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STABILIZING CAPITAL FLOWS TO EMERGING MARKETS

Washington, DC—A new Institute study by Senior Fellow John Williamson concludes that a series of new policy actions by creditor and debtor countries could curb at least some of the volatility in capital flows that causes so many problems for emerging market economies and investors alike. In *Curbing the Boom-Bust Cycle: Stabilizing Capital Flows to Emerging Markets*, he proposes several initiatives with this aim:

- Emerging markets should limit, and perhaps ultimately eliminate, foreign currency borrowing by their governments. These governments should instead start *issuing inflation-indexed and plain vanilla bonds on their local markets, and growth-linked bonds on the international market.* A growth-linked bond pays an interest rate that varies with the growth rate of the domestic economy. For example, a country with a normal average growth rate of 4 percent a year and an ability to borrow at 7 percent could issue a bond that promised to pay 7 percent plus or minus the differential of realized growth over 4 percent (plus a premium if that were needed to persuade investors to buy such bonds). This would mean that the country would pay more when growth was strong and the country was in a position to pay more, and would pay less when times were difficult.

- Emerging-market governments should also *discourage their private-sector borrowers and lenders from issuing and holding assets denominated in foreign currency* since currency mismatches in debtor countries aggravate crises. This might be accomplished by imposing higher taxes on interest earned on foreign-currency assets than on interest from domestic-currency denominated assets, or by limiting the tax concessions on interest on borrowing that is denominated in foreign rather than domestic currency.
- A switch in the lending policies of the multilateral development banks (MDBs), designed to *eliminate currency mismatches in the borrowing of emerging markets from the MDBs*. These banks should borrow in a synthetic currency unit whose value is defined by a basket of emerging-market currencies indexed to the countries' own price levels (CPIs). They could then largely avoid currency exposure by lending to emerging markets in their own currencies, on an indexed basis, in roughly the same proportions that the basket is composed.
- Commercial banks in creditor (as well as debtor) countries should *switch their provisioning rules to a forward-looking basis*. Under this system, a bank making a loan adopts provisions based on past historical experience of loan defaults at the time when a loan is first made, rather than waiting for evidence that the particular borrower or individual loan is in difficulty before any provision is made. This avoids pressure to cut back lending, and thus aggravate recession, at times of difficulty.
- *Emerging markets ought to retain the right to use capital controls in certain situations*, especially where they are being flooded with excessive capital inflows.

Normally this should be accomplished via (a) the imposition of uncompensated reserve requirements (on the Chilean model); (b) the taxation of capital flows; or (c) creation of a parallel foreign exchange market through which pension funds and mutual funds would be obliged to channel their transactions.

These are the main policy recommendations that Dr. Williamson advocates to ameliorate the costs that the volatility in capital flows imposes on both debtors and creditors. The costs to debtors are obvious in the business cycles that have in recent years been largely a reflection of capital flows and the crises that have often followed a sudden stop to capital inflows. But there are also important costs to creditors, who lose large sums of money during crisis episodes.

One way of avoiding the costs of crises provoked by variations in capital flows might be to repress the capital flows, but this would be to forego the benefits—of reallocating capital to areas where its return is higher, of risk diversification, and of enhanced access to intellectual property—that capital mobility can bring. The study seeks instead to develop an agenda of policy proposals to limit the fluctuations in capital flows and the costs that these variations bring in their train.

In addition to the main proposals outlined above, several more technical proposals are developed:

- The reported maturity of bonds ought to be calculated until any put option—i.e., any clause that gives the lender the right to demand his money back before the loan expires—falls due. This might discourage lenders from inserting such provisions, which reduce the time that borrowers can be sure of commanding the borrowed funds, into bond contracts.

- Insurance companies ought not to be forced to sell bonds that may have been downgraded during a crisis. Ideally they should be allowed to decide for themselves what is in the best interests of their policyholders, as the "prudent man rule" permits, but at the least any regulations ought to govern what they *buy* rather than what they *hold*.

About the Author

John Williamson, senior fellow at the Institute for International Economics since 1981, was project director for the UN High-Level Panel on Financing for Development (the Zedillo Report) in 2001; on leave as chief economist for South Asia at the World Bank during 1996–99; economics professor at Pontificia Universidade Católica do Rio de Janeiro (1978–81), University of Warwick (1970–77), Massachusetts Institute of Technology (1967, 1980), University of York (1963–68), and Princeton University (1962–63); adviser to the International Monetary Fund (1972–74); and economic consultant to the UK Treasury (1968-70). Among his numerous studies on international monetary and developing world debt issues are *Dollar Adjustment: How Far? Against What?* (2004), *Dollar Overvaluation and the World Economy* (2003), *After the Washington Consensus: Restarting Growth in Latin America* (2003), *Delivering on Debt Relief: From IMF Gold to a New Aid Architecture* (2002), and *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option* (2000).

About the Institute

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