Commentary: Capital flows and policy in emerging-market economies

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The purpose of Harris's paper is to identify lessons that South Africa may learn from capital flows and monetary policy in emerging-market economies. The analytical framework that he used is the Mundell–Fleming model developed in the early 1980s and he focuses on the so-called impossible trinity, that is, given highly mobile capital flows, a country cannot have both a fixed exchange rate regime and an independent monetary policy. Harris concludes that there are no useful lessons for South Africa to learn from other countries. I do not agree with this assessment. Even though countries and their circumstances differ, I believe that one can always learn from others' experiences. Even though

Table 1: Emerging-market countries grouped by exchange rate arrangement (as of 31 December 2006)

De facto exchange rate regime (number of countries)		Country
Hard peg (5)	No separate legal tender/ currency board (5) (*2)	Bulgaria, Ecuador (*), Greece(*), Lithuania, Panama
Intermediate (14)	Other fixed pegs (10) (*5)	Argentina (*), Egypt (*), Jordan, Latvia, Morocco, Nigeria (*), Pakistan, Qatar, Slovenia (*), Venezuela (*)
	Pegged rate in horizontal band (3) (*2)	Cyprus, Hungary (* **), Slovak Republic (*)
	Crawling peg (*1)	China (*)
	Rates within crawling bands	
Float (19)	Managed float (10) (*6)	Colombia (* **), Czech Republic (**), India, Malaysia (*), Peru (* **), Philippines (**), Romania (* **), Russia, Sri Lanka (* **), Thailand (* **)
	Independent float (9) (*3)	Brazil (**), Chile (**), Indonesia (**), Israel (* **), Korea (**), Mexico (**), Poland (* **), South Africa (**), Turkey (* **)

* Indicates country whose exchange rate regime has changed since 1999
** Indicates an inflation target monetary policy framework

Sources: Fischer (2007); IMF (2007); Batini and Laxton (2006) there is a rapidly growing body of literature on this topic, in my response I will focus only on, firstly, monetary policy, as this is the main theme of the conference and, secondly, exchange rate regimes, capital inflows and restrictions, as this is the focus of this session.

On the conduct of monetary policy, White (2001) rightly remarks that the process of re-evaluation and changes has continued over time and is by no means over yet. Monetary policy is conditioned on certain broad issues. First of all, policy-makers have to act within an economic, political and philosophical framework. Second, conditional on this framework, the policy strategy that they follow should be consistent over time and, third, policy-makers must make certain operational decisions to exploit whatever room for manoeuvre remains within the confines of the framework and the strategy (White, 2001). Owing to the existence of the "impossible trinity", the most important choice is the exchange rate regime. With the size and mobility of capital flows increasing, it appears that the exchange rate system is the one that needs to be sacrificed and many countries have moved to a flexible exchange rate regime.

Capital flows have allowed emerging-market economies to tap into the larger pool of global savings to augment their resources for development. Foreign investment has acted as a vehicle for the transfer of technical and managerial skills, thereby speeding up the growth of productivity. Furthermore, openness has improved domestic policies as market disciplines have acted to penalise unsustainable domestic policy developments. Despite difficulties, there is a general presumption that capital inflows are, on balance, favourable in their welfare effects (Sinclair and Shu, 2001). By contrast, capital flows can be highly disruptive, and the growing size and complexity of the financial system have led to greater costs when crises occur.

A key policy decision for countries facing large capital inflows is to what extent should pressures be resisted for the currency to appreciate by intervening in the foreign-exchange market. In practice, capital mobility is not perfect (even in the absence of direct capital controls) and perhaps leaves more scope than what the "impossible trinity" suggests. The *World Economic Outlook* (IMF, 2007) indicates that there is a tendency by emerging-market policy-makers to "lean against the wind" by accumulating reserves to moderate the appreciation of the currency during periods of large capital inflows. At the same time, some sterilisation also occurs. Growth in real government expenditure also increases strongly as capital inflows surge. More recently, capital controls appear to have been eased when large inflows occurred.

Sinclair and Shu (2001) highlight some difficulties around comparing empirical work on capital flows and capital controls. First, there is no generally accepted measure of the intensity of capital controls; second, there may be a two-way causal link between capital controls and capital flows; and third, it is difficult to disentangle the effects of capital controls and other factors.

Some general lessons learnt regarding capital restrictions are that they lead to harmful long-run welfare effects, impose high administrative costs, may be an invitation to corruption and that no single capital control measure is universally effective. Furthermore, capital controls tend to be more effective when accompanied by suitable macroeconomic policy as part of a reform programme. Finally, and most importantly, capital controls are no substitute for sound macroeconomic policies and prudential regulation (Sinclair and Shu, 2001). Policy-makers must maintain a longer-term commitment to price stability and remain concerned about how financial instability might impede the pursuit of this objective (White, 2001).

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IMF *see* International Monetary Fund.

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