Self-insurance or self-destruction?

By Gene Frieda
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Though the US Federal Reserve is turning a blind eye to the spillover effects of its monetary policy, the rest of the world is worrying about the impact that capital-flow reversals will have on emerging economies. Will the foreign reserves that these countries have built up in recent years prove adequate to protect their financial systems, as liquidity flows back toward developed economies?

The short answer is no, because excessive self-insurance ultimately does more harm than good. In order to break the destabilizing cycle of short-term capital flows and excessive accumulation of foreign reserves, the International Monetary Fund, with broad support from the G-20, must devise new rules regarding monetary-policy spillovers.

Severe crises leave an imprint on a nation's psyche. In the late 1990's, the currency and banking crises that ravaged Asian economies led the affected countries' leaders to a simple conclusion: no amount of insurance was too much. Although the introduction of floating exchange rates removed the incentive to borrow in a foreign currency (and thus the need for self-insurance), the political humiliation of losing sovereignty to the IMF – if only temporarily – was so devastating that the economic costs of building a massive foreign-currency war chest seemed worthwhile. But these countries' leaders failed to grasp the full consequences.

Foreign-exchange reserve accumulation depresses the exchange rate, ostensibly as a smoothing device. But stronger emerging-market currencies in the 2000's would likely have led to earlier rebalancing toward domestic demand. And if these countries had recycled a smaller stock of foreign reserves into US Treasuries, agency bonds, and subprime securities, US interest rates would likely have remained higher, emerging-market current-account surpluses would have declined earlier, and advanced-economy deficits would have contracted, thereby restoring some semblance of equilibrium. But, of course, that is not what happened – to the detriment of global financial stability.

Furthermore, the accumulation of self-insurance can beget competition similar to an arms race. Whether to prevent the appearance of inadequate insurance or to avoid losing export share, sizable interventions in currency markets became widely accepted among Asia's emerging economies as a natural response to large capital inflows – directly contradicting these countries' commitments to floating exchange rates.

Given that persistent currency intervention reduced volatility, it encouraged ever-larger capital inflows, under the presumption of less risk. At the same time, the currencies of countries that chose not to intervene became targets of speculative inflows, owing to the expectation that they would appreciate.In other words, spillovers occurred not only between advanced and emerging economies, but also among emerging economies.

Nonetheless, countries like South Africa and Mexico – both of which chose to forego intervention – did better, in many ways, than their intervention-happy counterparts. Both suffered little financial fallout from the currency weakness that followed the Fed's announcement last May that it would "taper" its purchases of long-term assets. Truly floating exchange rates generally served their purposes: removing the incentive to accumulate external debt, encouraging flexibility within the real economy, and promoting the development of deep and liquid capital markets.

Another consequence of self-insurance is rooted in the ostensibly laudable goal of preserving national sovereignty. Specifically, governments may be tempted, especially around election time, to use self-insurance as a substitute for adjustment, rather than to help cushion the impact of a shock or support economic rebalancing. The alternative – "renting" insurance from multilateral bodies like the IMF – would demand fulfillment of certain reform obligations.

The fact is that emerging economies' self-insurance policies, like the Fed's ultra-loose monetary policy, fuel a reflexive feedback loop. While any suggestion that countries cede monetary-policy independence would be foolhardy, some rules are clearly needed to limit spillovers – rules that should come from a revamped IMF, with the US Congress demonstrating its support through a long-overdue quota increase.

Specifically, the IMF should be responsible for assessing spillovers and mobilizing liquidity support for vulnerable economies accordingly, either through central-bank currency-swap lines or IMF liquidity facilities. Such multilateral insurance would lessen the need for self-insurance, without impinging on countries' sovereignty.

To be sure, such rules would not insulate economies entirely from monetary-policy spillovers, which are an inescapable element of an economy's adjustment process. But they would help to mitigate the kind of tail risks that have plagued the financial system over the last two decades. Only with a well-defined mechanism for managing spillovers can the vicious cycle of capital-flow volatility and excessive self-insurance accumulation finally be broken.

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