

Suman Bery: The wisdom of Professor Calvo

We need fresh perspectives to assess our financial vulnerability

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I first worked on Latin America in the late 1980s. At that time many of the countries of the so-called "Southern Cone" of South America (Argentina, Chile, Uruguay, Brazil and Peru) were engaged in the dual tasks of restoring democracy after an extended period of military rule, and stabilising their economies after extended periods of high inflation.

It was at that time that I first encountered the subtlety and sophistication of Latin American macroeconomic theorists. These academics, some home-grown, most the product of the great US economics departments, succeeded after many unsuccessful attempts in purging their countries of chronic inflation.

Listening to them at that time speak among themselves and with their peers and students, they came across to me like a group of particle physicists commenting on phenomena too exotic to be understood by mere mortals. Yet, much as particle physics led to the taming of nuclear energy, so did the deep thinking of these scholars lead to the practical success of disinflation, and the development of a series of ideas that have since become established parts of the toolkit of macroeconomists.

A distinguished member of this fraternity, Professor Guillermo Calvo, now at Columbia University in New York, visited Delhi last week as the guest of NCAER and of the Brookings Institution, Washington DC.

He was here to participate in our annual joint conference, the India Policy Forum, and to deliver the public lecture that is traditionally delivered on that occasion.* Nandan Nilekani was in the chair; Montek Singh Ahluwalia was the Chief Guest, and Bimal Jalan kindly served as the main commentator.

Why might the work of an Argentine monetary theorist be of interest to an Indian audience? It is because, as we now know, while being rid of high inflation might be a necessary condition for an emerging market to avoid a domestic financial crisis, it is very far from being sufficient.

This was abundantly proved by the East Asian crisis of 1998, where neither high inflation nor fiscal excess could be held responsible, but where the long-term costs have been immense. Latin America itself has continued to be affected, as demonstrated by the Mexican crisis of 1994 and the Brazilian crisis of 1998.

These more recent crises have led Calvo and his colleagues to examine the mechanisms by which these crises originated, and how they spread through the domestic economy. As I discuss more fully below, the principal mechanism is what these researchers have christened "sudden stops" (SS; sometimes also called a "systemic sudden stop" (SSS)). A sudden stop is defined as a large, unexpected cutback in international credit flows either to a country or to a large sector in a country (such as minerals, or real estate).

Assuming that the original inflows had indeed been allowed to boost domestic demand (typically by boosting domestic credit growth), their sudden reversal is will represent a significant, unanticipated contraction in credit availability and in final demand. Such a reversal, in turn, is often associated with important second-round effects, generating a wider contagion effect. First, there may be a sharp change in the prices of affected sectors (real estate again comes to mind). These effects can harm the solvency of domestic banks exposed to those sectors, causing them also to retract and aggravating the downturn. Second, as more credit-worthy borrowers lose access to foreign funds they may shift their demand to domestic financial institutions, displacing small and medium-enterprises who traditionally depend on local banks. These mechanisms have been documented and analysed in a number of emerging

market episodes.

These issues are now relevant for India for two reasons. First, over the last decade our financial and corporate sectors have become steadily more exposed to international finance. This has occurred as global liquidity became abundant and the "India story" became more widely accepted. Second, the financial crisis in the advanced economies has revealed the undercapitalisation of many institutions in the sector and has forced shrinkage of balance sheets.

Using RBI balance of payments data, the net outcome has been a sharp unwinding in the scale of net capital inflows from almost 9 per cent of GDP at the beginning of 2008, to less than half that amount by the end of the year, a massive shift by any standards.

What then is the right policy mix? Many in India would argue for capital controls, both on inflows and on outflows. Calvo points out, though, that these would not avoid the SS problem, since that can be provoked just by a slowdown in the rate of inflow, rather than requiring an outright reversal.

Instead he points to two other policy instruments which he favours: tight financial regulation (ie, liquidity and risk management in commercial banks and other systemically important institutions, including management of maturity and currency mismatches); and the accumulation of a substantial stock of international reserves in the up phase to offset the withdrawal of cross-border finance in the down phase.

While these were indeed policies aggressively utilised by the RBI in managing this latest cycle, Calvo's take on them was in fact subtly but importantly different from the usual domestic discussion.

First, on the issue of accumulating international reserves, most of the domestic debate has been concerned with managing the nominal exchange rate and the impact on the money supply.

Calvo turns this discussion on its head, noting that a large share of the growth in reserves has been acquired through seigniorage, and that a large part of the money stock is "covered" by international reserves, a sign of reduced vulnerability.

Equally, though, Calvo expressed concern on the long-term evolution of certain other ratios; the growth of M2 as a share of GDP; the growth in the share of private credit in bank assets; and the steady rise of public debt. Taking together he felt that these all increased the possibility of an India-specific sudden stop, even while emerging markets as a whole have actually been rather unscathed by the crisis in the OECD.

My main "take-away" from the talk was that eternal vigilance is the price of stability, and that it is the banking system's overall balance sheet that needs continuous scrutiny. This is the agenda that we local analysts must now pursue.

** "Lessons from Systemic Financial Crises" Professor Calvo's slides may be found at www.ncaer.org.*

The author is Director-General, NCAER. Views expressed are personal