Good morning. It is my great pleasure to welcome you to today’s conference, Managing Capital Flows - Lessons from Emerging Markets for Frontier Economies.

I am sure you will agree that Mauritius - long known as “the star and the key” of the Indian Ocean because it lies at the crossroads of Africa and Asia - makes an ideal location for our conference, whose participants span a wide range of countries, not only geographically, but also in terms of financial development and access to private capital.

Capital flows, and their successful management, have long been a focus of the Fund’s work and policy advice. Indeed, when John Maynard Keynes and Harry Dexter White - the principal architects of Bretton Woods - were discussing the IMF’s Articles of Agreement, they clashed on many points, but they were surprisingly in agreement when it came to cross-border capital flows.

Both men took as their starting point that, as White said, “the desirability of encouraging the flow of productive capital to areas where it can be most profitably employed needs no emphasis,” but, equally, they recognized that “there are periods when failure to [manage flows] ... have led to serious economic disruption.”

Soon after the global financial crisis, with emerging market economies experiencing sizable inflows in the wake of quantitative easing, unconventional monetary policies, and widening growth differentials with advanced economies, the IMF embarked on a work program to help our member countries craft policy responses that would reap the benefits of financial globalization while minimizing the risks and challenges of large inflow surges.

A good deal of analytical work by my Fund colleagues was shared with emerging market members at a conference on these issues held in Rio de Janeiro in 2011.

This work, together with a series of IMF Board papers, underpinned the subsequent “Institutional View on the Liberalization and Management of Capital Flows” endorsed by our membership in 2012.

Emerging market economies continue to grapple with these issues, currently in the context of asynchronous normalization of monetary policies in advanced economies, sharp movements in oil prices, and globally diverging economic performance.

By and large, emerging market economies have handled these episodes of large inflows and sharp outflows very successfully, and while the bulk of the credit for this must lie with their own policy makers, I believe that the policy dialog with the IMF has contributed positively.

In particular, EME policy makers seem, on the whole, to have taken to heart the key insight that the best way to deal with volatile capital flows is to maintain a disciplined response during the inflow phase to ensure the economy is resilient when outflows occur. And that is why their experience may be so valuable for drawing lessons more broadly across the Fund’s membership.

The Next Frontier

Today’s conference is focused on frontier economies. Why? For the simple reason that, just as today’s emerging markets were yesterday’s frontier economies, so will today’s frontier economies be tomorrow’s emerging markets. Indeed, despite global economic and financial turmoil, growth in frontier economies has improved markedly over the past decade.

African frontier economies, for example, have managed to raise their growth rates from an average of 3½ percent per year in the 1990s, to more than 6 percent per year in the 2000s; similar trends are evident in Asian and Latin American frontier economies as well.

Financial markets have woken up to this fact, which is why we have been seeing not only rising volumes of private capital but also greater diversity in the sources and modalities of flows to frontier economies.

In some frontier markets, capital inflows predominantly take the form of foreign direct investment, often linked to the exploitation of natural resources.

In others, private capital flows mostly correspond to public sector borrowing, either through sovereign issuances or by participation in local bond markets. In yet others, private capital flows to the economy more broadly, including to the financial, corporate, and even household sectors through debt or equity instruments.

These various types of flows call for somewhat different emphases in the appropriate policy response, but before getting into that, I would like to recall some of the key benefits that capital flows can bring:

- First, countries that are open to capital flows are better able to take advantage of investment opportunities, and achieve higher growth. Particularly frontier economies with large infrastructure needs stand to benefit from being able to tap foreign savings.
- Second, capital often brings more than mere financing; it brings cutting-edge technologies, know-how, and ancillary benefits.
- Third, financial openness promotes financial development, allows countries to better insulate absorption against output shocks, and permits greater risk-sharing through international portfolio diversification.
- And fourth, much like the benefits of trade in goods, financial integration leads to a more efficient global allocation of capital, benefiting capital-importing and capital-exporting countries alike.

At the same time, we need to be cognizant of the challenges that large-scale inflows can bring.

For countries where private flows are mostly to the public sector, the key challenge is ensuring that the capital is used productively - and that public debt remains sustainable, recognizing that repaying the debt will eventually require both higher government revenues and greater foreign exchange earnings.

Beyond sustainability of the public finances, the main macroeconomic concerns include overvaluation of the currency, which may undermine competitiveness and result in economic dislocation when the flows recede, and overheating of the economy, with inflationary pressures and excessive credit growth.
As flows extend more generally to the private sector as well, the main financial-stability risks include fragile external liability structures - excessive reliance on short-term debt - and foreign currency exposure of unhedged domestic balance sheets, as Swiss Franc mortgage holders in Poland, Hungary, and Croatia have recently learned.

One way to meet these challenges would be to try to insulate the economy from foreign flows - halting or even reversing the process of capital account liberalization. In my view, that would not be the right way. It would imply foregoing all the benefits that capital flows can bring.

We have only to look at my own country, the United States, which went from being the quintessential frontier economy in the nineteenth century to an advanced economy in the twentieth, to see the critical role that foreign savings can play in fostering economic development.

But it would be equally wrong to ignore the challenges and risks associated with inflow surges. Not all borrowing and lending decisions are rational; inflow-fuelled credit booms can inflate asset prices; risks can be - and often are - underestimated. As Keynes reportedly quipped "the market can stay irrational longer than you can remain solvent."

A Balanced Approach

Over the past few years, in the spirit of Keynes and White, researchers at the IMF having been trying to craft a balanced approach to managing capital flows that allows recipient countries to reap the benefits of financial globalization while also minimizing the risks associated with inflow surges.

Central to this approach is to maintain macroeconomic policy discipline and strengthen financial supervision and regulation.

Where private capital flows are mostly financing the public sector, including large infrastructure projects, sound judgment is required to assess realistically social rates of return, as well as the government's ability to raise revenue, and the economy's capacity to generate foreign exchange.

The IMF-World Bank debt sustainability framework, together with recent advances in modeling, can help inform such judgments.

As capital begins to flow to the economy more generally, other policies come into play:

- The first buffer is the exchange rate which, in countries without fixed exchange rates, should be allowed to appreciate provided that it does not become overvalued.

- Monetary policy may be eased in the absence of overheating in order to reduce the incentive for further inflows. But if capital flows result in inflationary pressures and credit booms, then the policy interest rate may need to be tightened to ensure the inflation target is not jeopardized.

- In addition to safeguarding debt sustainability, fiscal policy should be geared to maintaining a counter-cyclical stance, which will typically imply tightening in the face of inflows.

- Foreign exchange reserves can be accumulated in the face of appreciation pressure, especially if reserves are low by country insurance metrics, sterilization costs are manageable, and there is little risk of undermining the clarity and credibility of the monetary policy framework.

- Macro prudential measures, where available, can be applied to safeguard financial stability when inflows are fueling excessive credit growth.

Assuming these instruments are being deployed to the extent that they are available and effective, if there are remaining concerns about the possible consequences of inflow surges, then capital controls - let's call them capital flow management measures - can be deployed to help stem the aggregate volume of inflows; they should not, however, substitute for warranted macroeconomic adjustment.

Beyond flow imbalances, national authorities need to be mindful of possible balance sheet mismatches and vulnerabilities - such as unhedged foreign currency exposure of corporates or households - and be prepared to apply macro-prudential measures to limit systemic financial risks.

If capital flows are the source of risk, such measures can also be seen as capital flow management measures intended to restrict certain types of capital flows and shift the composition toward less risky forms of liabilities (FDI; equity; local currency instruments).

All this is not to imply that the burden of managing capital flows should fall entirely on the recipient country. A balanced approach involves both recipient and source countries.

As a multilateral institution, the IMF is seeking to promote a cooperative approach, including by examining cross-border spillovers, applying its Integrated Surveillance Decision, and analyzing the impact of policies "at both ends" of capital flows.

From Theory to Practice

So much for broad principles. In applying this basic framework to frontier economies in practice, certain critical questions need to be answered:

- What is the appropriate extent and pace of capital account liberalization?

- How to maintain budgetary discipline when foreign money is plentiful and cheaply available?

- To what extent do frontier economies face generalized inflow surges, especially of portfolio flows to the non-official sector that might necessitate a broader policy response?

- How to determine whether the exchange rate is broadly consistent with fundamentals and desirable policies?

- How effective is sterilized intervention? How does monetary policy operate in the economy?

- What macro prudential tools are available, and how to calibrate them?

- Finally, how to build capacity, and coordinate the different agencies responsible for the various policy measures - the central bank, fiscal authorities, macro prudential regulator - to ensure an effective response, while respecting operational independence?

These and other topics will, I hope, be the subject of today's discussions.

Learning from (Shared) Experience

For all our theories, models, and analytics, if there is one thing we know at the Fund, it's that we do not know everything.

That is why we are so pleased not only to have notable academics, but also high-ranking officials and practitioners from so many of our member countries here today to discuss, peer-to-peer, how they have coped with volatile capital flows, and to share their experiences of what has worked, and what has not.

I wish us all a fruitful day of discussions that we might learn how best to harness the tremendous potential of private capital flows to obtain sustained growth and
economic prosperity - in frontier, emerging market, and advanced economies alike.