CAPITAL FLOWS AND MACROPRUDENTIAL REGULATION

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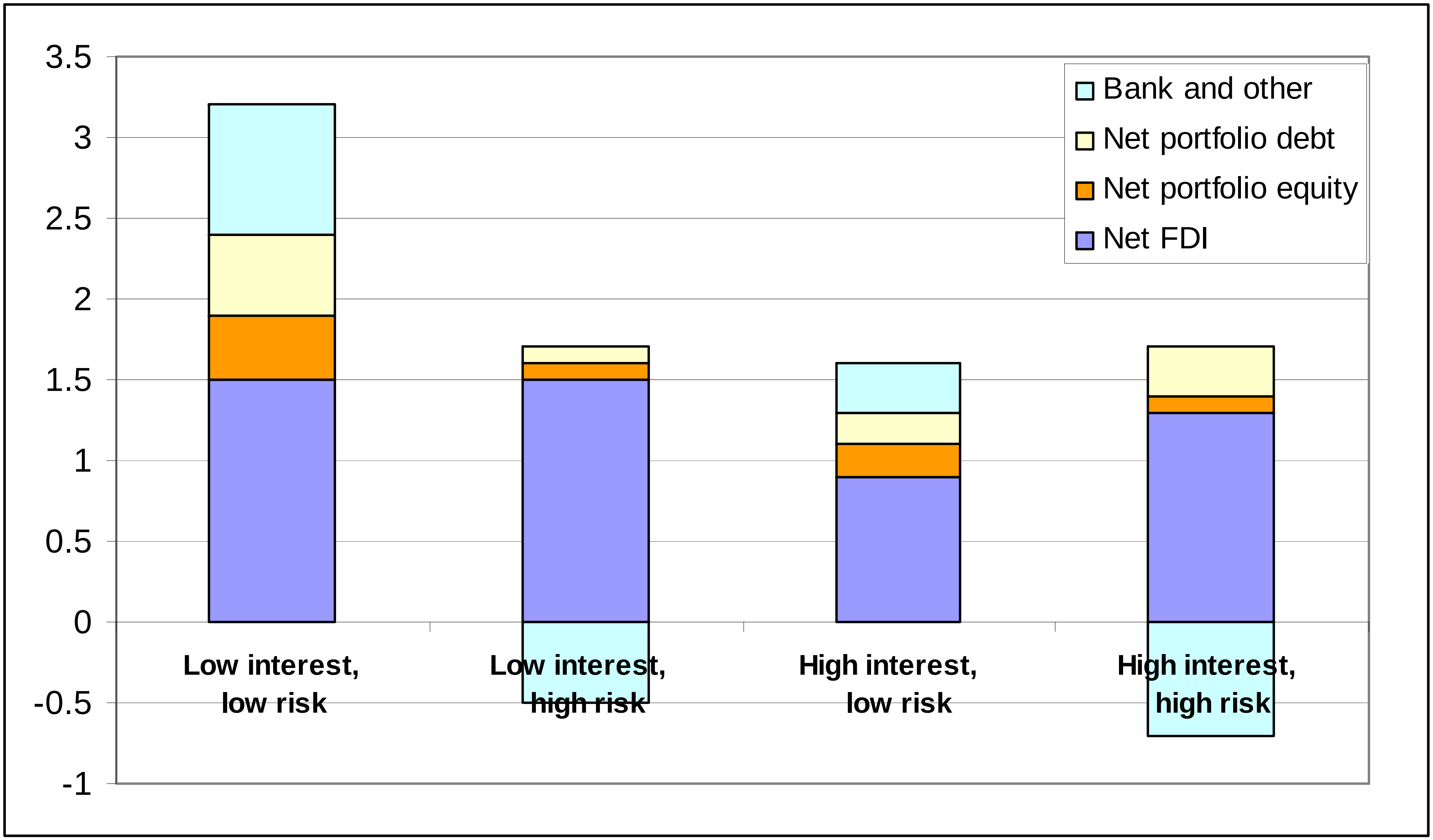
CHARACTERISTICS OF CAPITAL FLOWS

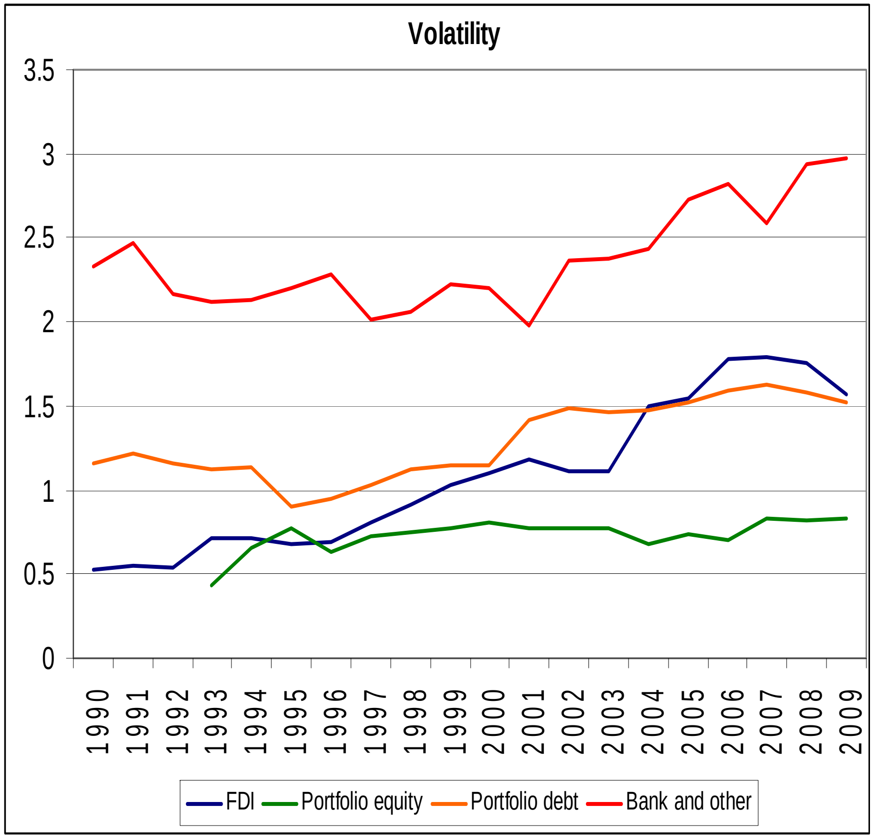
The basic observation: capital flows are volatile

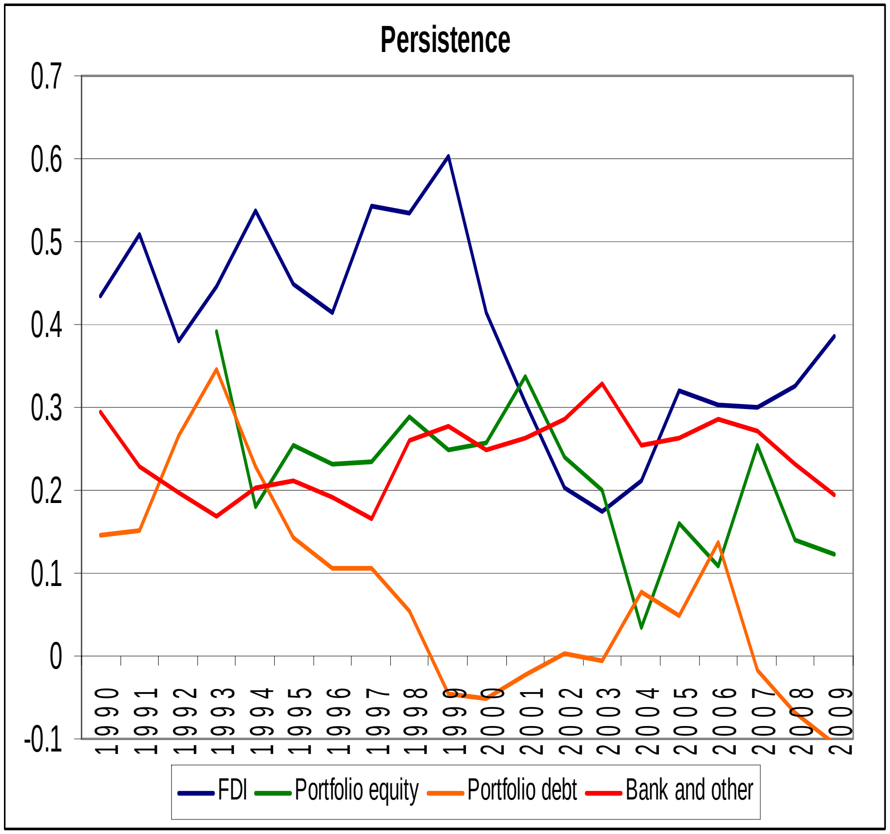
- ❖ Volatility has increased over time and it is generalized, but higher for EMEs than for AEs
- ❖ Flows towards EMEs are highly sensitive to monetary policy in AEs, and to risk perception
- ❖ Different types of flows differ in terms of volatility and persistence (though differences have narrowed down)
- ❖ Recent surge is peculiar because of pace rather than level

Bank and portfolio flows are highly sensitive to interest/risk mix (IMF *WEO*, 2011)



Volatility has increased, particularly for FDI. Persistence is low and has declined.

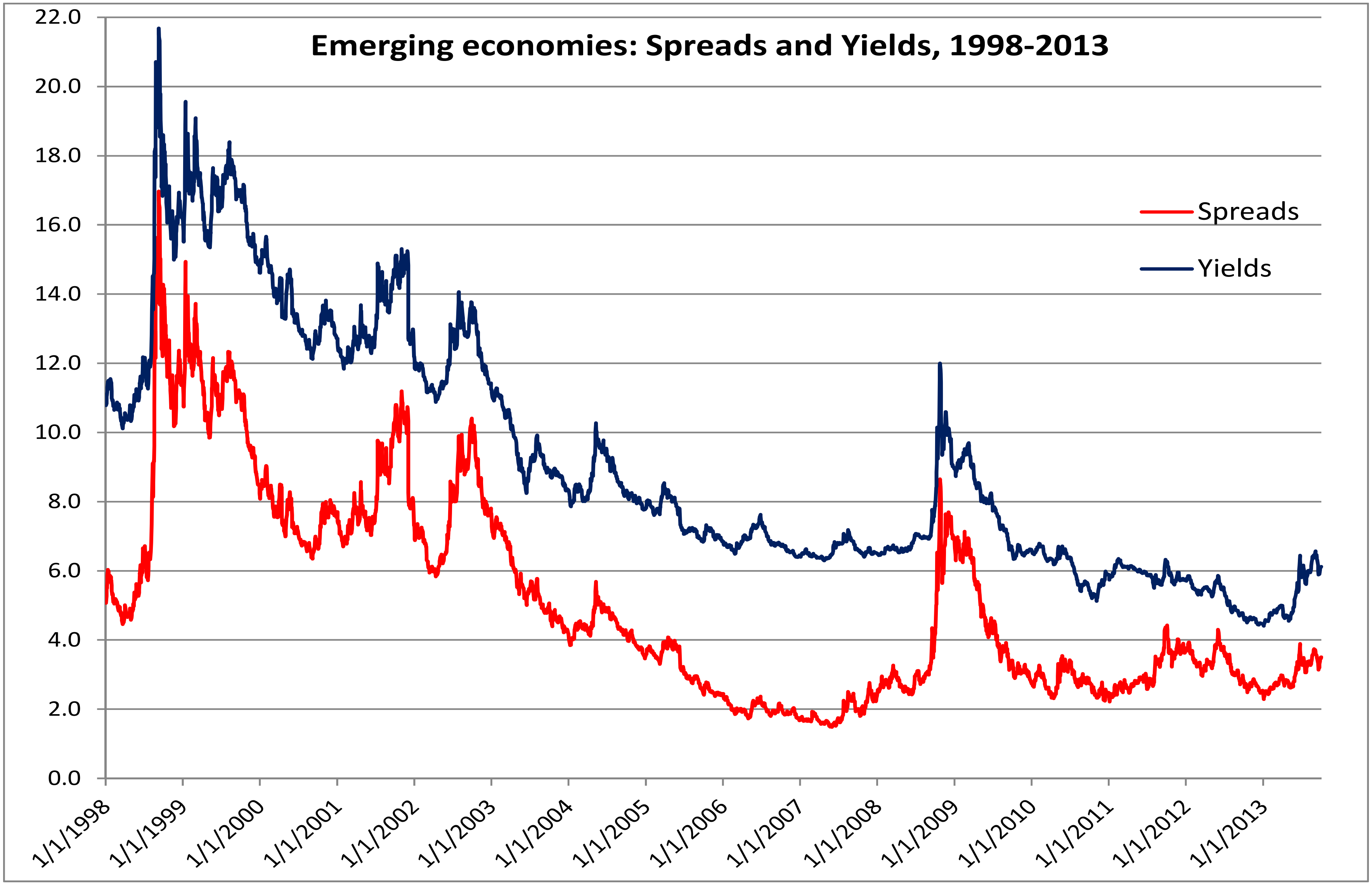




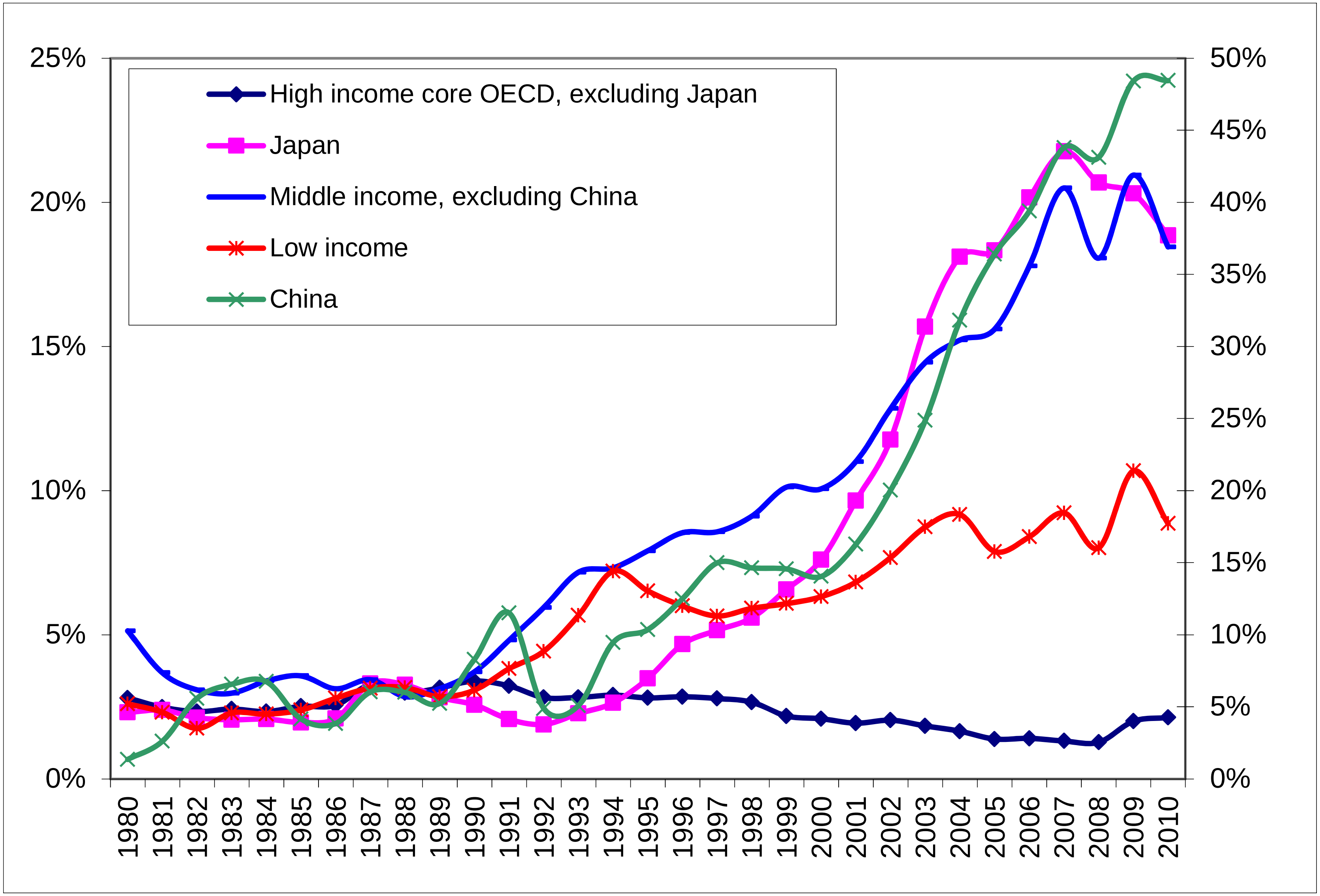
Some additional features

- ❖ Integration into global financial markets is a integration into a market that is segmented by risk categories.
- ❖ The riskier segments (including that for emerging markets) behave in a more pro-cyclical way.
- ❖ Segmentation has declined due to: reserve accumulation, development of domestic bond markets, and stronger growth of EMEs.
- ❖ These achievements may become a double-edge sword, when they attract excessive capital flows.
- ❖ EMEs markets are relatively small ➢ A small portfolio decision in AEs has major effects on EMEs

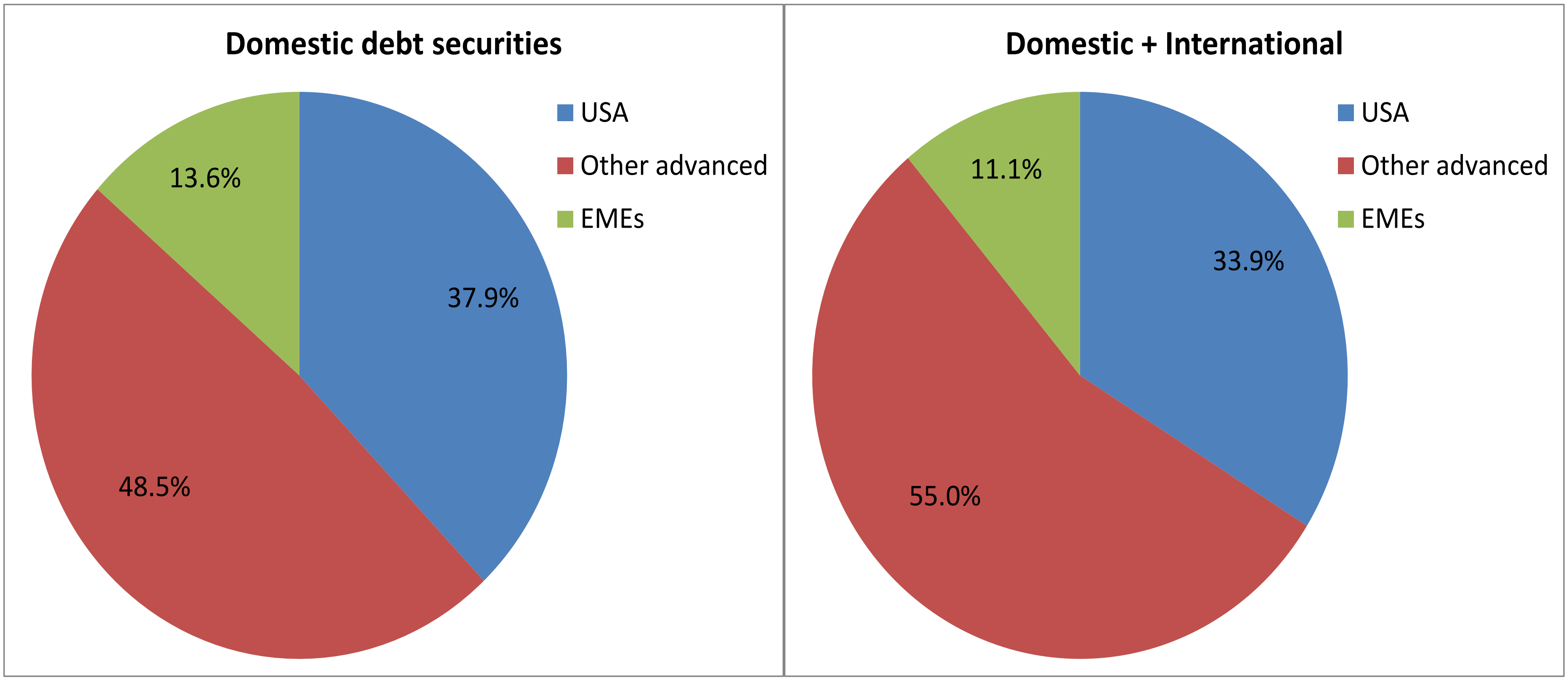
Emerging markets are more pro-cyclical, but segmentation has declined…



… thanks largely to massive reserve accumulation



Capital markets of EMEs are small compared to those of AEs



The post-crisis scenario

❖ Significant spillovers of US monetary policy.

❖ The problem has not been QEs, as it has not increased the money supply in the US, but the interest rate differentials between EMEs and AEs.

❖ Now, fears associated with Fed tapering (and with US default fears).

❖ With structural imbalances in the world economy, interest rate arbitrage is a source of instability

❖ So, global (i.e., not only national) capital account regulations may be necessary to manage persistent incentives to interest-rate arbitrage.

THE POLICY DEBATE

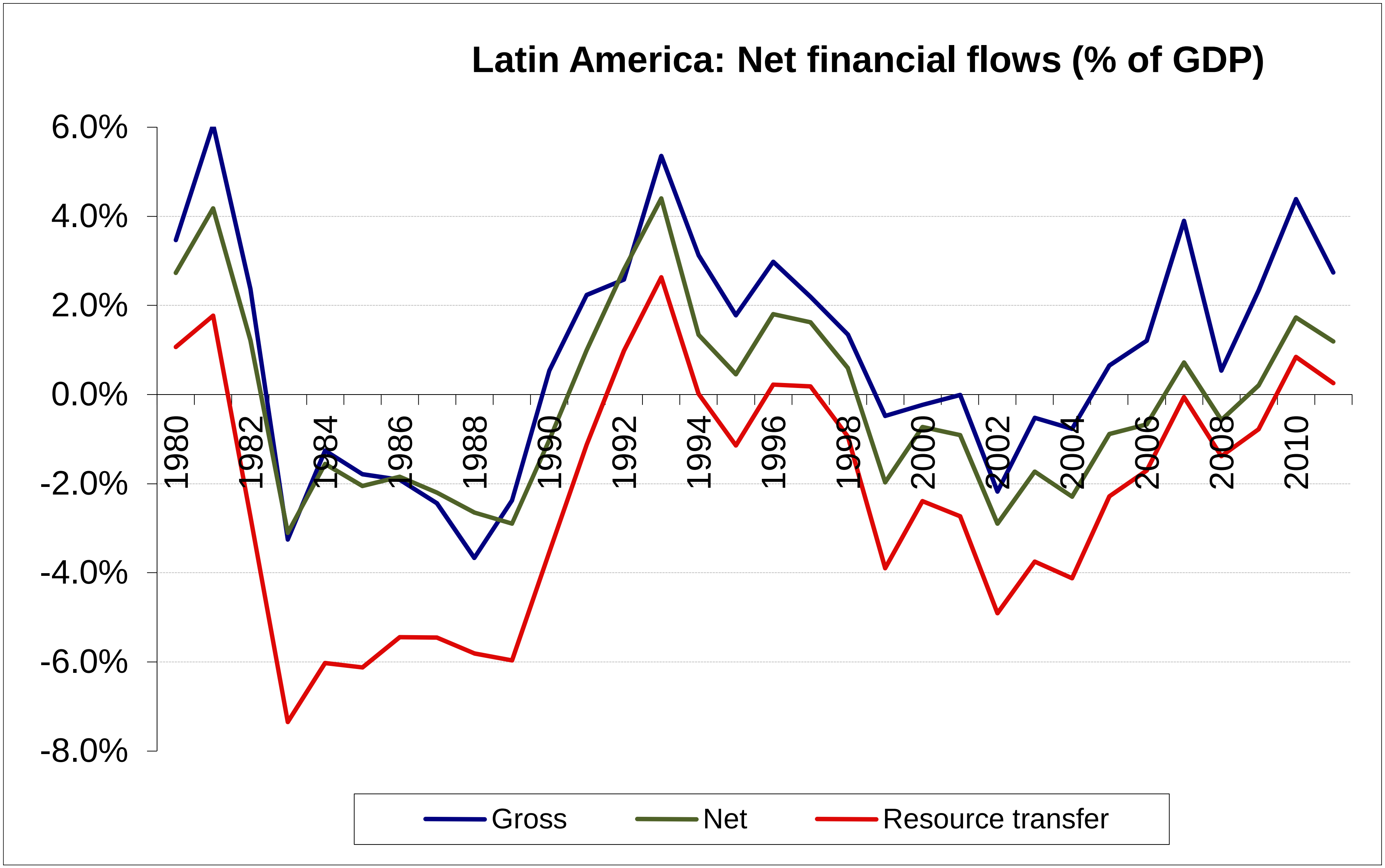
The major problem:
Balance of payments dominance

- Macroeconomic regime in which the short-term macroeconomic dynamics is essentially determined by external shocks, positive or negative.
- Major shocks: terms of trade and external financing. The latter may be partly endogenous, but it is largely driven by common external factors.
- In both cases, the “first best” policy should be to intervene in the source of the shock: stabilization fund (or taxation) and macroprudential (including capital account) regulations.

The policy issues (1)

- ❖ Medium-term cycles, not short-term volatility are the most difficult to manage.
- ❖ The reasons are simple:
  - ✓ Capital flows directly generate pro-cyclical effects on spending, credit growth and asset prices.
  - ✓ They also reduce the room of maneuver for counter-cyclical macroeconomic policies
- ❖ Fiscal policy can always be counter-cyclical, but:
  - ✓ Pro-cyclical financing reduces the room of maneuver for counter-cyclical fiscal policies.
  - ✓ Austerity during crises generates political economy pressures to spend during the recovery, thus generating a pro-cyclical dynamics.

The medium-term cycle



The policy issues (2)

- Monetary/exchange rate autonomy: with free capital movements, countries may be just choose where they want the instability of capital flows to be reflected in the domestic economy.
- Exchange rate flexibility has real costs:
  - ✓ It can easily lead to overvaluation and a risky growth pattern.
  - ✓ It increases the risk of producing tradables = it is a "tax on international specialization" (Kindleberger)
- These two issues explain the revealed preference for intermediate exchange rate regimes.
- But the essential instrument used, heavy counter-cyclical reserve accumulation, has costs.

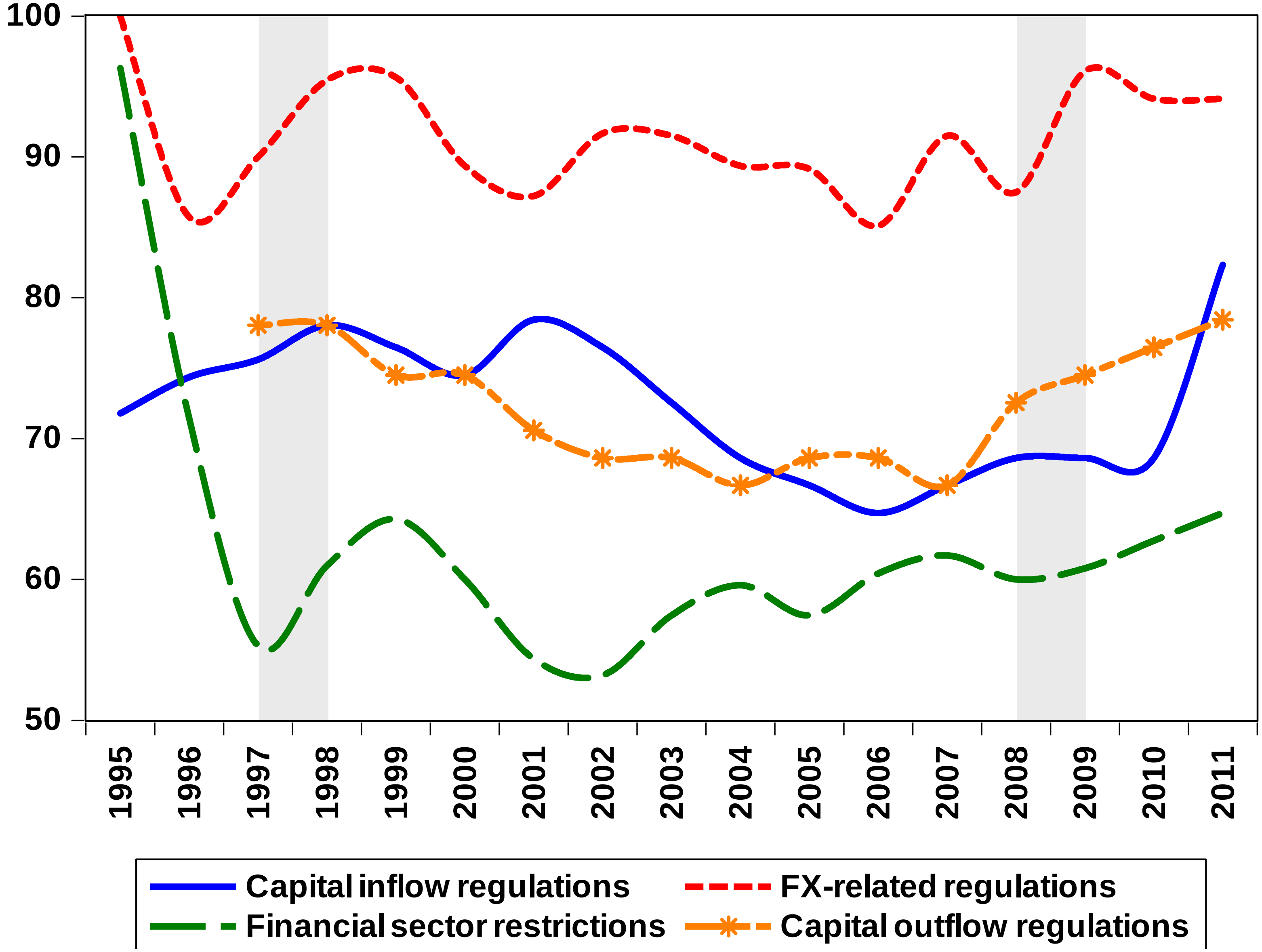
The policy issues (3)

- Given the limitations of all instruments, counter-cyclical policies require more instruments than objectives, including an acceptable level and stability of the real exchange rate.
- Counter-cyclical prudential and capital account regulations are essential ingredients of such policies (macroprudential framework).
- Thus, they are <u>not</u> measures of "last resort". They are essential ingredients of an optimal policy package.
- This is particularly true of capital account regulations, as they target the major direct source of shocks.

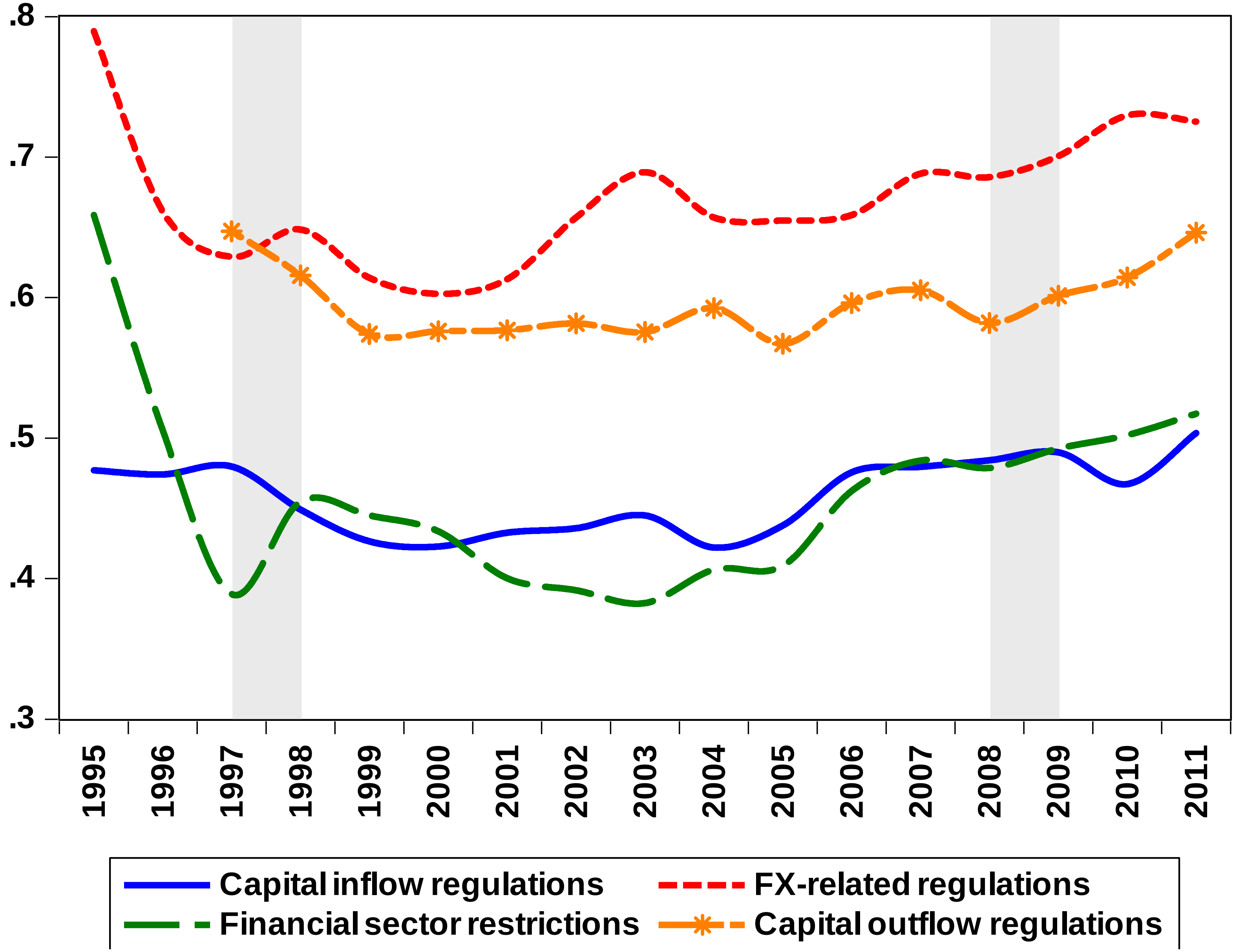
Macroprudential regulations (1)

- Two basic objectives:
  - Macroeconomic stability: overheating/inflation and exchange rate over/under-valuation and volatility.
  - Reducing financial stability risks: rapid credit growth, asset price bubbles, currency and maturity mismatches.
- There is a continuum between three types of regulations:
  - Strict counter-cyclical prudential regulations (capital, provisions and/or liquidity). Basel III.
  - Foreign-exchange related prudential measures
  - Capital-account regulations.

Frequency in use of regulations



Intensity in use of regulations



Macroprudential regulations (2)

- Their use should be based on certain criteria:
  - Characteristics of financial system.
  - Effectiveness.
  - This may imply that simple quantity-based regulations (prohibitions, quantitative limits) may be better…
  - … and that selective policies may also be preferable.

The IMF's 2012 "institutional view"

- Capital account interventions recommended as a policy of "last resort", once all other macro policy options are exhausted.
- Preference for capital inflow over outflow measures.
- Preference for price-based measures over quantity-based.
- "Institutional view" still embraces liberalization but warns about the costs of pre-mature capital account and financial liberalization.

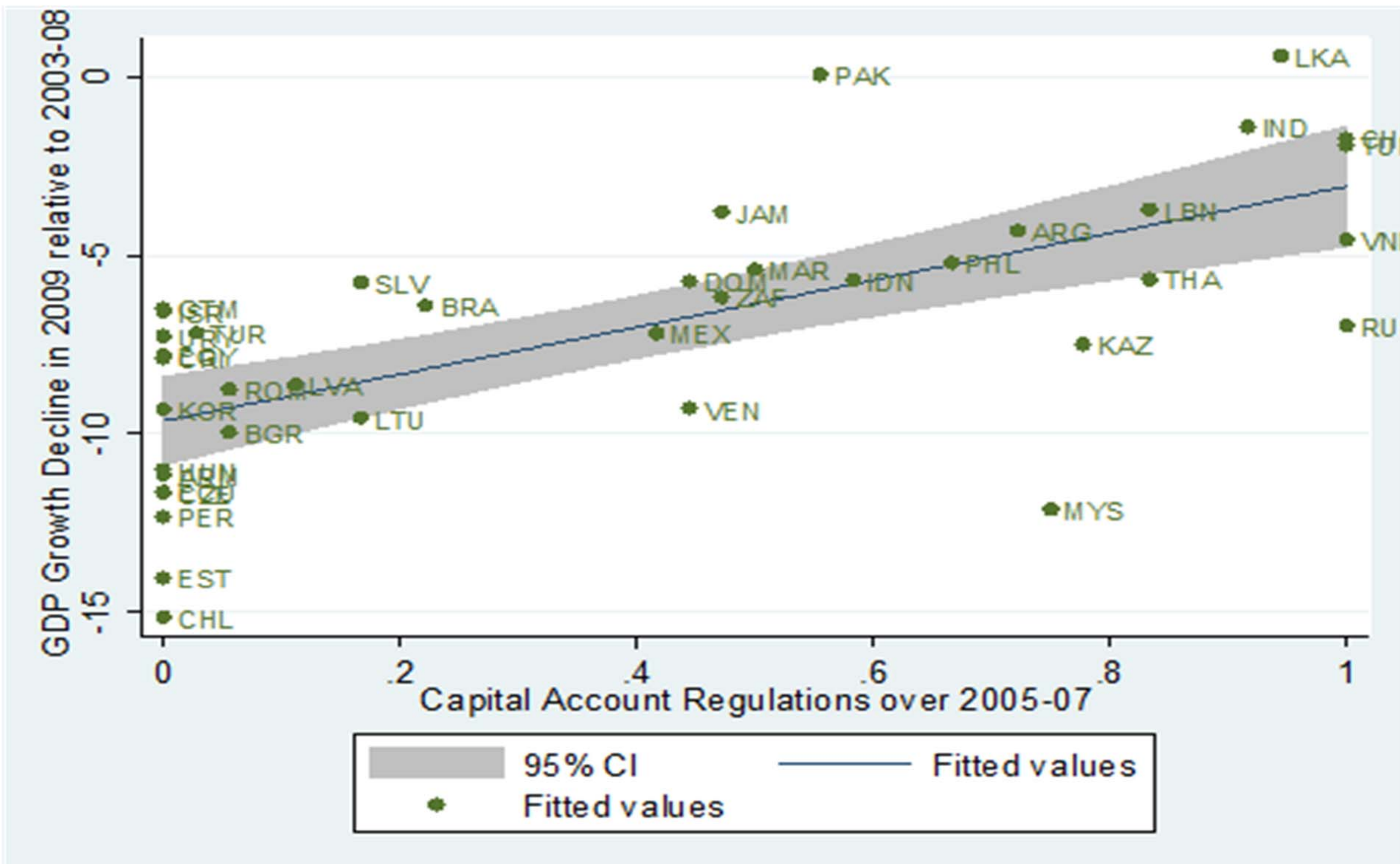
Effectiveness:
What does the literature say?

- Largely based on individual country studies.
- Strong evidence of positive effects on reducing financial stability risks (improving the “quality” of capital inflows).
- Diverse results of effects on reducing the quantity of inflows or exchange rate pressures.
- Some operate as “speed bumps”, as they tend to be circumvented after some time, and must therefore be dynamically strengthened.
- Institutional capacity: it is better to have permanent regimes that are managed in a counter-cyclical way.

My own research with Bilge Erten

- ❖ Panel data analysis for 51 emerging and developing economies over 1995-2011.
- ❖ All policy measures (except financial sector restrictions) are associated with lower foreign exchange pressure and reduced real exchange rate appreciation
- ❖ The effects of capital outflow regulations are larger than that of capital inflow regulations in magnitude.
- ❖ They enhance monetary policy autonomy by enabling the authorities to raise interest rates without attracting further inflows that appreciate the exchange rate .
- ❖ Restrictiveness of capital account regulations in the run-up to the crisis enhanced crisis resilience.

CARs and (conditional) crisis resilience



Two basic policy implications

1. Given their effectiveness, these policy measures should be considered as part of regular and permanent policy tools and not as instruments of last resort or temporary measures.

2. Every developing country that is subject to large swings in procyclical capital flows must have the policy space to use capital account regulations as countercyclical tools that would serve as a first best policy response to eliminate the source of disturbance resulting from externally-driven capital flows.

What remains of the advantages of capital mobility / liberalization?

- Allow countries with limited savings to attract financing for productive investment

  … if countries can manage to run stable current account deficits; and, in any case, financing may be used for increased consumption.

- Foster the diversification of investment risk

  Certainly for source countries; for recipient countries, there are increased risks

- Contributes to the development of financial markets

  This is partly correct, so long as funds are stable

- Access to global capital markets is good, but full capital account liberalization has unclear benefits.

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