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THE WASHINGTON CONSENSUS IS LOSING ITS HOLD OVER INSTITUTIONS

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A rethink at the IMF over the use of capital controls would mark a major shift in its policy outlook

On 2 December, the Financial Times had a detailed story titled “The IMF supertanker may be changing course". The article was cautious. It noted that the International Monetary Fund might be edging away “from the Washington Consensus world view of freely floating exchange rates and opposition to capital controls that dominated its thinking for decades". It is welcome news, and better late than never. But for the adoption of capital controls, China might not have been able to stabilize its economy in 2016 soon after making an ambitious bid to become a global reserve currency. The renminbi had just been included in the basket of currencies that make up the Special Drawing Rights (SDR). However, economic concerns led to a massive capital flight that saw its foreign exchange reserves dwindle by a trillion. China imposed drastic capital controls to avoid the ignominy of a currency crash so soon after its SDR inclusion. Given China’s tight controls, it has worked. So far.

Free capital flows destabilized emerging economies after the crisis of 2009. Easy monetary policies in the developed world encouraged “carry trade"—cross-border investment in search of higher yields. Capital flooded into emerging economies with higher domestic interest rates. The Brazilian finance minister called it a currency war. Then, in 2013, as the then US Federal Reserve chairman Ben Bernanke contemplated tapering off the printing of dollars, capital flows reversed course, leaving emerging economies with a huge mess to clean up. Such a situation can arise again.

In 2020, if the US economy stumbles into a recession (now that its probability has almost fallen to nothing), the Federal Reserve Board would be left with no choice but to further expand and make public the stealth quantitative easing that it has already embarked on. We all know that the European Central Bank has been a hyper-enthusiastic practitioner of the art of printing currency and buying bonds that carry negative interest rates. In fact, the balance sheets of the three major central banks—that of America, eurozone and Japan—are still expanding. Asset purchases by these three central banks are at their highest since 2017, and it looks set to continue into 2020. On the back of these asset purchases, stock markets are setting new records, and not because there are so-called “green shoots" in the economy.

The liquidity that these asset purchases create will find its way into emerging economies next year, once signs of economic stability emerge in Brazil, Mexico, India and China, although the latter faces more risks than markets care to believe. They may temporarily paper over the cracks that continue to exist in emerging economies, leaving them worse-off when the next “tantrum" sends capital back to their home bases. That is why a rethink on the “capital account fundamentalism" in the IMF is very important. It would constitute the second important shift in multilateral institutions in recent months.

The first was the proposal that the Organisation for Economic Co-operation and Development (OECD) had floated in October, after about six years of work, for taxation of profits earned by multinationals so that profits are not shifted around, after having shopped for the lowest tax rates, eroding the tax bases of many countries. I had discussed this in a column in this paper (“OECD tax proposals may strike at the heart of global inequality", 12 November 2019).

However, these two will not be as effective as they could be without the third important pillar, monetary policy, giving way. Unfortunately, central banks in several advanced nations are as addicted to easy money policies as financial markets are. They seem to be resorting to it at the slightest provocation, instead of it being the last resort of a country's lender of last resort. These policies continue to encourage the scourge of financialization. In other words, finance continues to rise rather than decline in importance.

Unless central banks see the folly of their ways, global reliance on debt will keep rising rather than shrinking. If debt levels keep rising, the pressure to keep asset prices buoyant will remain high. The vicious circle will thus remain firmly in place. Far from narrowing, wealth and income inequality will continue to widen, thus.

Governors of central banks must have the courage of conviction of a central banker who passed away more than a week ago. Paul Volcker died on 8 December. He called the automatic teller machines the only worthwhile financial innovation that he had seen. A tribute paid to him by Greg Ip in the Wall Street Journal ("A Remembrance: The pragmatism of Paul Volcker", 9 December 2019) tried to co-opt him, posthumously, into the policy framework adopted by his successors because dead men don't talk and counter-factuals are impossible. Whether or not he would have emulated his successors (he did not endorse their policies) had he been in office, is moot. The consequences of their policies are unfolding. However, central banks must learn from the intellectual openness that remains alive in the IMF and OECD.

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