Macroeconomic governance in times of financial globalization: some issues to emerging economies

Workshop:
Currency hierarchies and global inequality
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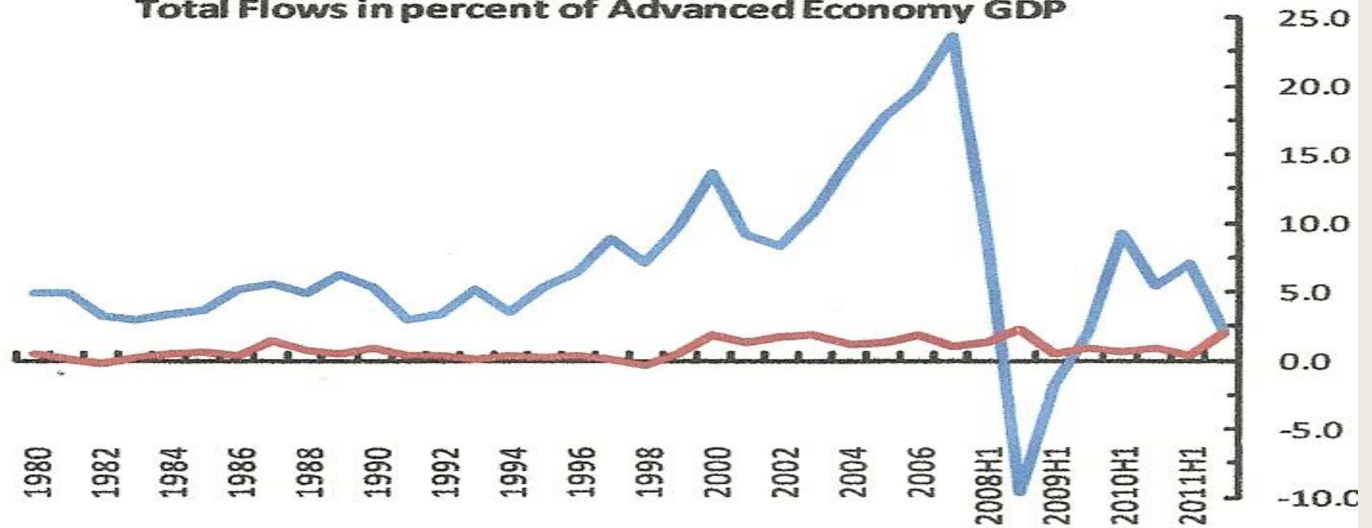
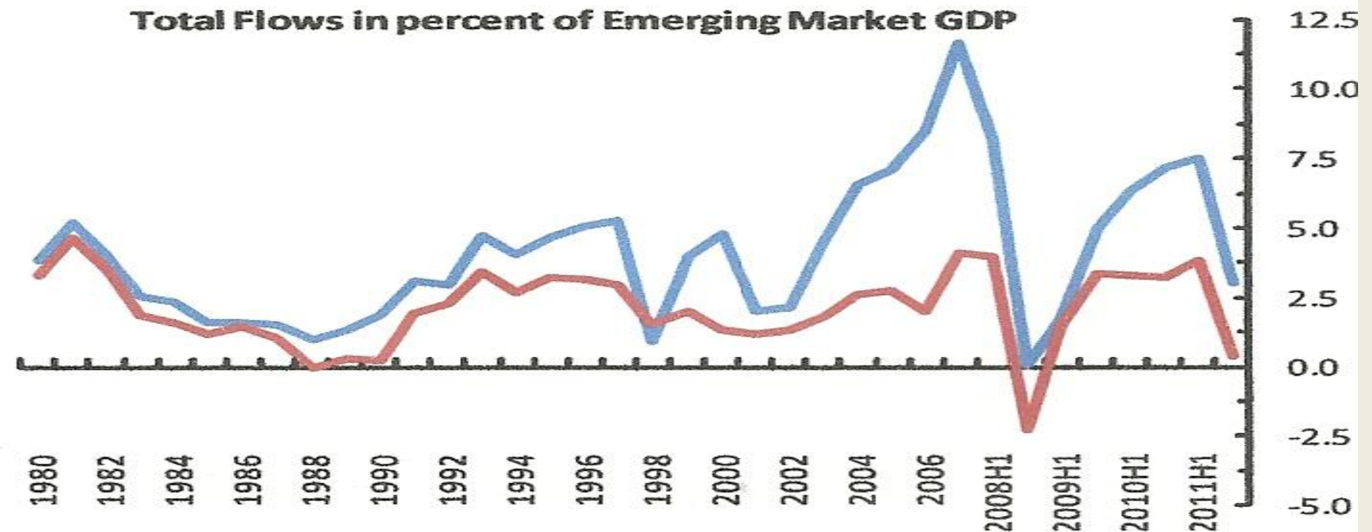
Presentation structure

- Recent characteristics of cross-border capital flows and some consequences to emerging economies.
- Are the implementation of free floating combined with more open capital account allowing a greater independence of monetary policy?
- IMF new institutional approach on capital controls versus “Integrated approach of CAR”.
- Some lessons from the recent Brazilian experience with capital account regulations (CAR).

Figure 1. Cross Border Capital Flows

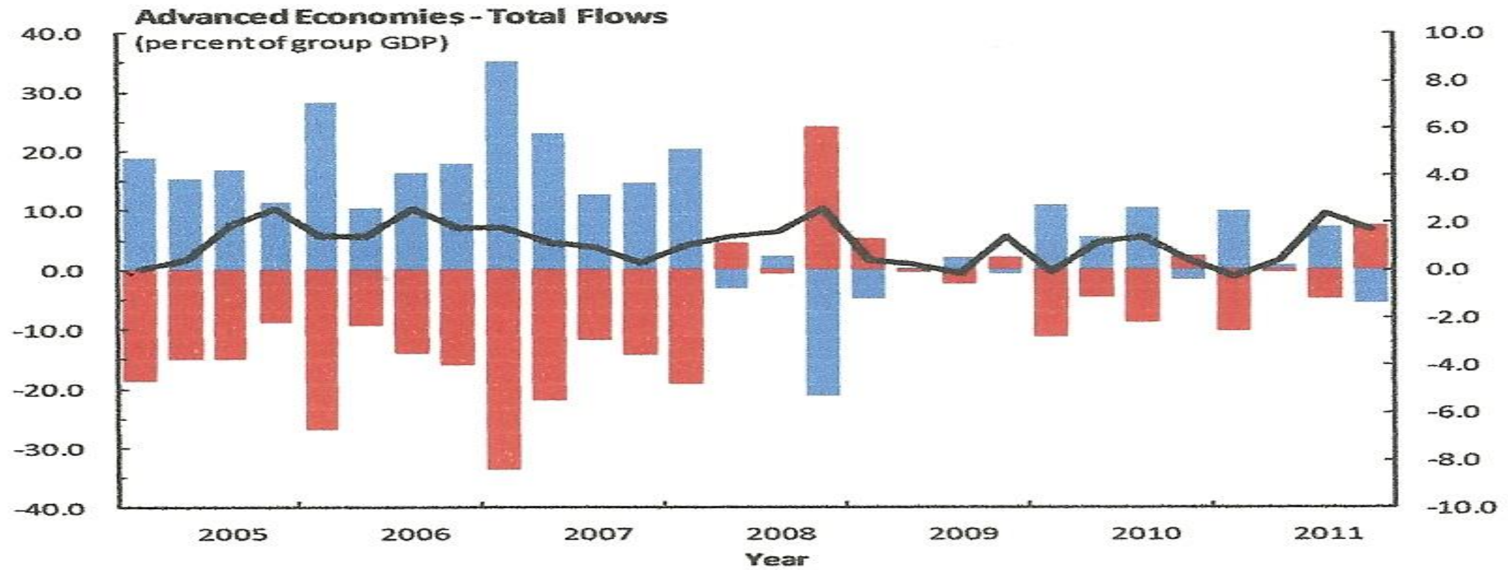


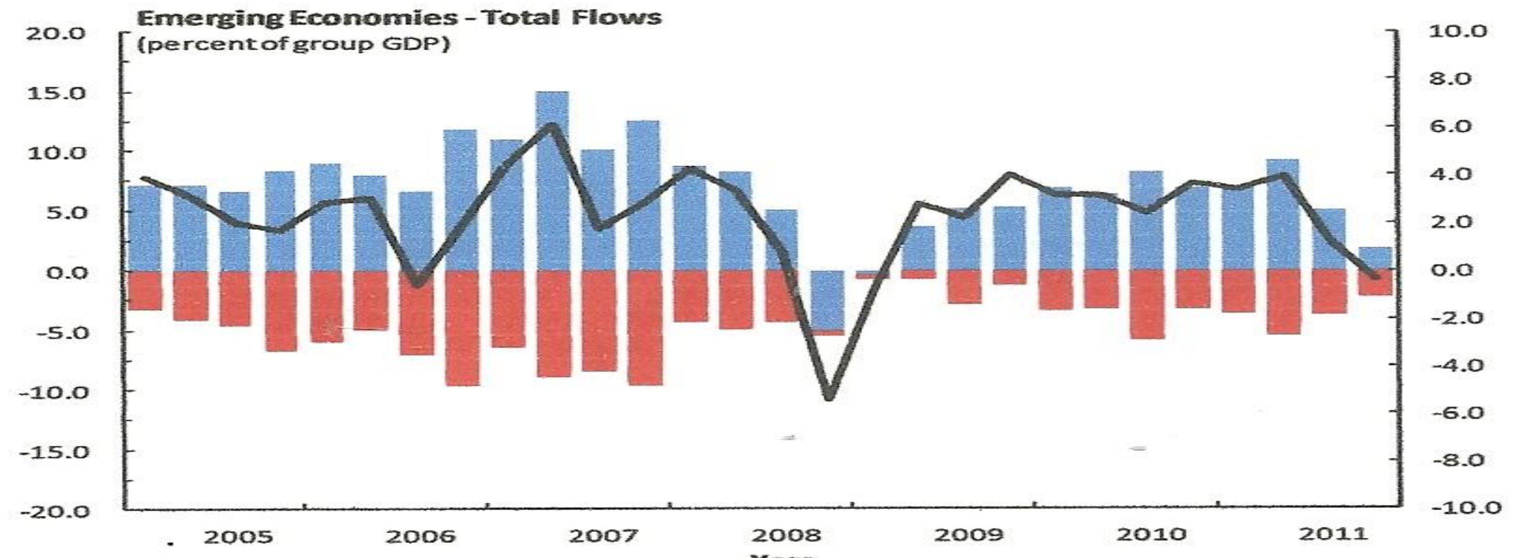


Sources: CEIC; Haver Analytics; IMF, *Balance of Payments Statistics;* national sources; and IMF staff calculations. Sources: CEIC; Haver Analytics; IMF, *Balance of Payments Statistics;* national sources; and IMF staff calculations.

Figure 3. The Evolution of Total Gross and Net Capital Flows

Gross Inflows
Gross Outflows
Net Inflows (right scale)





Characteristics of cross-border capital flows (Bluedorn et al, 2013; IMF, 2011)

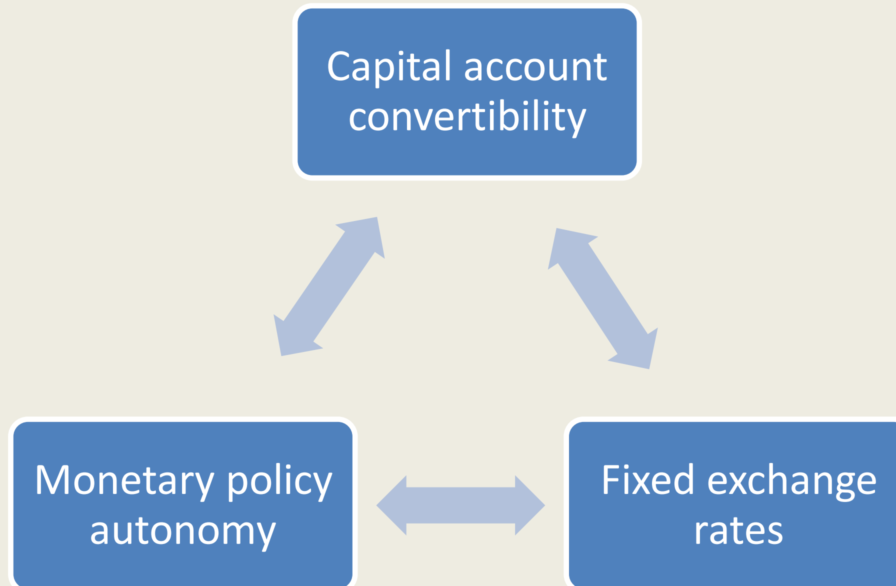
- Capital flows across all economy groups exhibit volatility. As the size of gross flows has grown, they have become more volatile everywhere.
- Both capital inflows and outflows tend to rise when global financing condition are easy, and to fall when these conditions tighten.
- In emerging economies gross inflows and net inflows both fell dramatically during the crisis and increase sharply afterward.
- *Net inflows have a more stable behavior in advanced economies,* where capital inflows and outflows are more complementaries, while *in emerging markets capital inflows increase more than capital outflows*, and consequently net inflows are more volatile.

Some consequences to emerging economies (Cardarelli et al, 2009; IMF 2009; Moreno, 2005)

- Episodes of large capital inflows are associated with acceleration of GDP growth, but afterwards growth often drops sharply.
- Fluctuations in GDP growth have been followed by large swings in the current account balance, with strong deterioration of the current account during inflow period.
- The surge of capital inflows also appears to be associated with a real effective exchange rate appreciation, damaging the competitiveness of export sectors and reducing economic growth.
- Emerging economies have much larger and volatile capital flows compared to the size of their financial market; consequently exchange rate volatility is higher compared to the advanced economies.

Impossible trinity (trilemma)

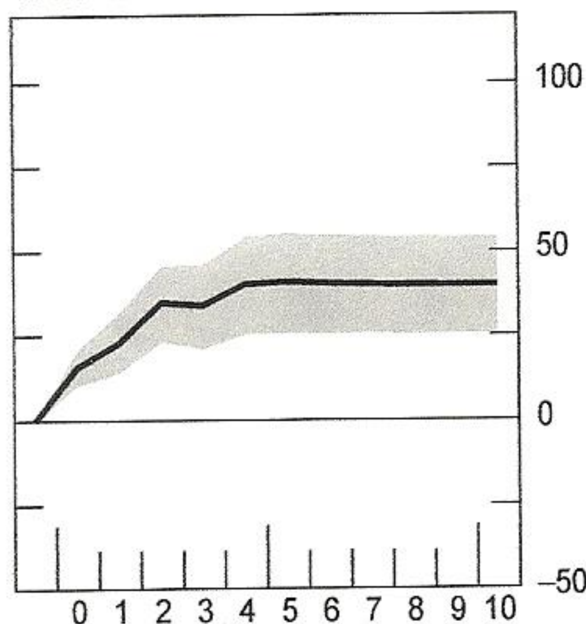
- Countries cannot have simultaneously pegged exchange rate, open capital account and independent monetary policy.
- That is, with free capital mobility, independent monetary policies are feasible if exchange rates are floating.



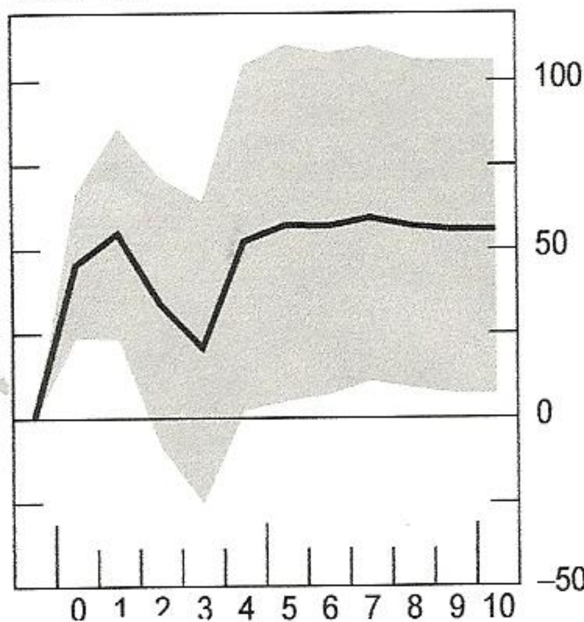
High co-moviment between US interest rates and domestic rates in emerging economies (Saxena, 2008)

Impulse response of domestic interest rate to US interest rate when exchange rates are floating and capital is mobile

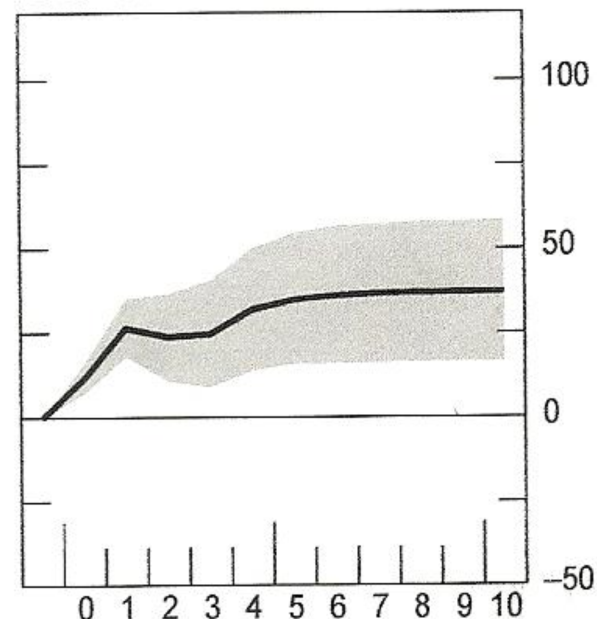
1975–2006



1990–99

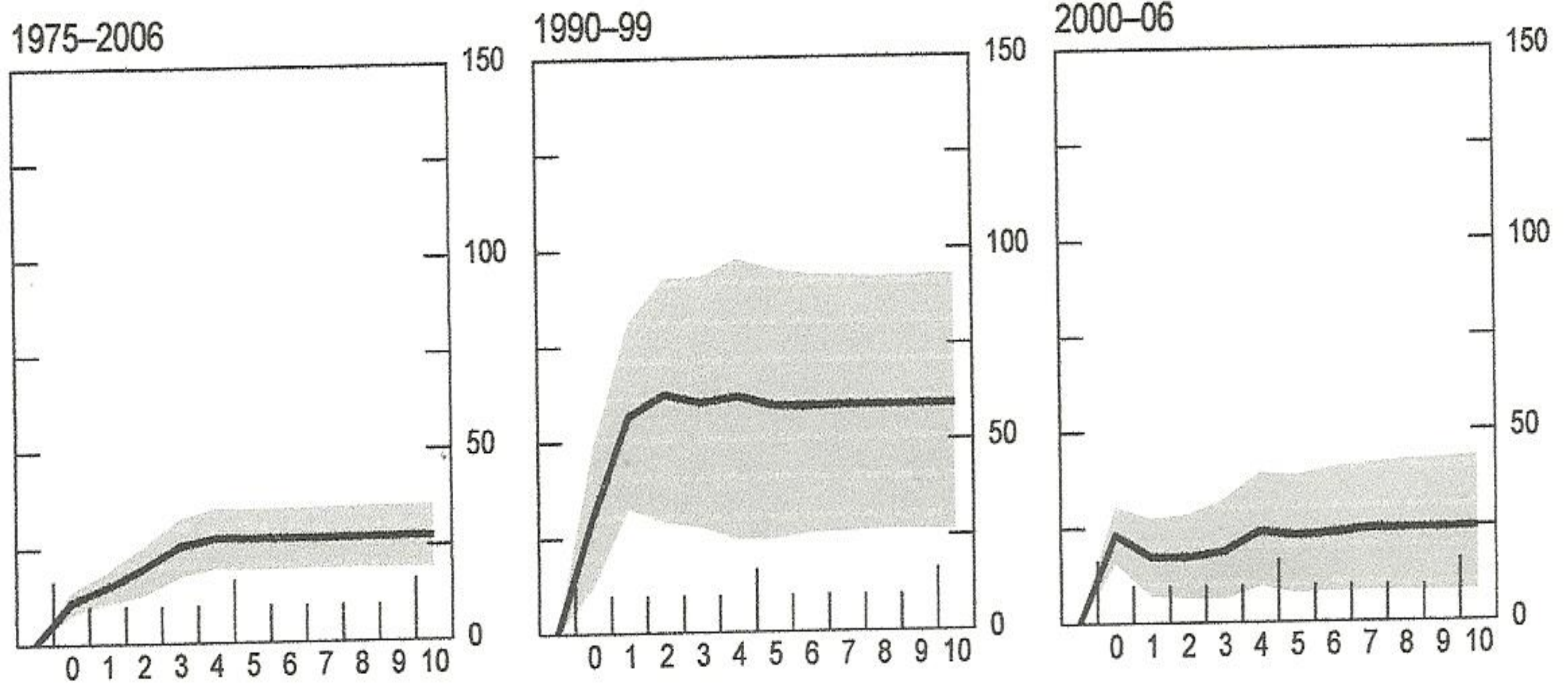


2000–06



Graph 3

Impulse response of domestic interest rate to US interest rate when exchange rates are fixed



So we can conclude that

- Flexible regimes tend to exhibit greater co-movement with US interest rates than the pegged exchange rate regimes.
- In other words, even with flexible exchange rate regime, the autonomy of the monetary policy has been reduced with greater international financial integration.
- Indeed, due to the ‘fear of floating’ behavior of monetary authorities, domestic interest rates are used to cushion exchange rate fluctuations.

Hélène Rey (2013)

- Monetary conditions are transmitted from the main financial centers to the rest of the world mainly through gross credit flows and leverage, irrespective of the exchange rate regime.
- The conclusion it that floating exchange rates cannot insulate economies from the global financial cycle, when capital is mobile.
- The global financial cycle transforms the trilemma into a "*dilema*": independent monetary policies are possible if and only capital account is managed, directly or indirectly via macroprudential policies".
- So it is the case for capital account regulation!

James Tobin (1978)

- “I believe that the basic problem today is not the exchange rate regime, whether fixed and floating. Debate on the regime evades and obscures the essential problem. That is *the excessive international* (…) *mobility of private financial capital.*” (p. 153, italics added).

IMF new institutional approach

- Capital controls are part of the toolkit when certain macroeconomic conditions are satisfied.
- There is a *triple hierarchy* between the instruments to manage capital inflows:

a) First, macroeconomic policies should be applied (building up foreign reserves, letting currencies appreciate, and cutting budget deficits).

b) Then prudential regulations on the domestic banking sector that affect cross-border flows should be implemented.

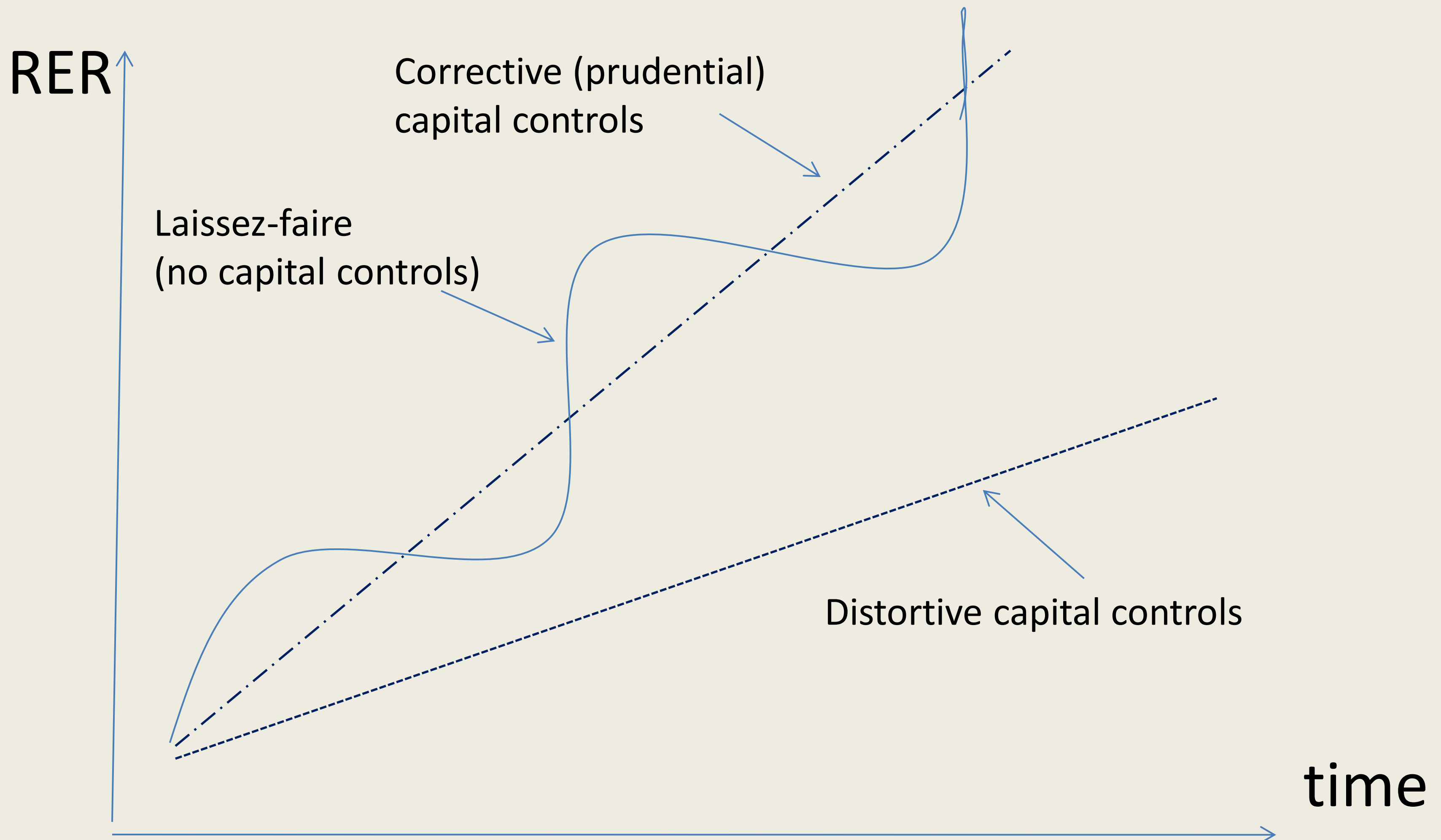
c) And finally when prudential tools are insufficient, capital controls could be applied as transitory measure of last resort.

Integrated approach of CAR

- CAR should not be seen as measures of last resort, but as permanent part of the policy toolkit to be used in a counter-cyclical way to smooth booms and busts (Gallagher et al, 2012), and also to increase the policy space to exert controls over the key macroeconomic prices (interest rate, exchange rate, etc.).
- CAR is a integral part of the macroeconomic policy as they can help economic authorities to solve some macroeconomic trade-offs.
- The IMF triple hierarchy is inappropriate to deal with policy issues, as there are important feedbacks and complementarities between capital controls and prudential financial measures.

-> Example: implementing limits on banks' operations in foreign currency reduces both financial risks and pressures on exchange rate.

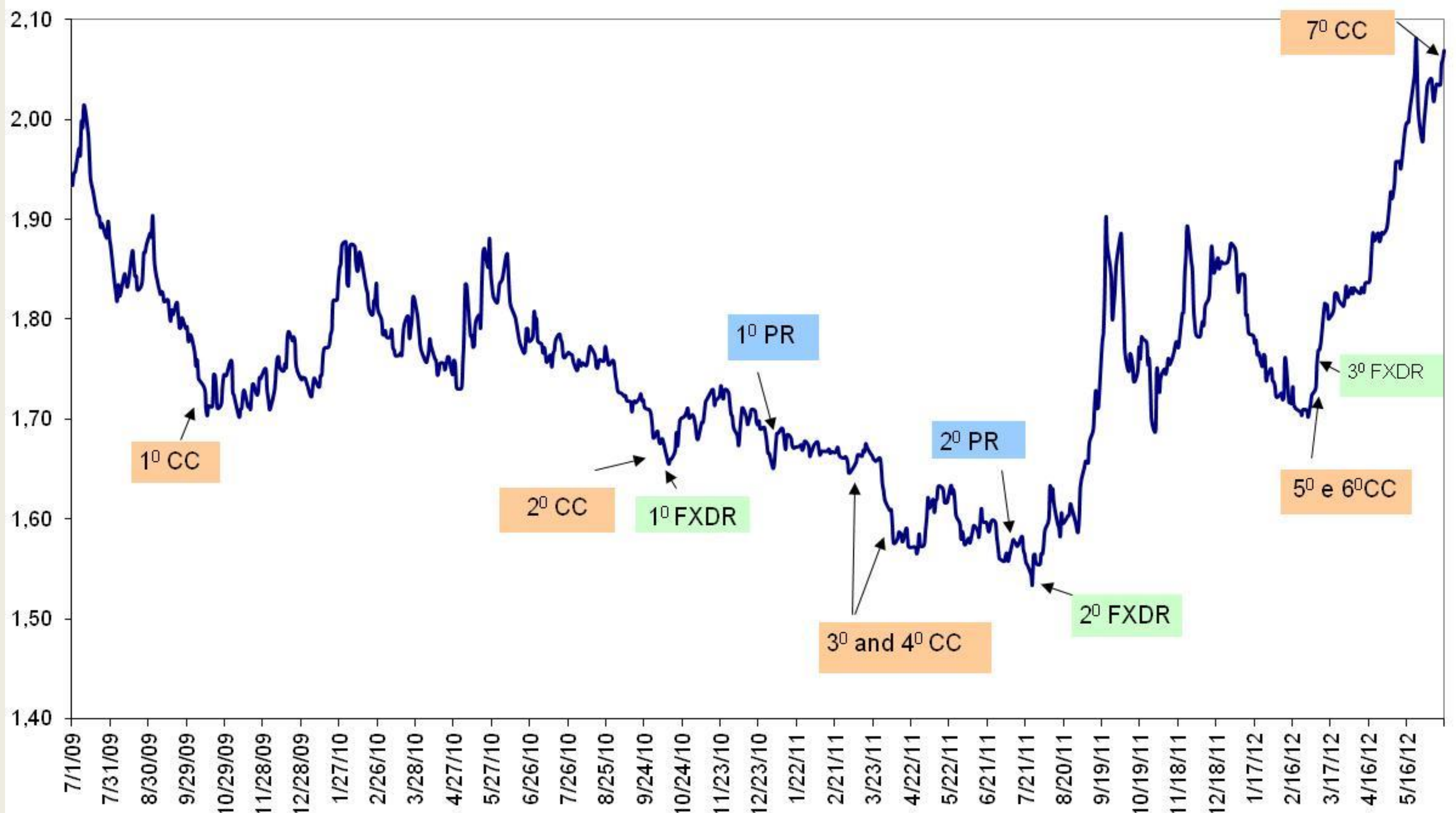
Behavior of real exchange rate with capital controls (Jeanne et al, 2012)



Brazilian experience on CAR (2009-11)

- Operations in derivatives FX markets are non-deliverable, that implies that can be carried out without any effective foreign capital flows. *Exchange rate is mainly defined in derivatives market.*
- Brazil began to implement "*price-based capital controls*" with the use of a financial tax on capital inflows (IOF), in low level in 2009, and later increasing the percentage and becoming even more comprehensive (including both portfolio and loans).
- It was only with the implementation of prudential regulation (reserve requirements on banks' short dollar positions in spot market) and derivatives regulation with financial tax on excessive long positions in BRL, that the currency began to devaluate.

BRL/USD exchange rate



Lessons from Brazilian experience

- CAR have to be dynamic and flexible, involving a steady "fine-tuning" to close the loopholes found by private agents through spot and FX derivatives transactions.
- It was only when Brazilian government adopted all the three kinds of techniques simultaneously (capital controls, prudential financial regulation and FX derivatives regulation) that policy effectiveness increased in terms of protecting the exchange rate from upward pressures.
- Therefore, it is not possible to establish a clear triple hierarchy between instruments to manage capital flows as supported by the current IMF approach.
- So we need a more integrated approach for the use of capital account regulations!

Thanks!