

# CAPITAL FLOWS, INTERNATIONAL IMBALANCES AND ECONOMIC POLICIES IN LATIN AMERICA

‘ECONOMIC POLICIES OF THE NEW THINKING  
IN ECONOMICS’ CONFERENCE – *UNIVERSITY  
~~OF CAMBRIDGE, 12/04/2012~~*

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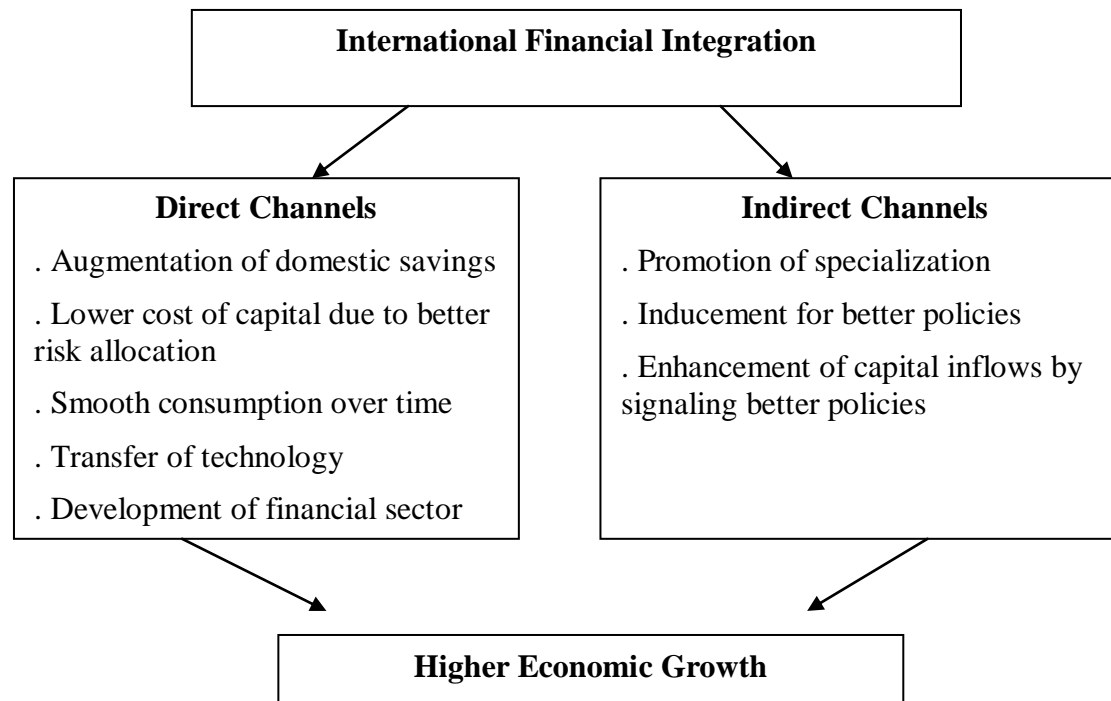
# Stilized facts

- Empirical literature shows evidence that capital flows to Latin America have been most determined by *push* factors (for instance, economic policy of the developed countries) rather than to *pull* factors (associated to domestic factors).
- After a succession of currency crises, Latin American countries adopted floating exchange regime but at the same time have made use of foreign exchange reserves accumulation policy and reduction of public external debt in order to reduce external vulnerability.
- More recently, due to the implementation of the 'easing' monetary policy in the U.S. and Eurozone, combined with the attraction of FDI due to the commodities boom, capital inflows to Latin America have increased a great deal. This trend has put pressure on the economic policy of countries of the region and has had consequences in the real side of the economy (output, industry, etc.)

# Objetives and questions...

- To analyze the *causes* and *consequences* of the recent capital flows boom to Latin America, focusing in the major countries of the region (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela).
- Are there specific determinants and features in the recent wave of capital inflows to LA?
- Why LA countries succeed in facing the contagious of the international financial crisis?
- Have LA countries succeed in managing capital flows?

# Theoretical benefits of international financial integration



*Source:* Adapted from Prasad et al (2003, p. 24)

# Problems related to capital flows

- Tobin (1978): “The main macroeconomic policy related to the integrated financial markets is not the choice of the appropriate exchange rate regime but the excessive capital mobility that reduces the autonomy of national governments to pursue domestic objectives”.
- Stiglitz (2000): Capital flows in emerging countries are markedly pro-cyclical as exacerbate economic boom and expose them to the changes in the economic circumstances outside the country.
- Kregel (2008): Washington Consensus policies in Latin America implemented domestic policies (exchange rate anchor, high interest rates, and financial liberalization) that hinder the domestic productive and technological re-structuring that could contribute to boost economic and employment growth in the region .

# Assymmetric financial integration

- Empirical studies show that in general exchange rate volatility is higher in emerging economies than in developed ones as the former have small and less liquid foreign exchange markets.
- In other words, such countries have much larger and volatile capital flows compared to the size of their capital market and economies.

# Factors affecting capital inflows in EMEs

	Cyclical	Structural
<b>Push</b>	<ul style="list-style-type: none"><li>- <b>Low US interest rates</b></li><li>- <b>Low global risk aversion</b></li><li>- Strained advanced economies balance sheets</li></ul>	<ul style="list-style-type: none"><li>- International portfolio diversification</li><li>- Low advanced economies potential growth</li></ul>
<b>Pull</b>	<ul style="list-style-type: none"><li>- <b>High commodity prices</b></li><li>- <b>High domestic interest rates</b></li></ul>	<ul style="list-style-type: none"><li>- <b>Capital account liberalization (during the 1990s and after the Asian crisis)</b></li><li>- <b>High emerging economies potential growth</b></li></ul>

# What can we learn from the empirical literature on capital flows?

- Fluctuations in net flows are much sharper for emerging market economies (EMEs) compared with advanced economies (AEs) – in the latter, gross outflows largely offset gross inflows, generating smoother movements in net flows (IMF, 2011a).
- Episodes of large capital inflows are associated with acceleration of GDP growth, but afterwards growth often drops significantly (Cardarelli et al, 2009). So, there is an inverted V-shaped pattern of net capital flows to EMEs around outside the policymakers control (IMF, 2011b).
- Fluctuations in GDP growth have been accompanied by large swings in aggregate demand and in the current account balance, with strong deterioration of the current account during the inflow period and sharp reversal at the end (Cardarelli et al, 2009).
- Historically, *portfolio flows* have been more volatile and their volatility has recently risen. *Bank flows* have historically been less volatile but their volatility rises sharply around crisis times FDI is only slightly more stable than other types of flow for EMEs, and its volatility has increased recently due to increase of direct borrowing by a firm subsidiary (IMF, 2011b).



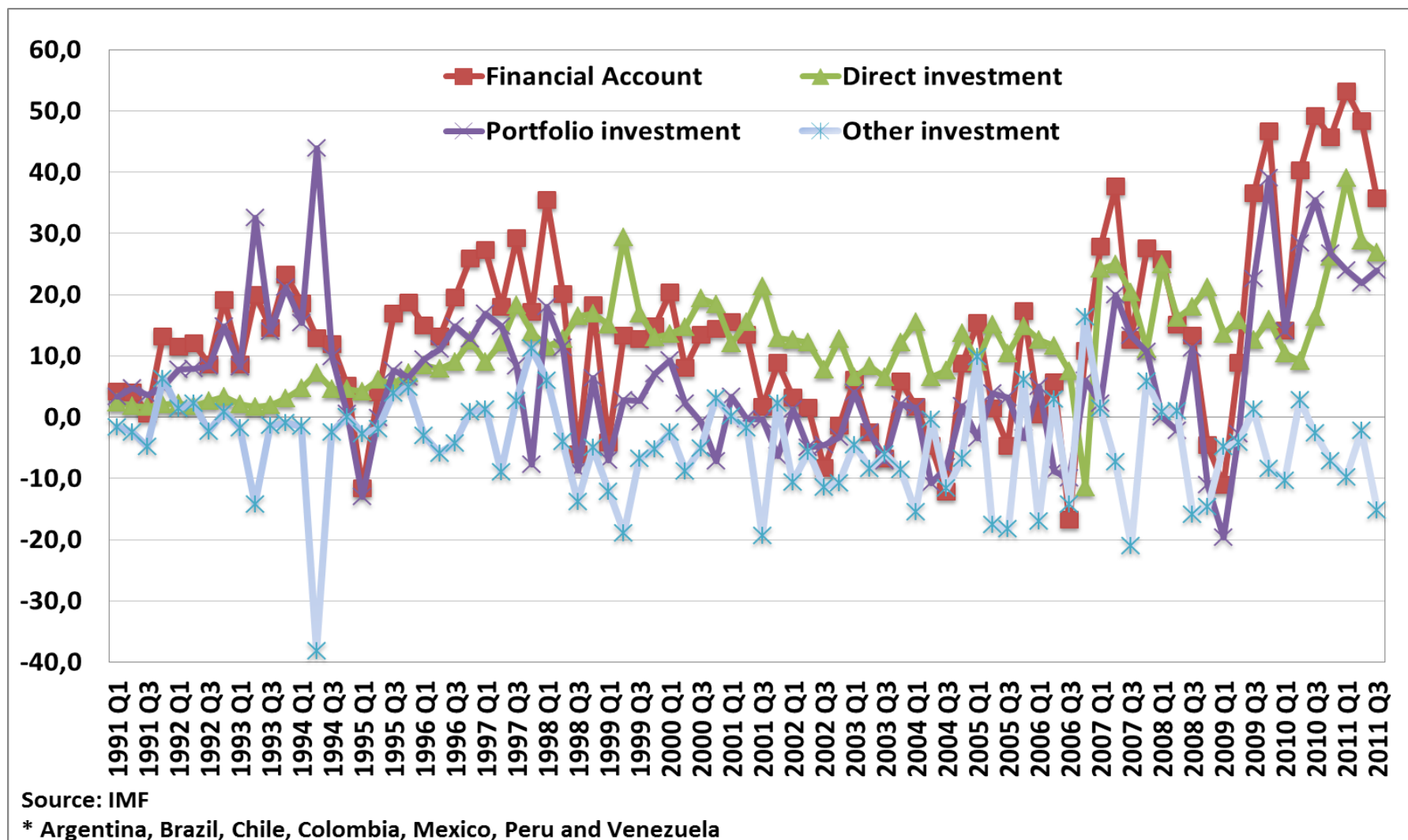
# Recent waves of capital flows to EMs

- **1st wave** (early 1990s until 1997-1998 Asian crisis):
  - Initial impulse given by the expansionary monetary policy in the USA.
  - Predominance of portfolio flows and FDI.
  - Most EMEs made use of some sort of intermediary exchange rate regime or semi-pegged ones.
- **2nd wave** (2006-2008)
  - Much stronger current account positions for most EMEs, and substantial acceleration in the accumulation of foreign reserves.
  - Period of “great moderation”. (low interest rates)
  - Predominance of net FDI flows relative to net financial flows (portfolio and other flows) in all EMEs regions.
- **3rd wave** (since 2009Q3): recovery driven primarily by portfolio flows, and secondarily by FDI.
  - “Quantitative easing” and slow economic recovery of AEs.
  - Better economic performance of the EMEs.

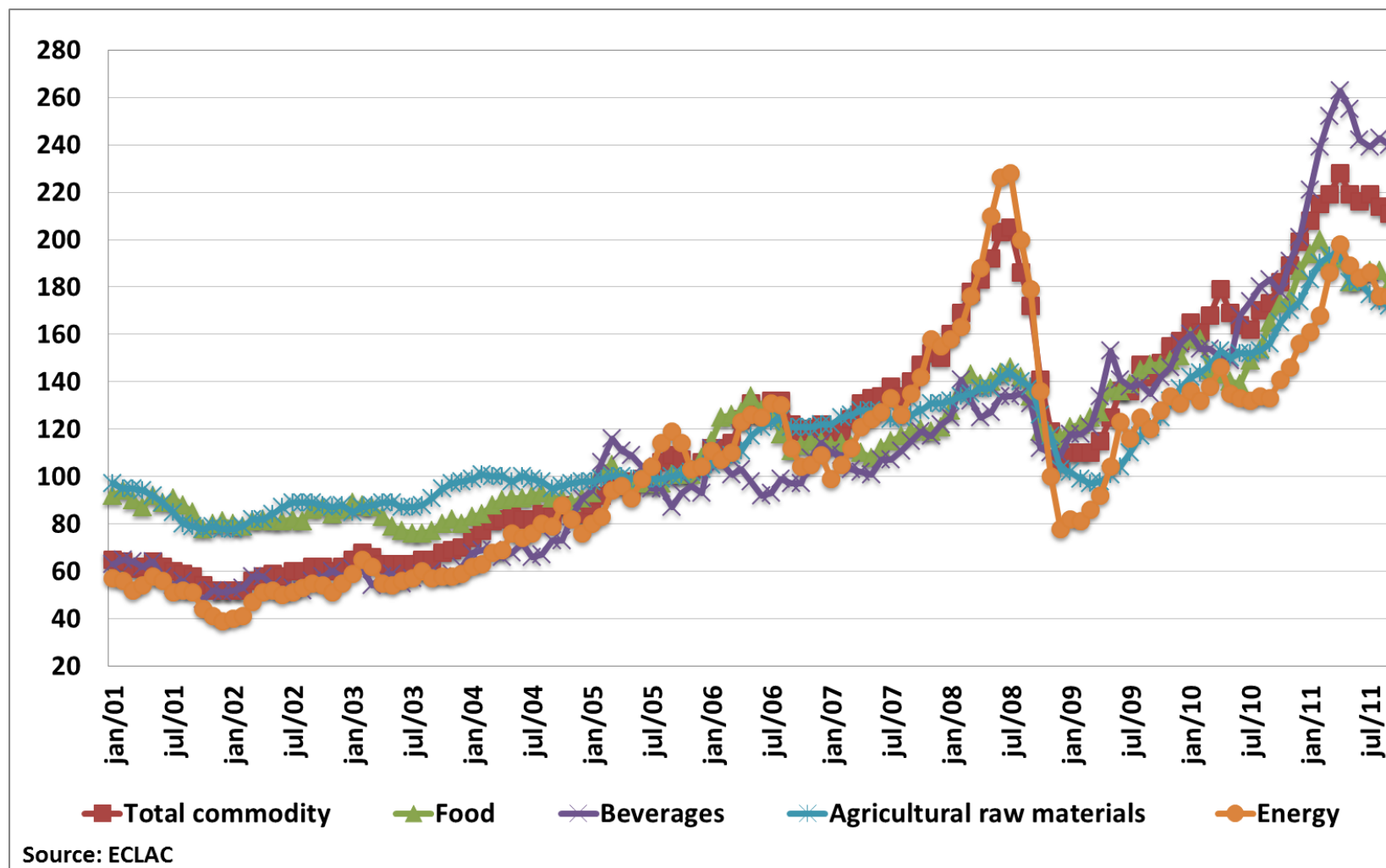
# Washington Consensus and New Consensus on Macroeconomics in LA

- LAs countries adopted liberal reforms (privatization, trade liberalization and capital account liberalization) during the 1990s, but with different styles. For instance while Argentina adopted a “big bang” reform, Brazil adopted a more gradual reform.
- However, most countries experimented a quick and deep process of capital account liberalization, including portfolio capital liberalization for both residents and non-residents.
- After the 1990s currency crises, some LA countries adopted a regime of macroeconomic policy inspired in the NCM: floating exchange regime, inflation targeting regime, and primary fiscal surplus. Brazil, Chile, Colombia and Mexico in 1999, and Peru in 2002.
- However, this ‘model’ of economic policy has been managed with some flexibility, before and after the 2007-08 international crisis.

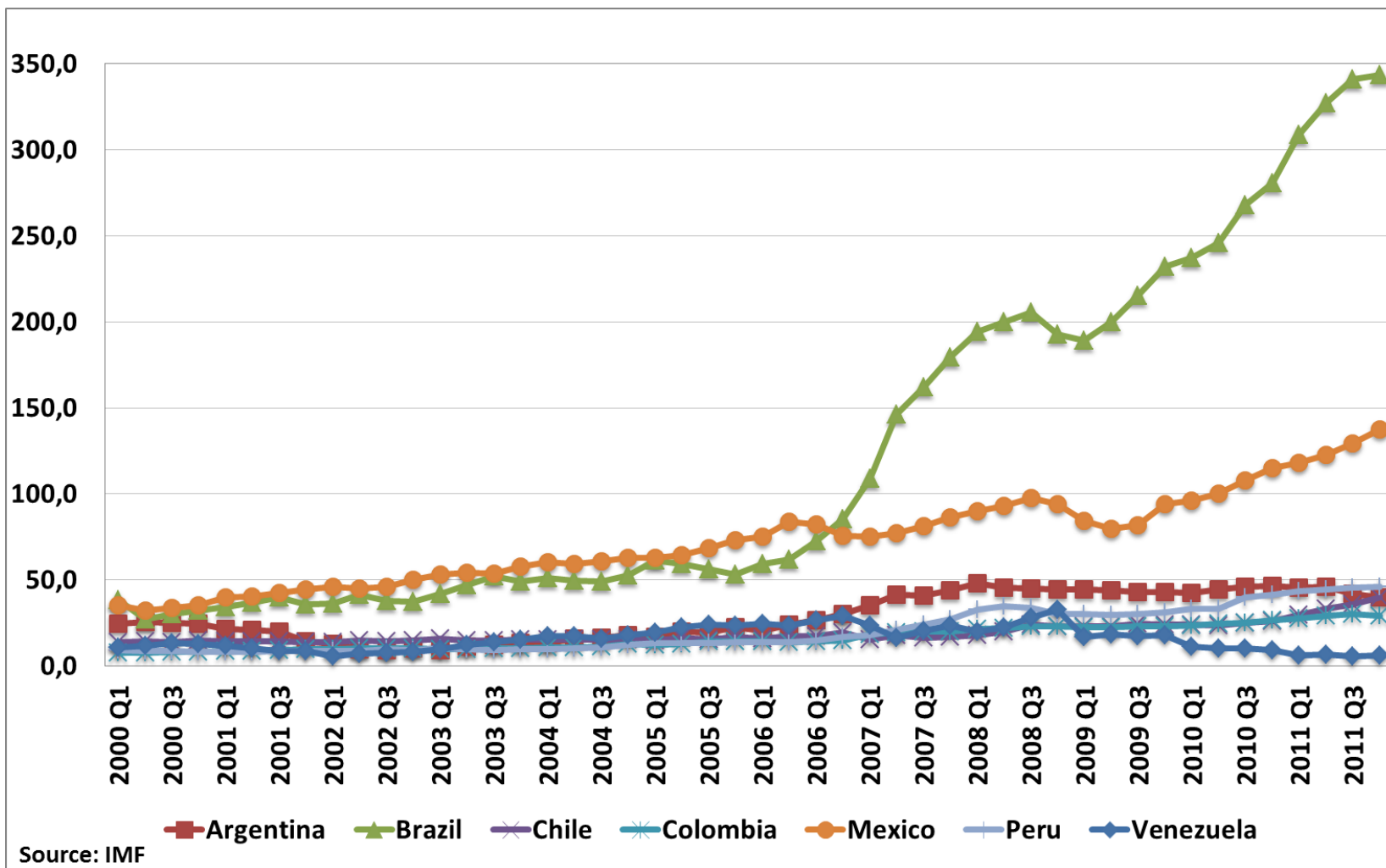
# Financial account (net balance in US\$ billion)



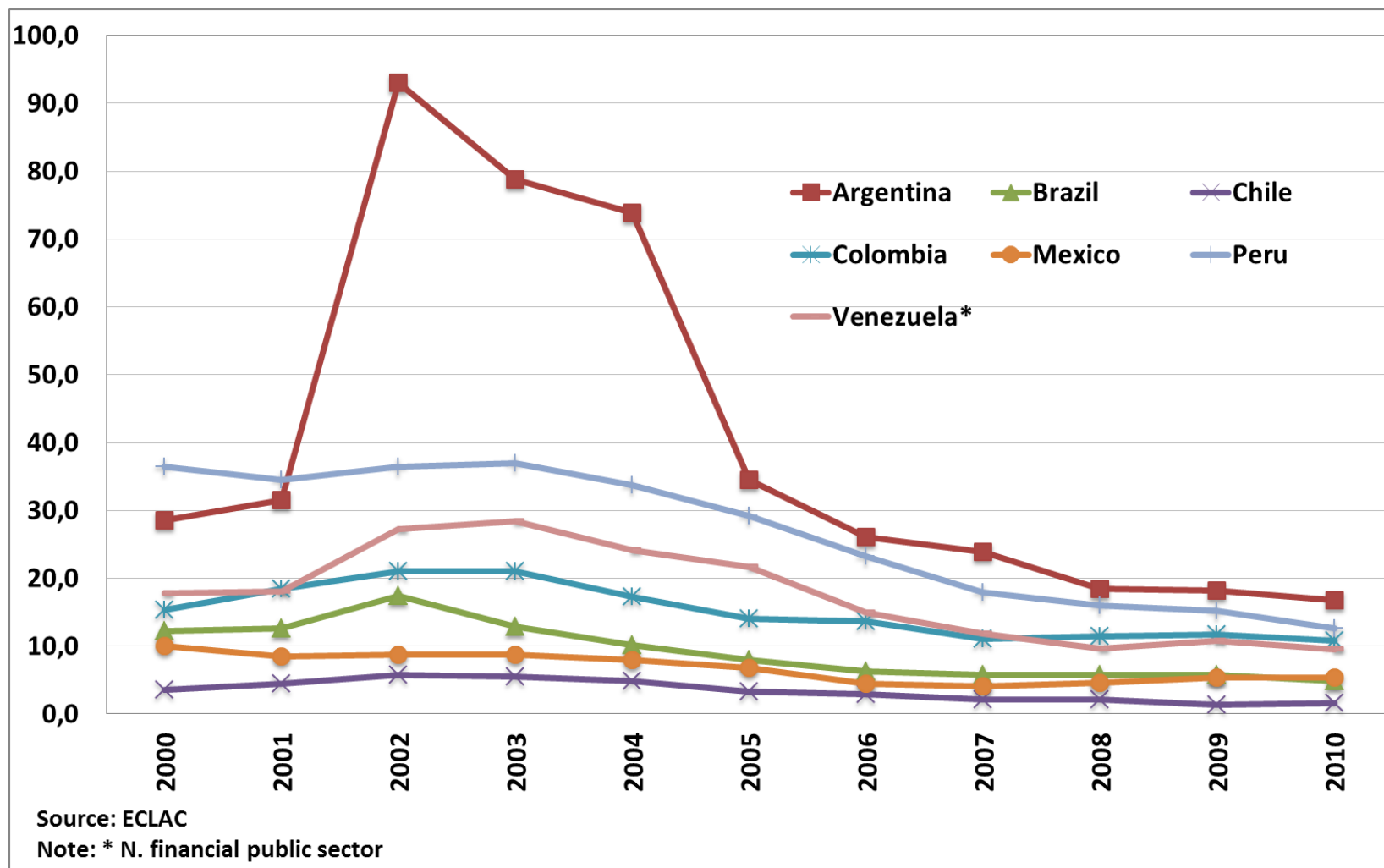
# Commodity price index (2005 = 100)



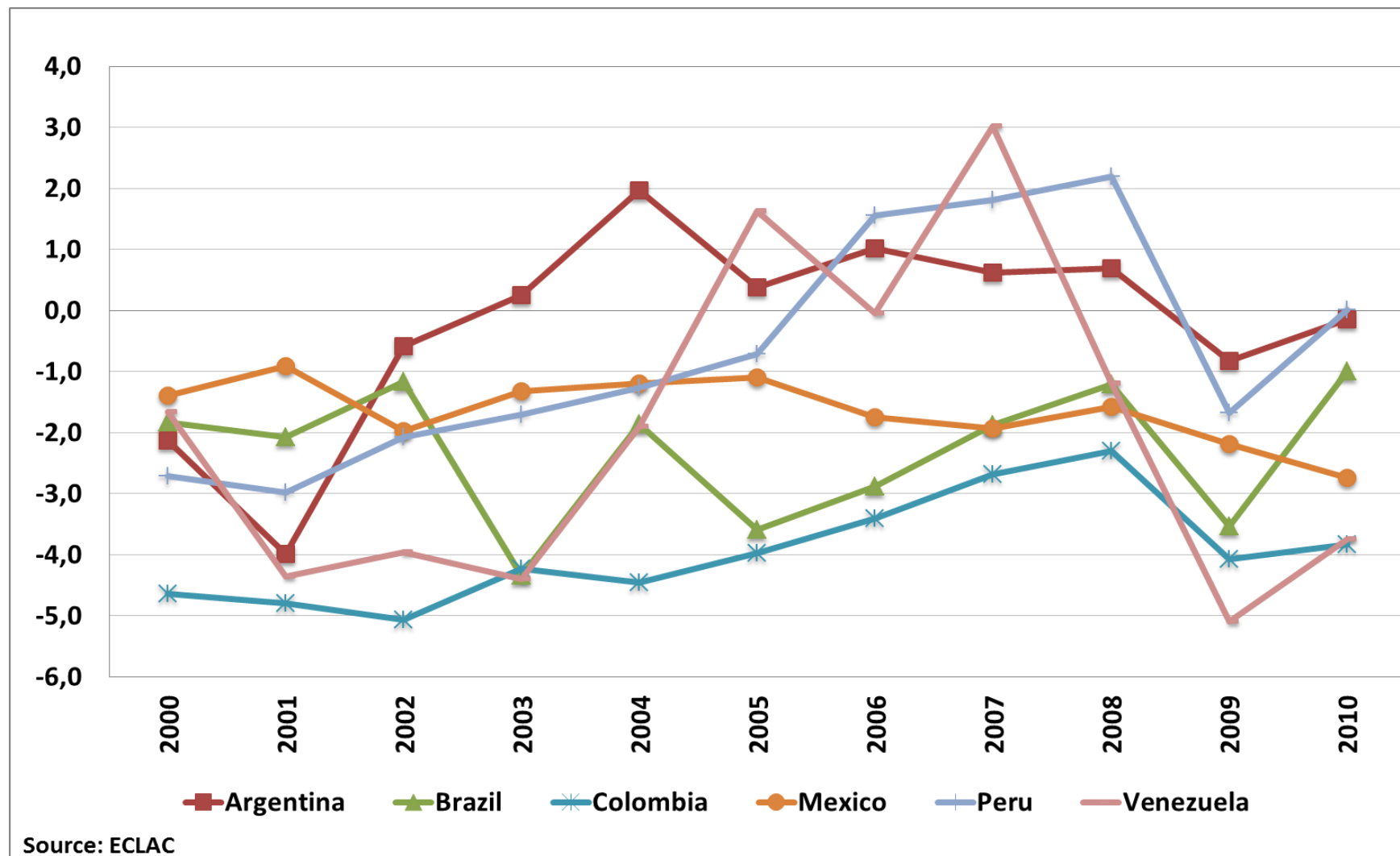
# Foreign exchange reserves (US\$ billion)



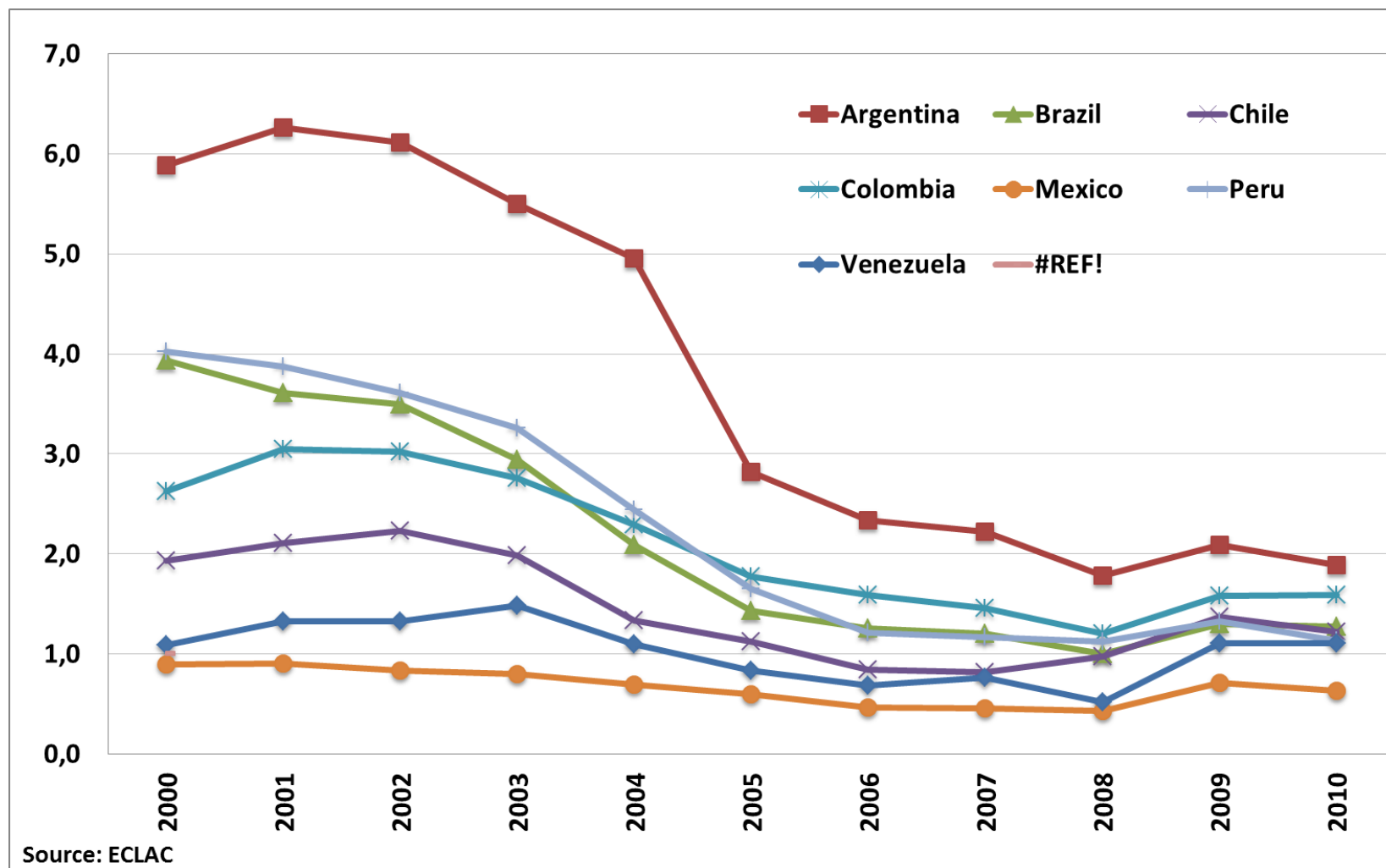
# Public external debt (% GDP)



# Overall fiscal balance (% GDP)

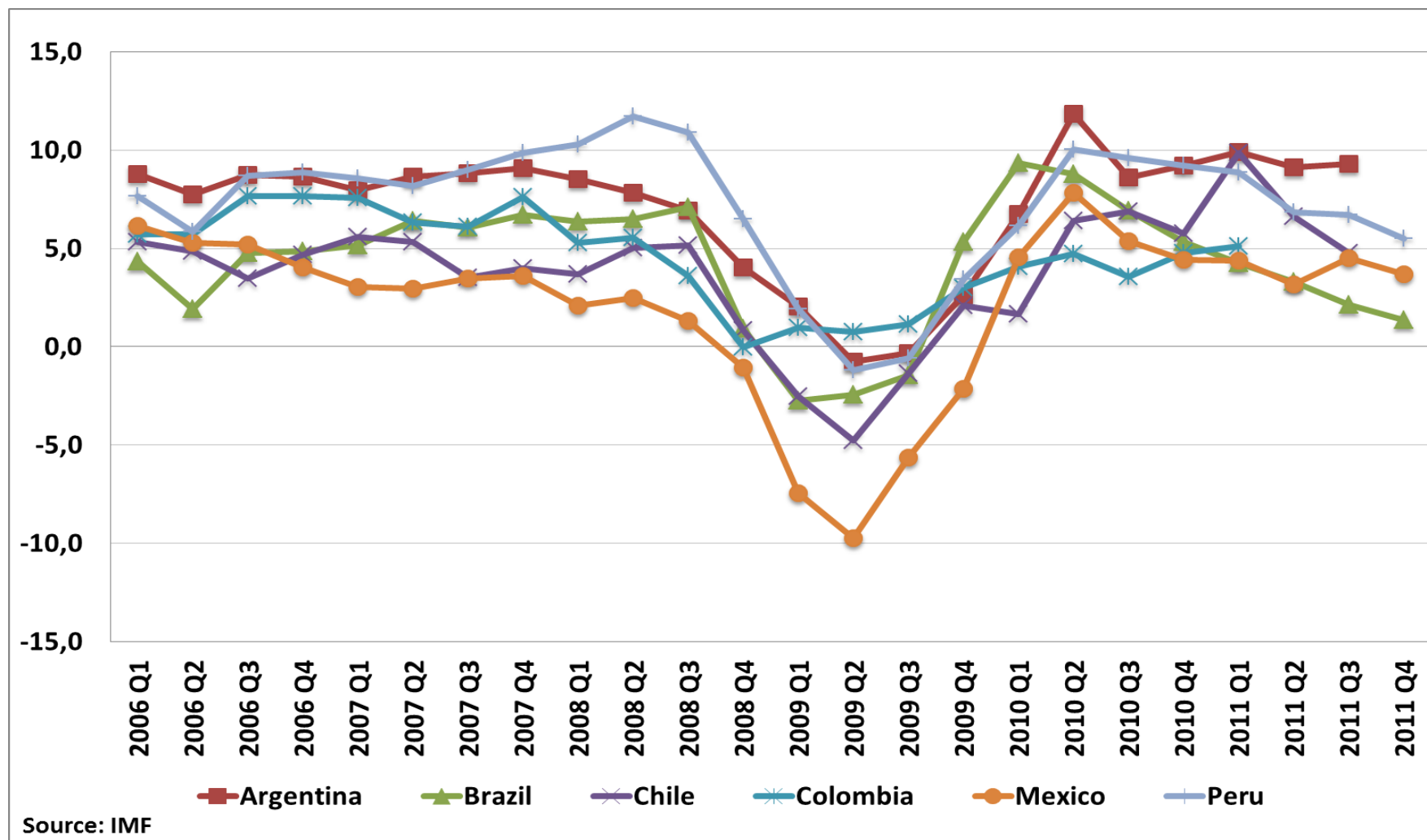


# External debt-over-exports

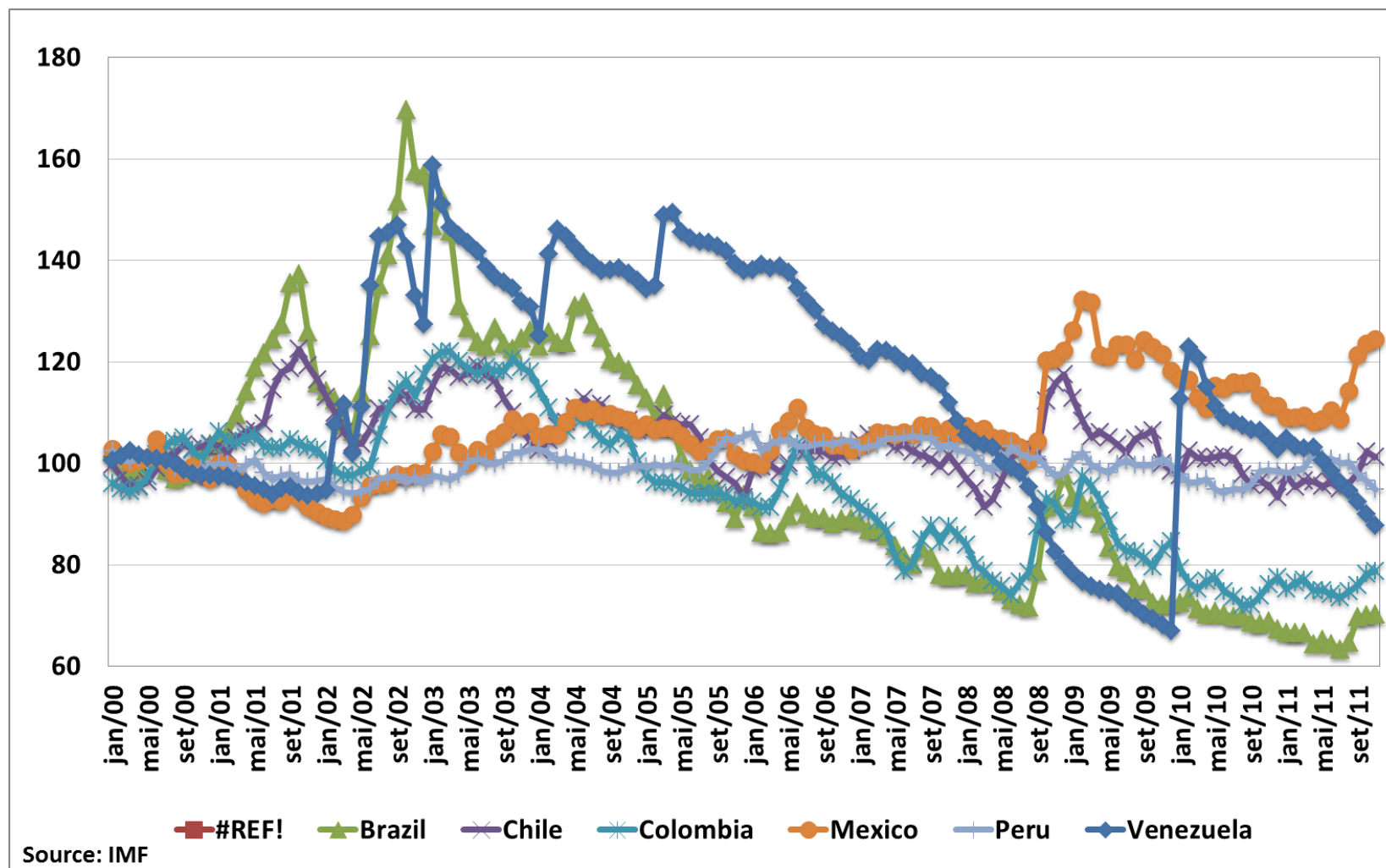




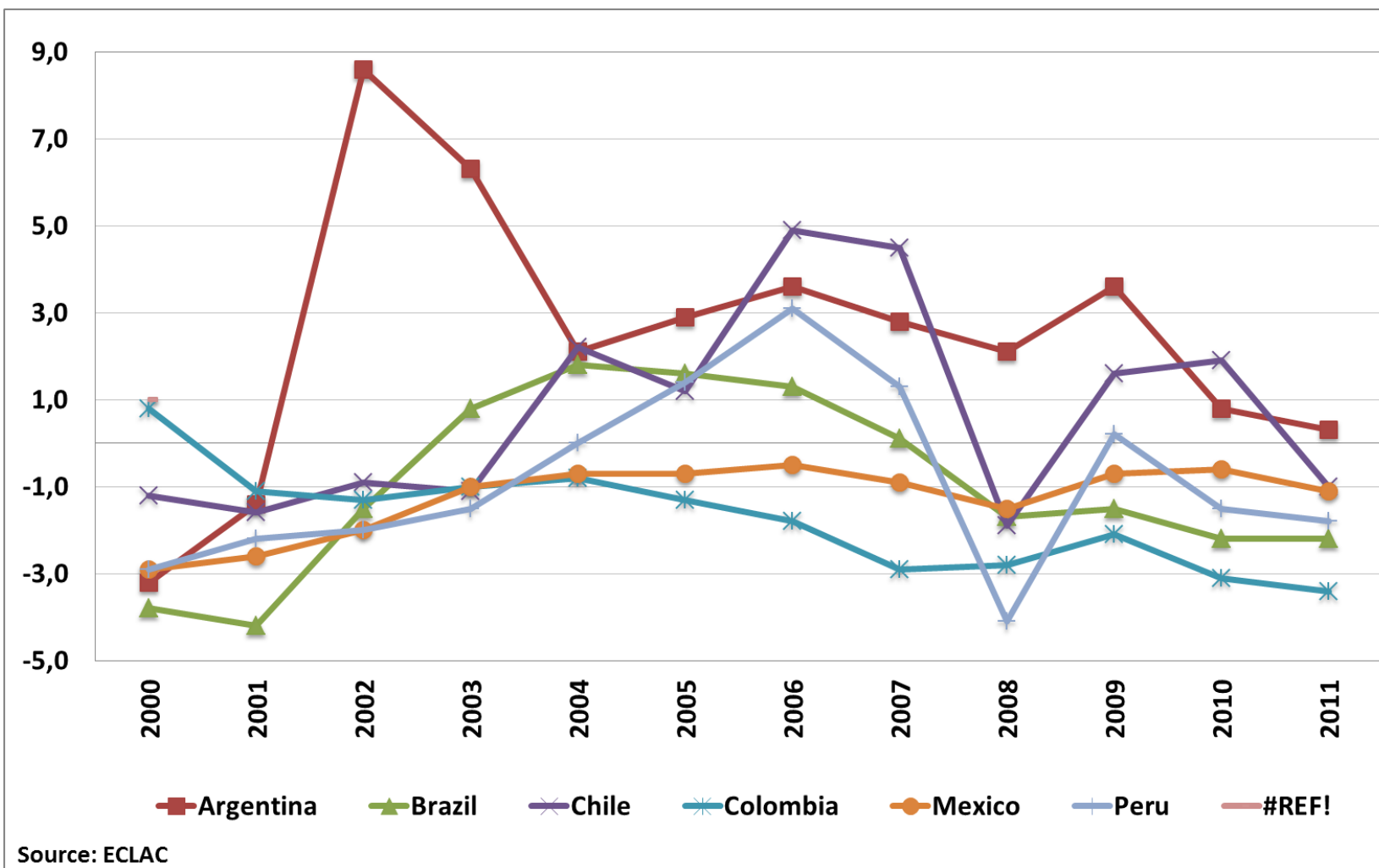
# GDP growth (%)



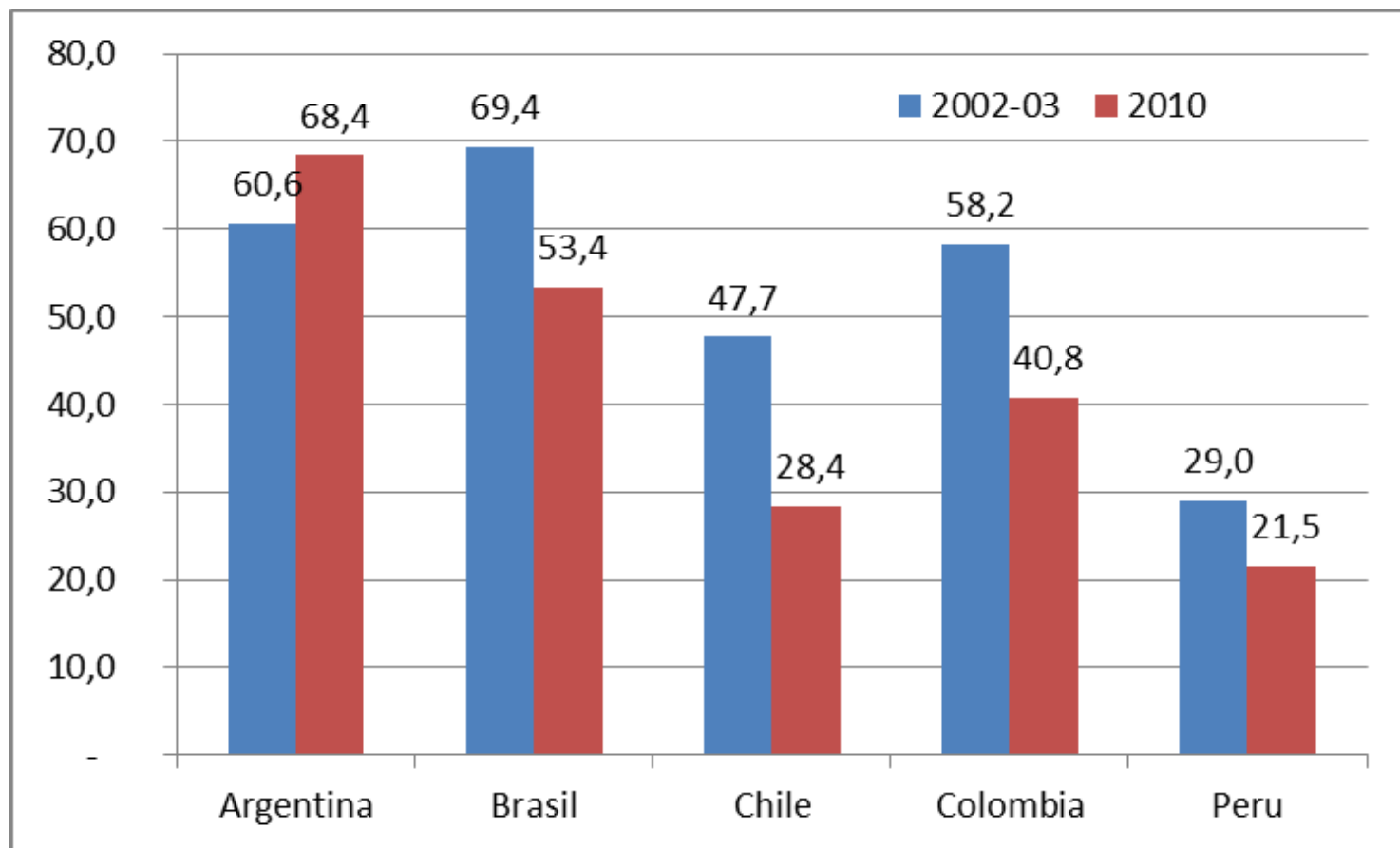
# Real effective exchange rate (2000=100)



# Current account-over-GDP



# Industrial exports-over-total exports (%)



# Some conclusions...

- Capital flows have been volatile in LA, with predominance of portfolio capitals and FDI. Since mid-2009 there is a quick recovery of capital inflows.
- There was a quick and deep contagious of the international financial crisis in LA, but recovery was also quick. Previous policy of reduction of external vulnerability plus adoption of floating exchange rate regime provided some space for contra-cyclical economic policies.
- However, for most economies there is a gradual trend to real appreciation of exchange rate due to massive capital flows.
- Current account deficit widened (1.4% of GDP in 2011), due to increase in imports and income deficit, but still is not so high.
- Trend to re-primarization of exports and des-industrialization: “Dutch disease”? Concern about sustained and long-term growth....

# Economic policies

- International reserves have increased again (except Argentina and Venezuela) and sterilization policies (issuing debt) have been adopted in various countries.
- Some countries have introduced some controls on capital inflows: Brazil reissued the tax on portfolio inflows to discourage carry trade, and Peru introduced reserve requirements (120%) for nonresidents' deposits.
- Argentina has used a managed floating exchange regime, with strong intervention in foreign exchange market, but recently increase of inflation has resulted in exchange rate appreciation.
- Mexico is becoming a 'outlier' in LA, in terms of economic dynamism, due to its dependence to the American performance ('maquiladoras').

# Perspectives....

- Massive capital inflows trend...what to do to face it?
- For multiplicity of policy objectives economic authorities should actively search for more instruments (capital controls, prudential measures on credit, etc.).
- How to be compatible inflation targeting with exchange rate targeting? Mix of sterilization + capital controls + fiscal restraint + low interest rate (Frenkel and Rapetti, 2011).
- To evaluate seriously the efficacy of capital controls: price-based or quantitative controls? They should be dynamically adjusted to compensate the tendency of financial markets to elude them.