think that's where there is a question mark. And of course, we at the IMF have been thinking a lot about that. Most of you have probably heard the joke that the acronym IMF stands for “It's Mostly Fiscal” because whenever we see an economy in crisis, our response is “fiscal consolidation”. Somebody in the IMF the other day said, actually our new acronym is “It's Mostly Flows” because this issue has pre-occupied us to such a degree in recent years.

So if we accept the three stylized facts, what are the implications for policy? I am going to highlight five implications for policy and run through them quite quickly. First, we need to be ready to use more instruments. Second, the policy response has to be conditions based. We are very much in a world of “it depends”. Third, we need an integrated approach, where the pre-requisites for reforms and sequencing are incredibly critical, particularly when we are talking about the capital account and reforms to capital account management. Fourth, coordination is critical, both at the national and at the international level. And finally, political economy issues, which are the subject of this session, are best addressed through clear objectives, operational independence, transparency, and clear political accountability.

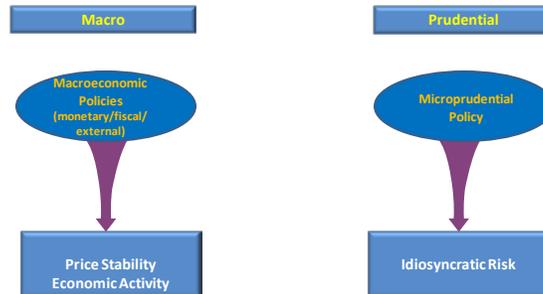
Let me say now something more specific about each of those five policy implications.

Let me start with the issue of the need to have multiple instruments and having conditions-based approaches to using them. This figure shows the way we used to see the world before the crisis, and this echoes a bit John Gieve's earlier presentation on segmentation.

Role for Macro-prudential Policies



How we saw the world before the financial crisis



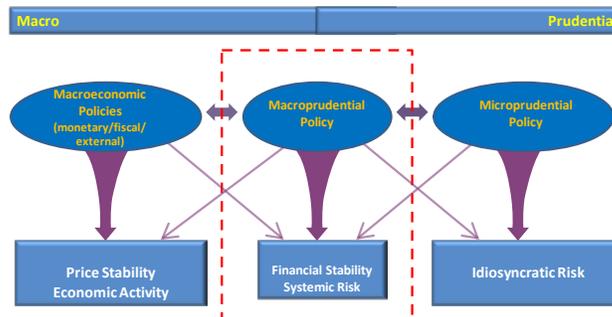
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We thought macroeconomic policy was the business of central banks and treasuries. They dealt with monetary and fiscal policy and their primary objectives were price stability and promoting economic activity. Prudential policy sat over here and it was very focused on individual institutions and idiosyncratic risks. After the crisis, we started to see the world in a much more connected way and the focus on macro-prudential policies and the importance of systemic risk became a much bigger issue.

Role for Macro-prudential Policies



How we see the world now



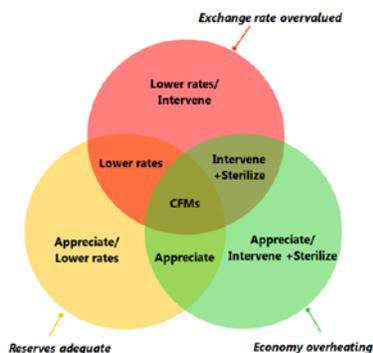
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There was also a renewed interest in thinking about fiscal policy more creatively as a support for aggregate demand and thinking about its counter cyclical role. Now, one key additional instrument that we need to add to our tool kit is capital flows measures, and this, slightly complicated graph, summarises our institutional view at the IMF.

Role for Capital Flow Measures (CFMs)



Managing capital inflow surges



Macro policy options

- Exchange rate appreciation, reduce interest rates, currency intervention

CFMs useful in certain circumstances

- Can use to address macroeconomic and financial sector vulnerabilities
- But not substitute for needed adjustment
- Preference for non-discriminatory CFMs (i.e., not based on residency)

Considerations for the use of CFMs

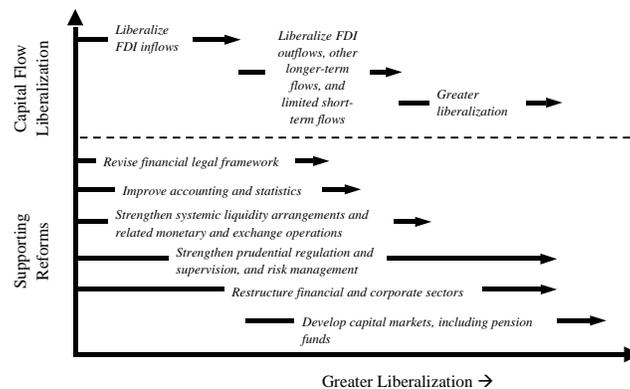
- **When to consider CFMs?**
 - In the intersection (i.e. when limited policy flexibility)
 - Other (i.e. when needed policy requires time)
- **How to design CFMs?**
 - Targeted
 - Transparent
 - Temporary
 - Non-discriminatory

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The main point is that there is an interplay between the exchange rate, reserves and where the economy is in terms of overheating or not. The point about the slide, which I won't go into in much detail, is that there is an intersection where capital flows measures are an appropriate policy response. It is not the only response, and there are a lot of other things you can do if your exchange rate is overvalued, such as let it adjust, as India did recently when it was affected by tapering talk. There are issues about when you use reserves, when you do not use reserves, and there are issues around when the economy is overheating, when it is appropriate to intervene and sterilize. But there is an intersection of space where capital flows measures can be useful. It was not an easy process to come to this new consensus—it took five papers to our Board to build the consensus among 188 member countries, but I think it is a significant step in terms of our thinking about the role of capital flows measures.

Let me go to the third point which is the importance of an integrated approach.

Integrated Approach: an example



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This slide shows that we think the liberalization of the capital account is an issue which has to be sequenced properly both in terms of the pace at which the capital account is liberalized but also the supporting reforms that are pre-conditions in doing this in a sensible way. You can see it is quite a broad agenda. FDI inflows are clearly a good place to start liberalizing but that cannot happen until the legal system is supportive, the accounting and statistics are in a good place, the prudential regulations and supervision and risks management has been strengthened, and so on and so forth. This is actually quite similar to the approach that India has taken in Tarapore II which lays out a sequenced set of reforms both of the capital account but also of supporting macroeconomic policies.

Increasingly we are shifting to a world where we are moving away from best practice to best fit. What policies and what reforms best fit an economy at a particular point in time. There are many examples since the crisis of countries trying to adopt this approach, and using capital flows measures in, sometimes, very effective ways. On the inflows side, we have heard many cases today; countries like Brazil, Indonesia, Korea, Peru, Thailand and Uruguay have since 2010 used different types of capital flow measures to manage the shock of the significant inflows that have resulted particularly from unconventional monetary policies in advanced economies. We have also seen some countries deal with significant outflows, countries like Korea, Russia, and South Africa had significant outflows which they coped with without capital flows measures. But we also have seen countries like Iceland, under an IMF program in fact, impose quite stringent capital controls on outflows in the midst of a massive crisis, and that created its own complexities.

Let me turn to the fourth point which is coordination and why that's so important, and let me start at the national level. It is an inevitable by-product of being in this increasingly interconnected and complicated world, that more coordination is necessary. At the national

level, coordination between the central bank, financial sector regulatory body and fiscal authorities has become ever more important. The crisis also revealed that coordination between monetary policy and macro-prudential policy is critical. But we are not of the view that there is any one size fits all to this question. I think Governor Subbha Rao asked what is the model of collaboration of policy coordination at the national level? Our view is that there are many models. The UK and Singapore have monetary policy, macro prudential policy and banking supervision, all under one roof. But there are other countries like Chile, Mexico, Uruguay, and Australia who have committees that are accountable for financial stability and macro-prudential policies. Our view is that clear accountability is what is critical. It is not so much the institutional set up. But unless there is a clear accountability for macro-prudential in particular, it is quite possible that it gets neglected. There are several reasons why coordination between monetary and macro-prudential policy is critical. Spill-overs and loose monetary policy can induce greater risk taking by the financial sector and you need macro-prudential as a guard against that. This potential complementarity between monetary policy and macro-prudential is also linked to the fact that there are economies of scale in the overlap of information and methodologies which can inform better policy making.

Let me say a few words about coordination at the international level which is a bit more complex. Clearly there are many levels at which international coordination needs to happen in this area. These include, for example, the debate about structural policies (Vickers, Likhanev and Volker) about global SIFIs, the issue of cross-border resolution, the questions about global liquidity and whether swap lines are adequate. I think the most difficult issue is around international policy coordination around tapering and unconventional monetary policies.

The available evidence is that unconventional monetary policies have at least so far been net beneficial to the advanced economies and to the global economy because of the growth effects. There are various estimates out there. The median estimate for the US and the UK is about 2 percent impact on GDP, and about 1 percent on emerging markets. But there is disagreement about the size of the spill-overs, the transmission mechanism of those spill-overs, and the impact across different countries. What everybody agrees on is that it is important to have independent analysis of the spill-overs and that it's important to have a forum like the IMF or BIS where countries can discuss the impact of tapering unconventional policies.

Where it gets more difficult is the issue that central banks have national mandates. They don't see it as their responsibility to worry about the consequences of their policies on others. Mervin King once said during the crisis that these global banks were international in life but national in death. I have a feeling that someday we are going to be saying about unconventional monetary policies that they were national in birth but international in death. There is a real question about what more can we do to reduce the disruption to the global recovery from the exit from

unconventional monetary policies. The IMF has put some ideas out there on the benefits of international policy coordination, but there are real political constraints. I would be certainly interested in hearing thoughts on what more could be done.

Let me turn to the final policy area which is political economy. Here, I think, I would hypothesize that the best outcome will come from clear objectives, operational independence, transparency and political accountability. I think we all agree that inflation is the most regressive tax, and that the poor are best served by a central bank that can deliver clear and credible, low and stable inflation. Inflation doesn't have to be the only objective of the central bank, but a low inflation environment is clearly in the best interest of the poor because they suffer the most from the inflation tax. Central banks can have other objectives, such as employment or growth. But again the one thing that is really important is that we are clear about what we are asking the central bank to deliver.

Having clarity on the objective then enables what is also absolutely critical and that is operational independence. There are the risks of short termism that result from electoral cycles. There is pretty clear evidence that central banks that have operational independence are better at delivering low and stable inflation. There is pretty clear evidence that countries that have independent fiscal councils and strong institutions end up having better fiscal policies. And I suspect in ten years' time we will also be standing here saying there is pretty clear evidence that more independent macro-prudential authorities are better at delivering financial stability. So operational independence is, I think, a key policy lesson and condition for success.

In exchange for that operational independence, we need to have more transparency and clear political accountability. On transparency, many countries have made significant progress. Central bank governors now hold press conferences, decisions are published, many countries are publishing financial stability reports, they are releasing minutes of macro-prudential councils, we have forward guidance, etc. I think the bar on this agenda will only get higher as public expectations for transparency will grow. Political accountability is also key and elected officials have to set the objectives for central banks and hold them to account through a parliamentary process. I think that combination is the most likely to deliver success. I think the final point I would like to make on political economy is there clearly are distributional consequences of monetary policies, macro-prudential policies and so on, but those are often best addressed through fiscal policies. I think it is important to understand them and take them into account but I think trying to set monetary, macro-prudential, or even supervision policies, with distributional consequences in mind is probably very difficult

Let me conclude. I think the crisis has taught us that the world economy is a lot more complicated and interconnected than we ever thought and so we need more instruments, more conditions-based policies, more coordination, more attention to sequencing. The policy life of

economists has never been richer. Let me also just say that while that is true, the world is also becoming more democratic. And so the importance of transparency and accountability to maintain the legitimacy of independent institutions, especially as their remit moves into spheres like macro-prudential which are politically more sensitive is absolutely critical. I am sometimes reminded of the joke of an American President who asked to see a one-handed economist and when asked why, he said every time I talk to an economist they say to me “On the one hand this but on the other hand that”. I think the crisis has meant that not only are economists two handed these days, they look like a Hindu god with many hands, and those hands are the conditions under which a country finds itself, where we are in the cycle, what the stage of financial market development is, and so on. I think the IMF has certainly adapted to that world. We have become an organization whose answer to the question of “what’s your doctrine on fiscal policy or capital account management?” is very often, “it depends”. It is a more complicated world but probably one that is more realistic and likely to deliver the better outcomes to which we all aspire.

Thank you very much.