Financial Flows to Emerging Economies and Policy Alternatives in Post-2008

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Luiz Fernando de Paula (UERJ)

Daniela Magalhães Prates (UNICAMP)

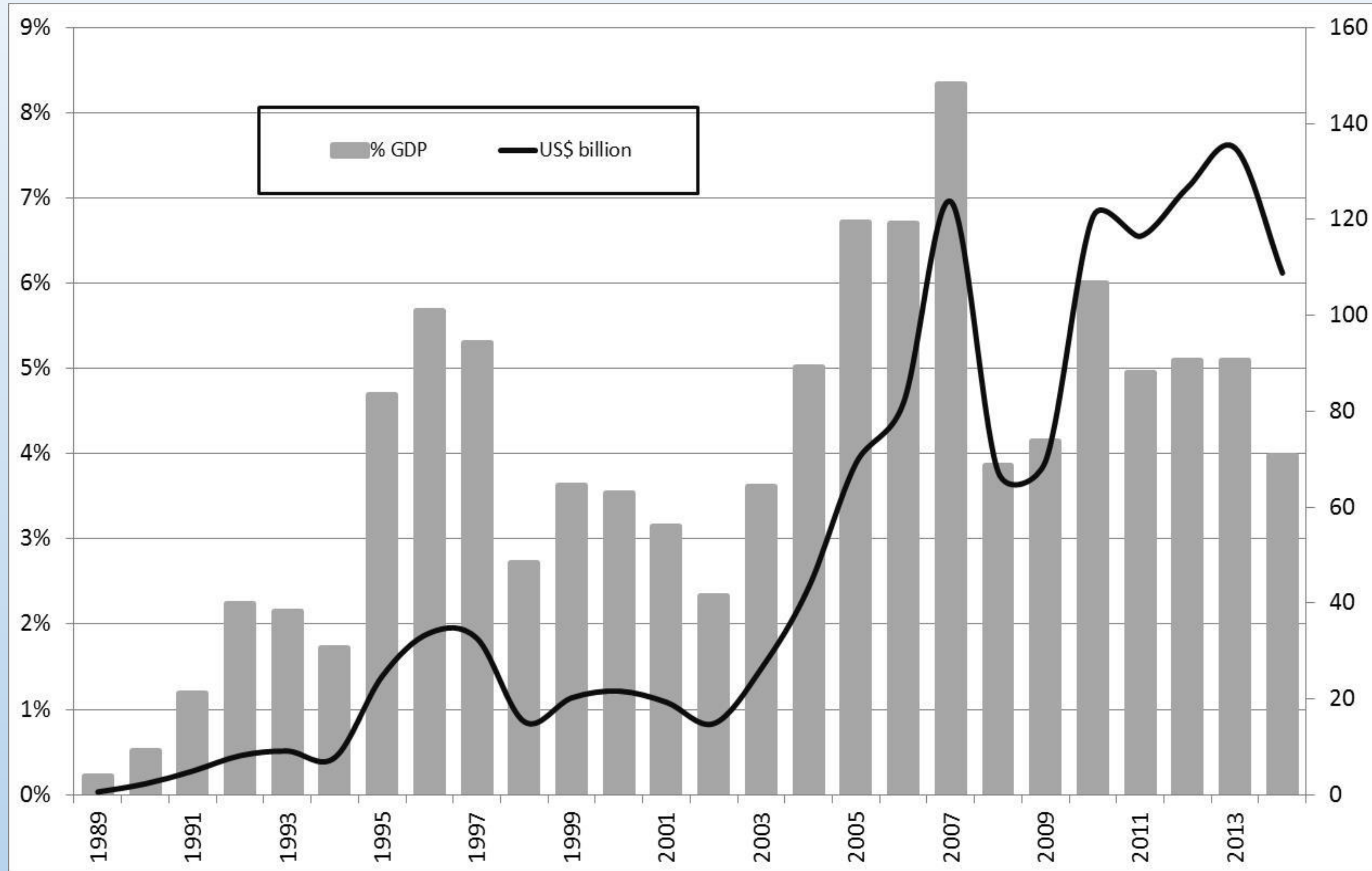
Stylized facts

- Cross-border capital flows have been intensified last decades with the greater international financial integration. Along with their greater size, gross flows have become more volatile and pro-cyclical, exacerbating economic fluctuations in Emerging-markets economies (EMEs).
- After the 2008 global crisis, “emerging-market” assets and currencies became objects of desire on the part of global investors, resuming policy dilemmas to EMEs stemming from the combination of high growth rates, accelerating inflation, excessive currency appreciation and/or asset price overshooting. Yet, some EMEs chose to regulate capital inflows in order to deal with these policy dilemmas.

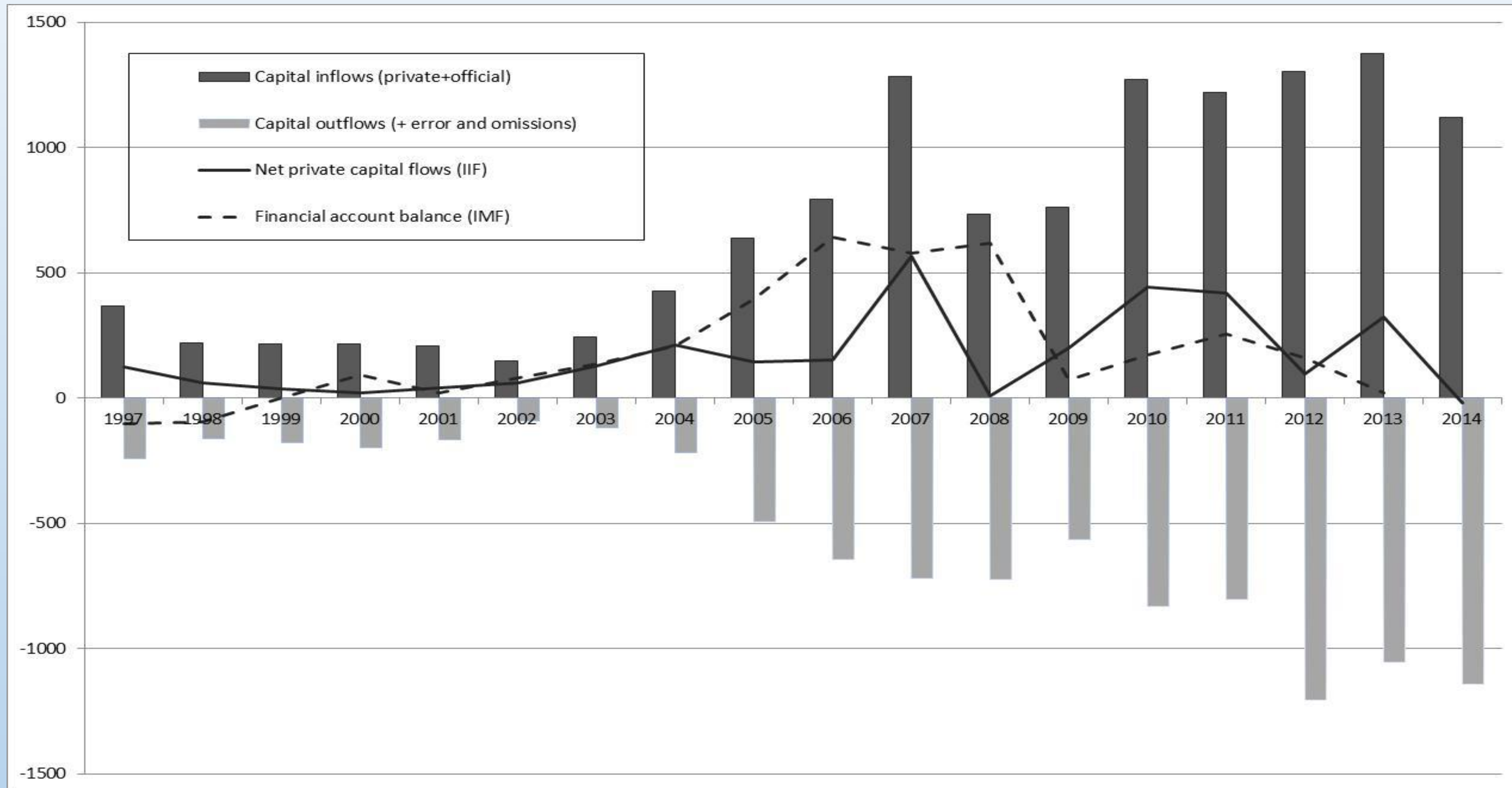
Objectives of the paper

- This paper aims at analysing some macroeconomic issues related to the recent waves of capital flows to EMEs and discussing some policies alternatives post-2008 to deal with them, with special focus on capital account regulation (CAR) and official intervention in foreign exchange market.
- For this purpose, firstly (section 2) the recent features of cross-border capital flows and some consequences to EMEs are analysed.
- Secondly (section 3), the relationship between capital flows and exchange rate regime in EMEs under conditions of an international monetary hierarchy are discussed.
- In section 4, some economic policy approaches to deal with capital flows, with emphasis on capital account regulation, are examined.

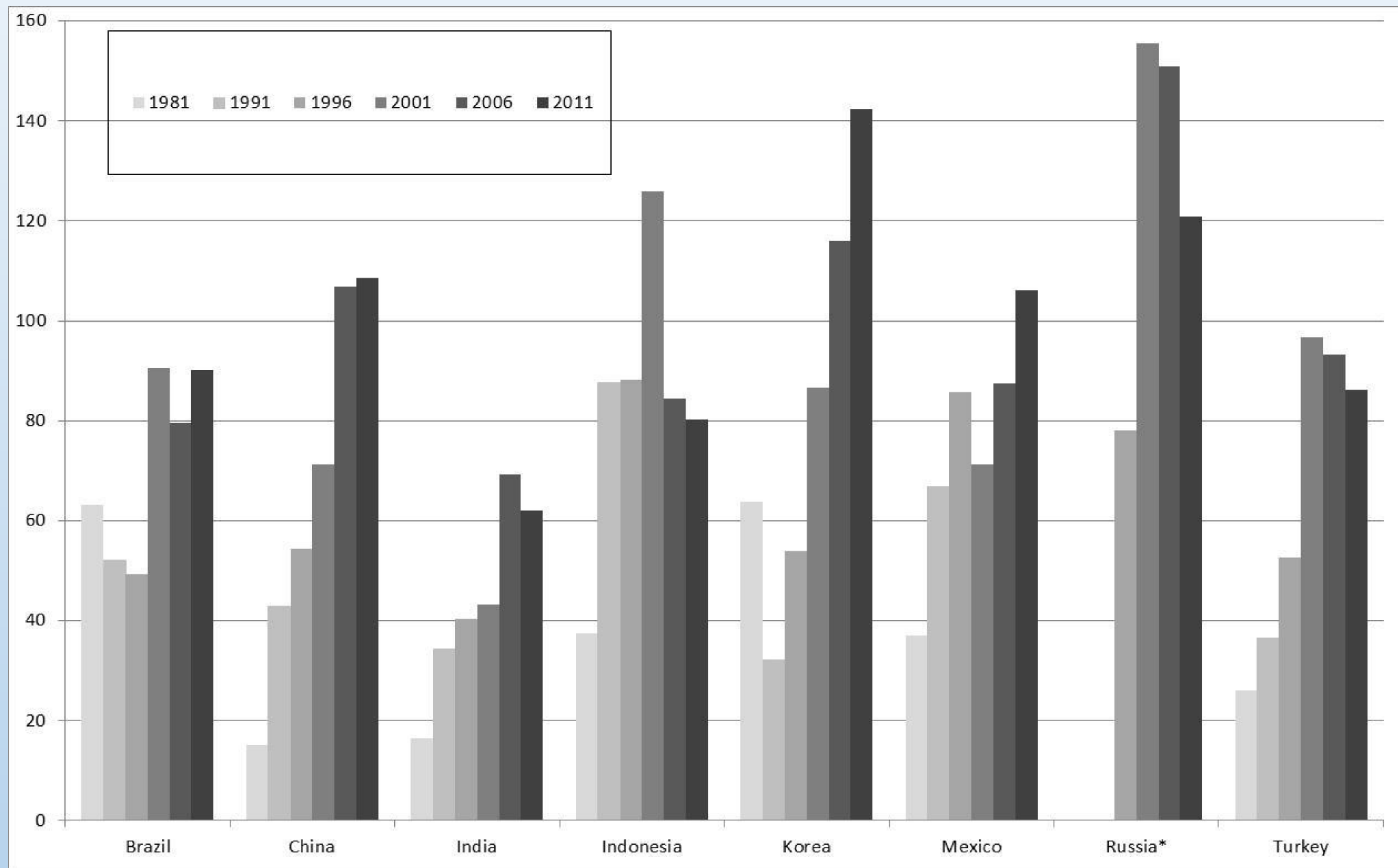
Private capital inflows to emerging economies



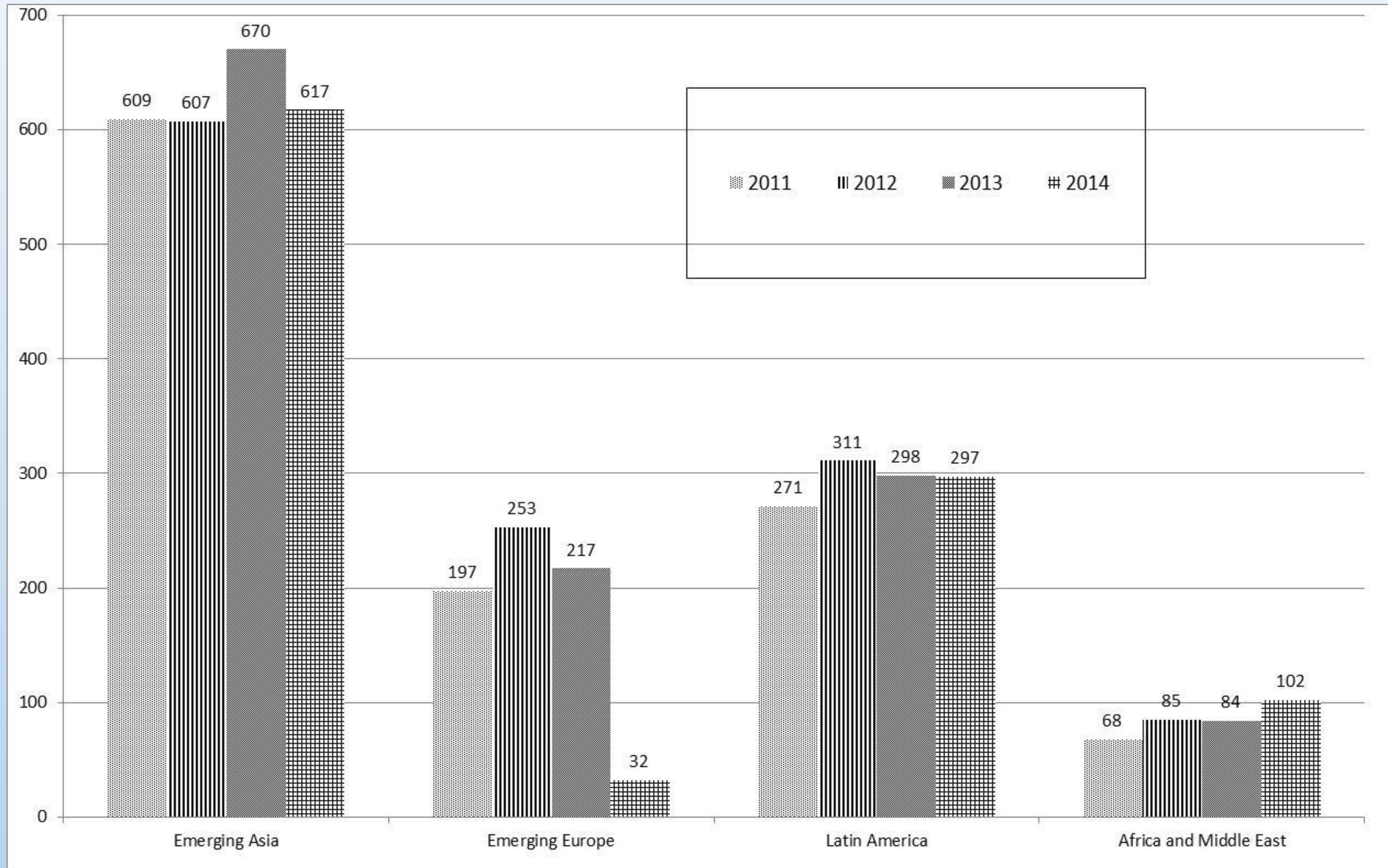
Capital inflows and outflows – emerging economies (US$ million)



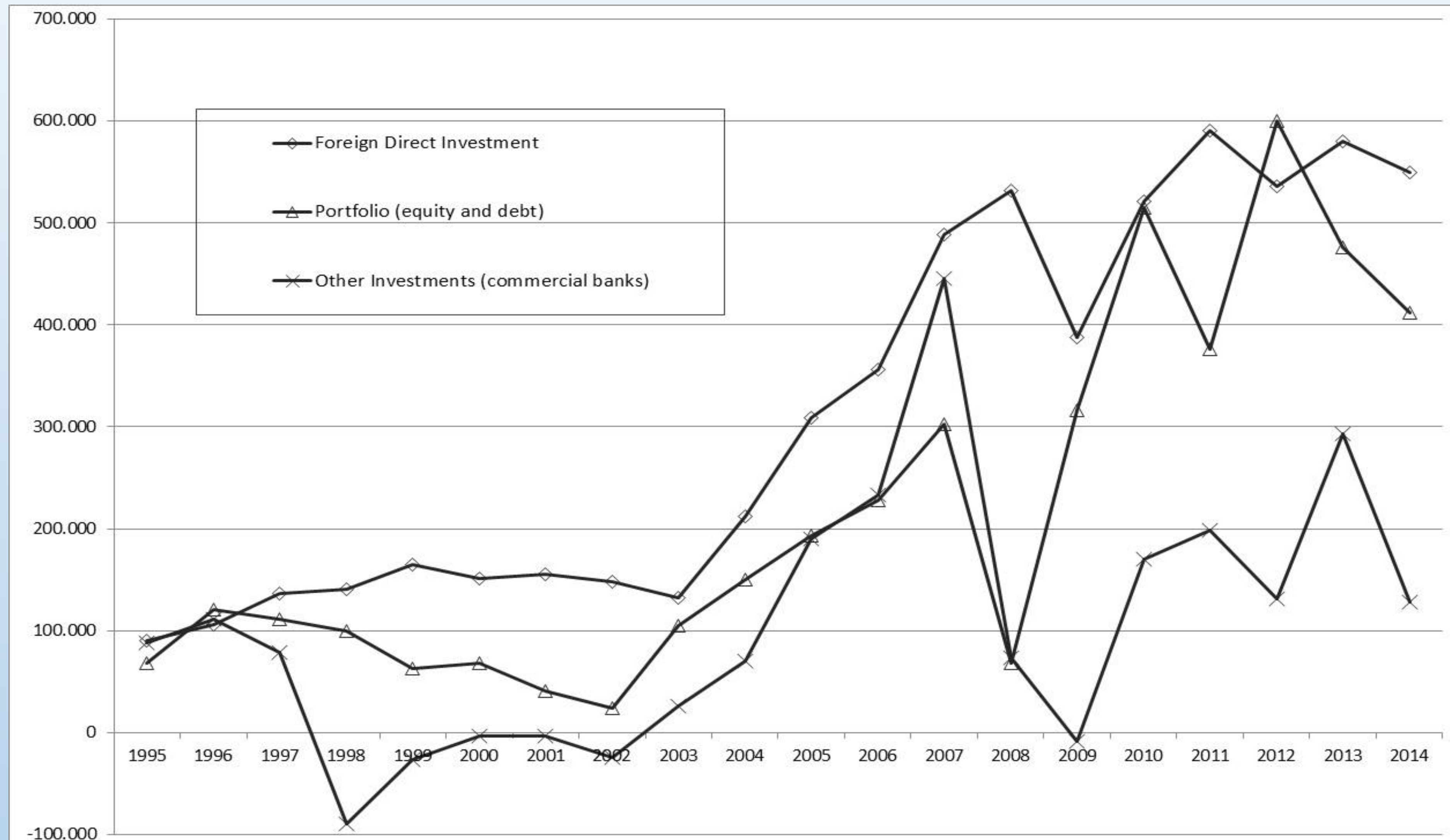
International financial integration (international assets plus liabilities over GDP)



Capital inflows by region (US$ billion)



EMEs – types of net capital inflows (US$ m)



Determinants of capital flows

- Concerning the determinants of capital flows, the literature distinguishes between *push factors* (global ones) and *pull factors* (country-specific). Most empirical works show that exogenous factors are the main determinants of large upward swings in capital flows to EMEs.
- Ghosh *et al.* (2012) found that surges of capital inflows to EMEs over 1980-2009 were synchronized among countries and that global factors – *US interest rates and risk aversion* – were key to determine whether a surge would occur, while domestic factors (economic performance, country's external financing needs, financial openness, etc.) seems to explain the magnitude of the surge.

Main features and consequences of k flows(1)

- Volatility of capital flows has increased over time and fluctuations in net flows are much sharper for EMEs compared with AEs – in the latter, gross outflows largely offset gross inflows, generating smoother movements in net flows (IMF, 2011a, p.125; Bluedorn *et al*., 2013).
- Exogenous (push) factors have been the main determinants of large upward swings to EMEs, while surges of capital inflows have been synchronized among countries and determined mainly by global factors - US interest rates and risk aversion (Ghosh *et al.,* 2012).
- Portfolio flows and banking flows have been very volatile compared to FDI and such volatility has recently risen. FDI has been slightly more stable than other types of flows, and its volatility has increased due to the rise of direct borrowing by subsidiary firms (IMF, 2011a).

Main features and consequences of k flows(2)

- EMEs tend to receive capital flows (gross and net ones) that are large compared to their domestic economies and absorptive capacity, in particular relative to the size and depth of their financial systems, so that such economies face problems related to an asymmetric financial integration.
- Episodes of large capital inflows have been associated with GDP growth acceleration, but afterwards growth often drops significantly: over one third of the completed episodes ended with a sudden stop or a currency crisis (Cardarelli *et al.*, 2009, p.5). Thus, an inverted V-shaped pattern of net capital flows to EMEs around outside the policymakers control has taken place (IMF, 2011a).
- The surges of capital inflows have been associated with *real effective exchange rate appreciation* , damaging the competitiveness of export sectors and potentially reducing economic growth in the long run (Cardarelli *et al.*, 2009), while contributing to macroeconomic overheating in the short run by increasing domestic consumption followed by widening current account imbalances.

Capital flows and exchange rate regime in emerging economies (theoretical studies)

- Tobin (1978) was one of the first mainstream economists to state that the main macroeconomic problem related to integrated financial markets is not the choice of the appropriate exchange rate regime but the excessive short-run capital mobility that reduces the autonomy of national governments to pursue domestic objectives with respect to employment, output and inflation.
- Stiglitz (2000) points out the pro-cyclicality of capital flows mainly to EMEs under conditions of asymmetric information, which exacerbate economic booms, exposing these countries to the vicissitudes associated with external factors.
- Post Keynesian literature (Schulmeister, 1988; Davidson, 1982; Harvey, 2009) highlight, in this setting, featured by floating exchange rates and free capital mobility, short-term capital flows constitute the chief determinant of nominal exchange rates, which are highly volatile. Therefore, the speculative feature of these flows, subordinate to financial investors' risk aversion/appetite, is the main cause of the volatility of exchange rates.

Capital flows and exchange rate regime in emerging economies (empirical studies)

- Saxena’s (2008), by analyzing the impact of capital flows and the exchange rate regime on monetary policy in EMEs in 1975-2006, found that (i) domestic short-term interest rates are significantly affected by foreign interest rates in countries with high capital mobility (ii) flexible regimes tend to exhibit greater co-movement with US interest rates than the pegged exchange rate regimes, and consequently even with flexible exchange rate regime the autonomy of the monetary policy was reduced with greater international financial integration.
- Rey’s (2013) analysis restated that capital flows’ boom and bust pattern is determined show that global financial cycle depends on two linked variables: the VIX (a measure of investor´s risk aversion) and the monetary policy (Fed Fund Rate level) in the U.S.
- Monetary conditions are transmitted from the main financial centre to the rest of the world through gross credit flows and banks’ leverage, irrespective of the exchange rate regime. Therefore, “fluctuating exchange rates cannot insulate economies from the global financial cycle, when capital is mobile. The ‘trilemma’ morphs into a ‘dilemma’ – independent monetary policies are possible if and only if the capital account is managed, directly or indirectly, regardless of the exchange-rate regime.

International monetary asymmetry

- Cohen (1998) adopts the concept of “monetary pyramid” to classify the different types of currencies, which should be distinguished according to their degree of “monetary internationalization”.
- Besides the superior position of the key currency (U.S. dollar - USD) – which has the highest degree of liquidity as it performs internationally the three functions of money (medium of exchange, unit of account and denomination of contracts, and store of value) – this system is marked by an asymmetry cutting across the currencies of AEs (other than the U.S), placed in an intermediary position, and those of EMEs at the bottom of the monetary hierarchy. While AEs’ currencies are also international currencies inasmuch they perform (in a lesser degree than the USD) the aforementioned functions of money, EMEs’ currencies are non-international ones, for they are incapable of performing at this scale these functions.
- EMEs are not able to issue international debt in their own currency (the so-called “original sin”, e.g. Eichengreen and Hausmann, 2005) and their currencies are the first victims of global investors’ “flight to quality”. Yet, although EMEs’ currencies are priced with a lower liquidity premium, they might be demanded according to investor´s expectations of financial return.

Consequences of international monetary asymmetry

- Peripheral countries' currencies, placed at the bottom of the currency hierarchy, are particularly vulnerable to the inherent volatility of capital flows, ultimately determined by an exogenous process (the global financial cycle). Consequently, their exchange rates are more volatile. In turn, the greater exchange rate volatility has more harmful effects than in AEs exactly because EMEs currencies are non-international ones, which increases the risk of financial fragility (due to the potential currency mismatches) as well as the pass-through of exchange rate changes to domestic prices. The higher pass-through in EMEs is due to the higher share of basic goods, which prices are set in the international market, in the consumption basket.
- On other hand, they also result in different degrees of monetary policy autonomy in EMEs and AEs. As Ocampo (2001a, p.10) points out: "whereas the center has more policy autonomy and is thus 'policy making' …. the periphery is essentially 'policy taking'".

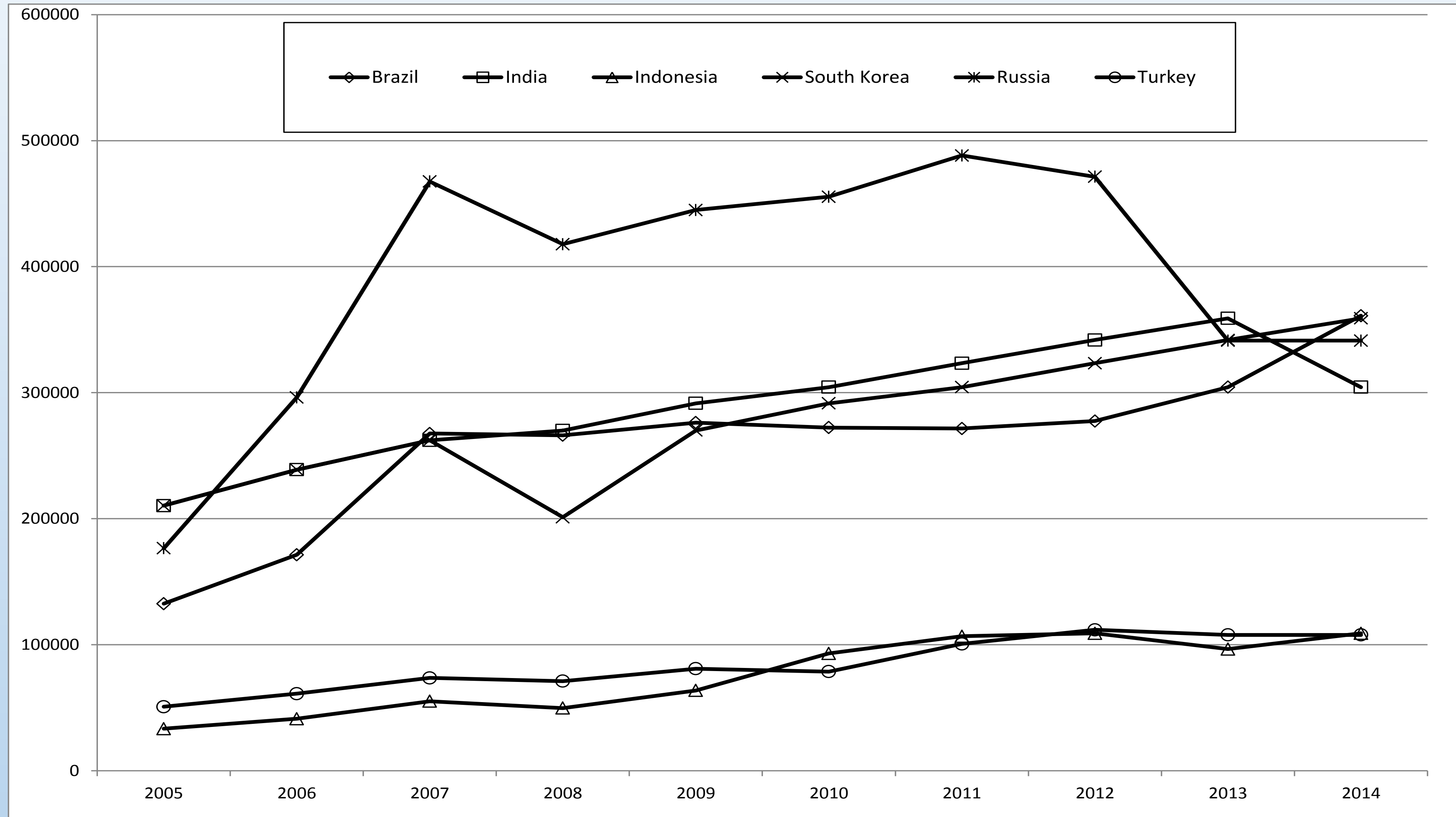
Economic policy approaches to deal with capital flows (post-2008)

- The combination of high growth rates under the double-speed recovery of 2009-2010, accelerating inflation (also associated with a renewed commodity prices boom), excessive currency appreciation, and/or asset price overshooting presented EMEs with policy dilemmas (Akyüz, 2011).
- The adoption of restrictive monetary policy would also help to contain growth and inflationary pressures, but it would encourage further capital inflows, which, in turn, would foster an asset price boom and exchange rate misalignment, aggravating the risk of future sudden stops and subsequent financial crises.

Economic policy approaches to deal with capital flows (post-2008)

- Rodrik (2006, p.12) points out, during 2003–2006 EMEs “over-invested in the costly strategy of reserve accumulation and under-invested in capital account management policies.”
- Indeed, after the financial crises of the 1990s in Latin America and in Asia, in most EMEs the managed exchange rate regimes (fixed or currency bands) were replaced by the dirty floating regime in which official intervention in currency markets became the rule and not the exception.
- Reserve accumulation policy: insufficient to immunize EMEs against the destabilizing effects of capital flows; can stimulate further capital inflows.

Foreign exchange reserves (US$ 1,000)



Capital account regulation (CAR)

- Brazil, South Korea and other emerging-market countries (such as Indonesia, Thailand, Peru and Turkey) chose to adopt capital account regulations (CAR) to deal with the aforementioned policy dilemmas.
- CAR includes prudential financial regulations and capital controls.
- (i) to reduce the vulnerability to financial crises related to speculative capital inflows and outflows; (ii) to drive a wedge between onshore and offshore interest rates in order to provide monetary authorities with some policy autonomy at least in the short-run; (iii) to maintain short-term stability of nominal exchange rate and curb currency appreciation pressures derived from excessive capital inflows.

Capital account regulation (CAR)

- Magud and Reihart (2006) reviewed more than 30 papers that evaluated capital controls either on inflows or outflows around the world, and concluded that “capital controls on inflows seem to make monetary policy more independent; alter the composition of capital flow; reduce real exchange rate pressures (although the evidence is more controversial)”, but “seem not to reduce the volume of net flows (Magud and Reihart, 2006, p.6-7).
- A great interest rate differential due to a restrictive monetary policy stimulates regulatory arbitrage with the aim of circumventing CAR, mainly in the case of countries with sophisticated financial markets and high degree of financial openness.
- CAR have to be broader and even more dynamic, flexible and adjustable, involving a steady “fine-tuning” to close the loopholes found by private agents.