

Global Liquidity and Financial Contagion: Policy Implications

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Questions we were asked to discuss

1. How do EMs protect themselves from excess exchange rate volatility when faced with changes in global liquidity and contagion?
2. Can monetary policy instruments in individual countries be effective in tackling exchange rate volatility when the causes are exogenous?
3. What are the most appropriate measures for cushioning the impact of exogenous capital movements?
4. Do CBs need to do more than inflation targeting?
5. What are the indicators of financial stability that CBs need to watch?

Protection against excess exchange rate volatility

- Answers to most of the other questions can be derived from answers to the first one
- Stylized facts:
 - Capital flows to EMs are largely exogenous;
 - there is a lot of contagion (on the upswing and on the downswing);
 - they can cause not only large fluctuations in exchange rates but also in domestic macro conditions and growth
- CBs need additional tools to deal with them: capital account measures
- Also, low inflation cannot be the only goal of CB policy
- It should also keep an eye on:
 - The exchange rate, important in EMs;
 - For prudential purposes: Asset markets, particularly real estate, stock markets, and household and corporate indebtedness
 - Macro prudential financial regulation should be designed with characteristics of EMs in mind

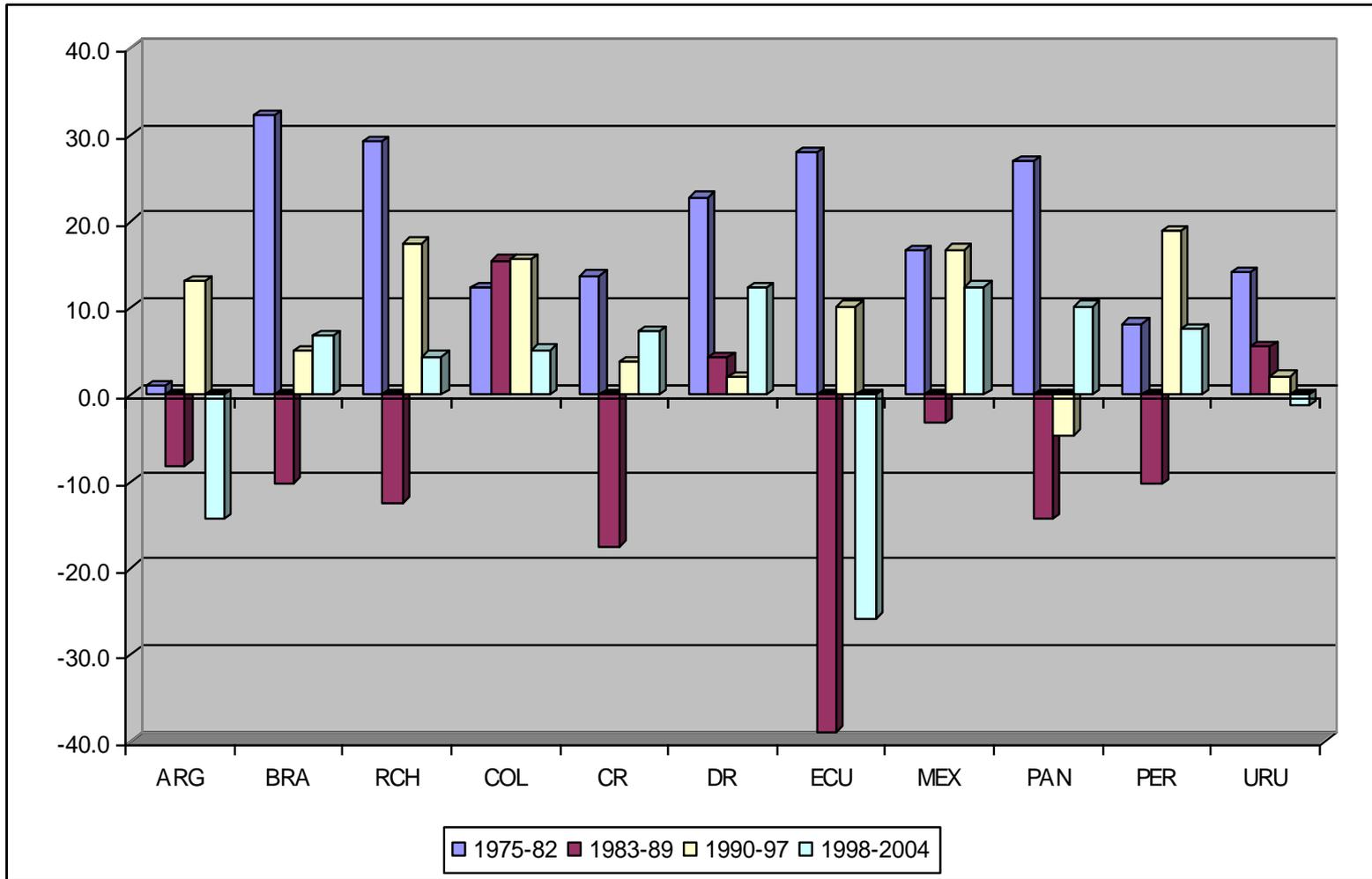
CB intervention in foreign exchange markets (use of monetary policy)

- CBs can adopt intermediate regimes rather than free floats (or fixed rates): all of these involve intervention
- All of them have been tried, with varying degrees of success: crawling pegs or bands, dirty floating
 - Intermediate regimes have their problems and one can understand the penchant of many CBs to move toward floating: it is the easiest to manage in a financially open economy
- When capital inflows/outflows are transitory, the most flexible alternative is dirty floating
- The problem is that we don't know how transitory is transitory: there have been long waves of large inflows to many EMs at the same time, followed by large outflows
- In these cases, leaning against the wind is very difficult, because it leads either to large accumulations of reserves (inflows) that are difficult to sterilize completely, or to dangerous reserve losses

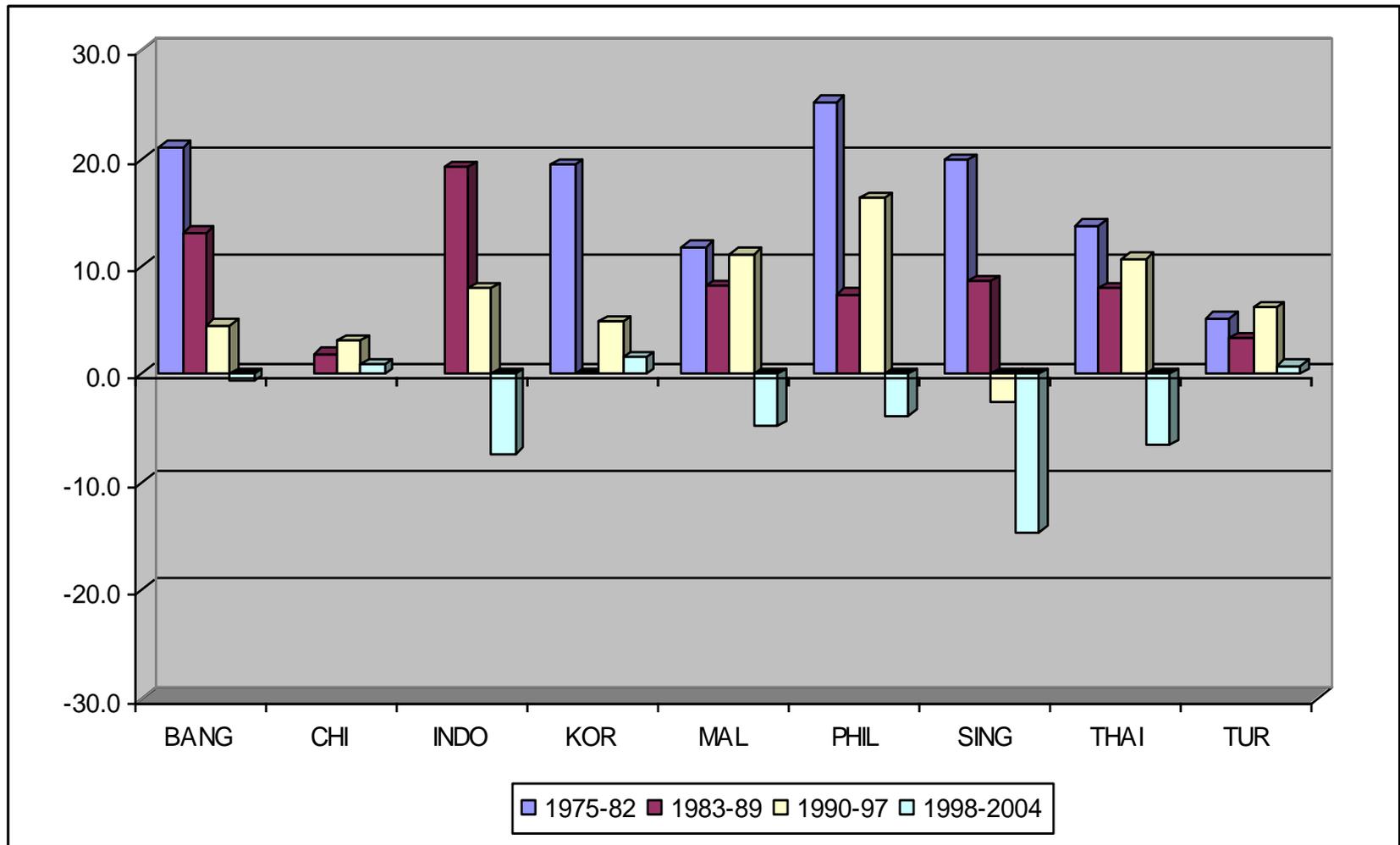
Net capital inflow as % of M2

| Period | Region | Average | Standard deviation |
|------------------|--------------------|---------|--------------------|
| 1975-82 | Asia (7) | 16.6 ** | 6.0 * |
| | Latin America (11) | 18.6 ** | 13.9 ** |
| | DM (18) | 2.4 | 3.6 |
| 1983-89 | Asia (9) | 7.7 ** | 7.7 ** |
| | Latin America(11) | -8.2 ** | 16.3 ** |
| | DM (18) | 2.2 | 3.3 |
| 1990-97 | Asia (9) | 6.9 ** | 5.9 ** |
| | Latin America(11) | 9.1 ** | 12.1 ** |
| | Developed (18) | 1.3 | 3.1 |
| 1998-2004 | Asia (9) | -3.9 | 4.0 |
| | Latin America(11) | 2.3 | 15.9 * |
| | DM (18) | -0.5 | 3.2 |

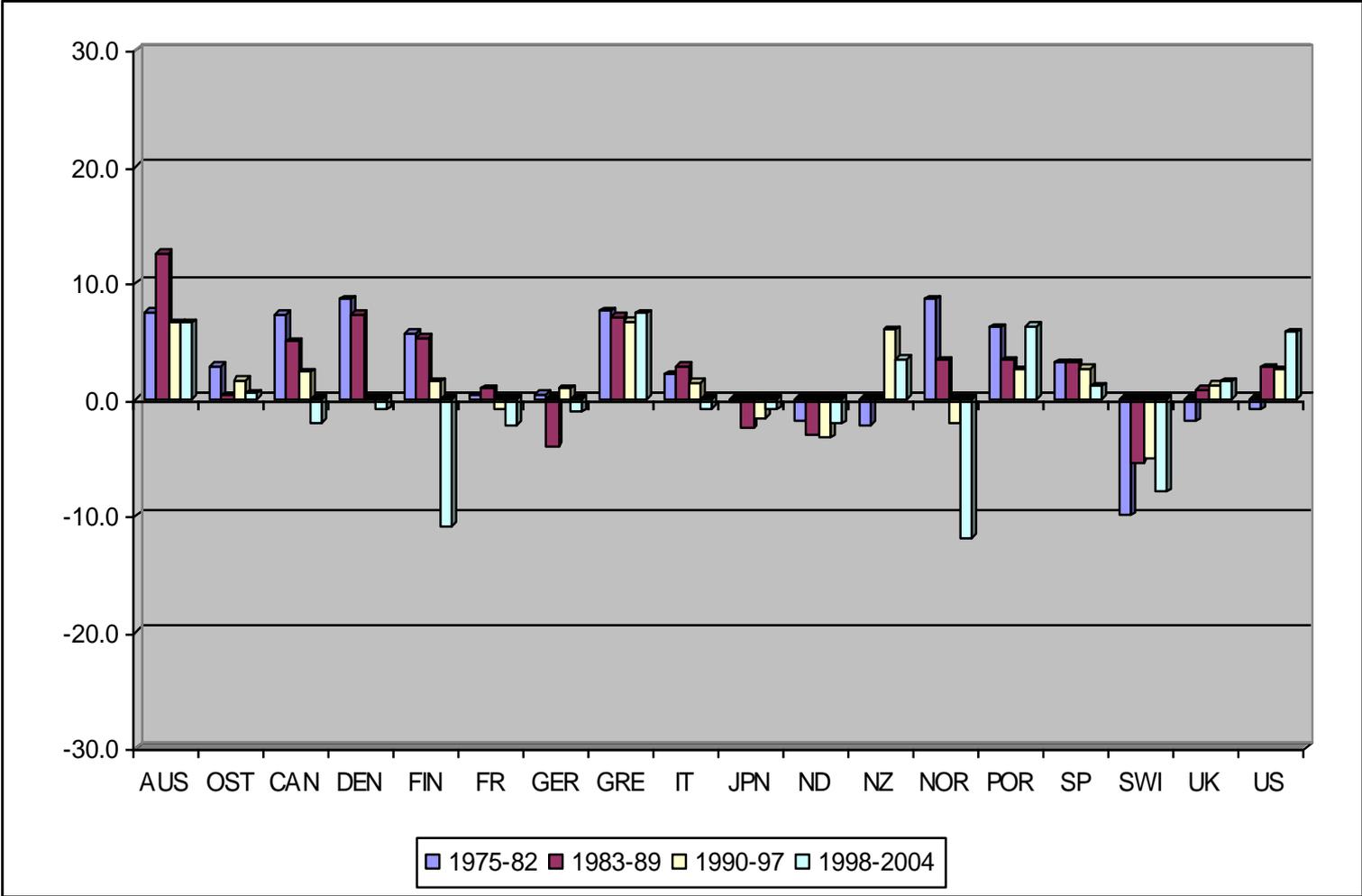
Latin America: Net capital flows as % of M2



Asia: Net capital flows as % of M2



DMs: Net capital flows as % of M2



Therefore, one needs more than monetary policy (i.e. exchange market intervention)

- When they are taking place, large and sustained capital inflows can be quite pleasant (except for producers of budding tradables): times are good, demand is expanding, asset prices are rising and people feel rich
- But they sow the seeds of future sudden stops (see Agosin and Huaita, 2012)
- So it is good to have additional tools (capital account measures) to moderate inflows (and also to contain outflows)

What can be done?

- Several countries have attempted capital controls
- The jury is still out with respect to the success of these measures: capital markets are notoriously porous
- The simpler the measures the better chances they have of being successful and the easier they are to apply
- Recently Shinn (2010) has suggested that, in a domestic context, bank borrowings from money markets ought to be taxed at a variable rate: financial crises are correlated with sharp increases in such borrowings
- In EMs, banks funding other than deposits comes largely from international financial markets

For EMs

- Banks are major participants in the carry trade: when interest rates on international markets are very low, the temptation to borrow for on-lending in domestic markets must be very hard to resist, and the potential risks of eventual depreciation are easily underestimated
- There is evidence that *corporates* are increasingly participating in this trade through bond placements; the creditors are not only banks but asset managers (Blackrock, PIMCO, etc.)
 - The potential problem is not only bank lending-borrowing; is is also large corporate borrowing
 - And it is not only short-term but also long-term

Banking regulation

- This is part of macro prudential measures relevant to financially open EMs
- Asset-liability mismatches in foreign exchange can be very dangerous in accentuating the impact of a financial account crisis
- Mismatches in foreign exchange derivatives (which are intermediated by banks) may also be important

A word on the current situation ...

- We are witnessing a reversal in capital flows to EMs, owing to the uptick in long rates in the US and risk-off attitudes with regard to EMs
- Some EMs are better equipped than others to deal with the situation
- Those with large CAD are more vulnerable than those that have more reasonable CAD or surpluses
- Countries with large reserves can withstand a period of capital outflows; the problem, again, is that we don't know how long it will last
- Some have accumulated reserves not by running current account surpluses but by the CB buying up capital inflows: they will certainly experience a combination of real exchange rate depreciation and reserve losses

Some countries haven't been sufficiently disciplined during the good times (the “This time is different” syndrome)

- In some cases, easy availability of cheap credit allowed governments to incur in deficits: counterpart of CAD may be fiscal
 - In these cases, fiscal retrenchment may be inevitable
 - Higher interest rates will not bring foreign capital back, because sovereign risk spreads have risen
- In others, the private sector could be behind the bulging CAD
 - Higher interest rates may be inevitable, with falling investment and employment

To conclude

- You prepare for the bad times during the good times
- Fiscal position during the upswing of the cycle is essential: fiscal policy has to be at least acyclical and hopefully anti cyclical – a flexible target for the cyclically adjusted balance helps
- Protect the exchange rate from appreciating during the upswing
 - Flexible but permanent capital account measures
 - Dirty floating and reserve accumulation
 - Guidance from the CB as to where the equilibrium exchange rate is likely to be (Williamson's soft bands)
 - The CB has to do a lot more than just worry about inflation, even if the exchange rate regime is formally a floating one