# Managing Capital Flows in Frontier and Emerging Markets: What are the Lessons?

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## Agenda

1. Why we care about capital flows?
2. A look at frontier economies.
3. Managing capital flows

## Why we care about capital flows? In particular massive inflows. Three main reasons

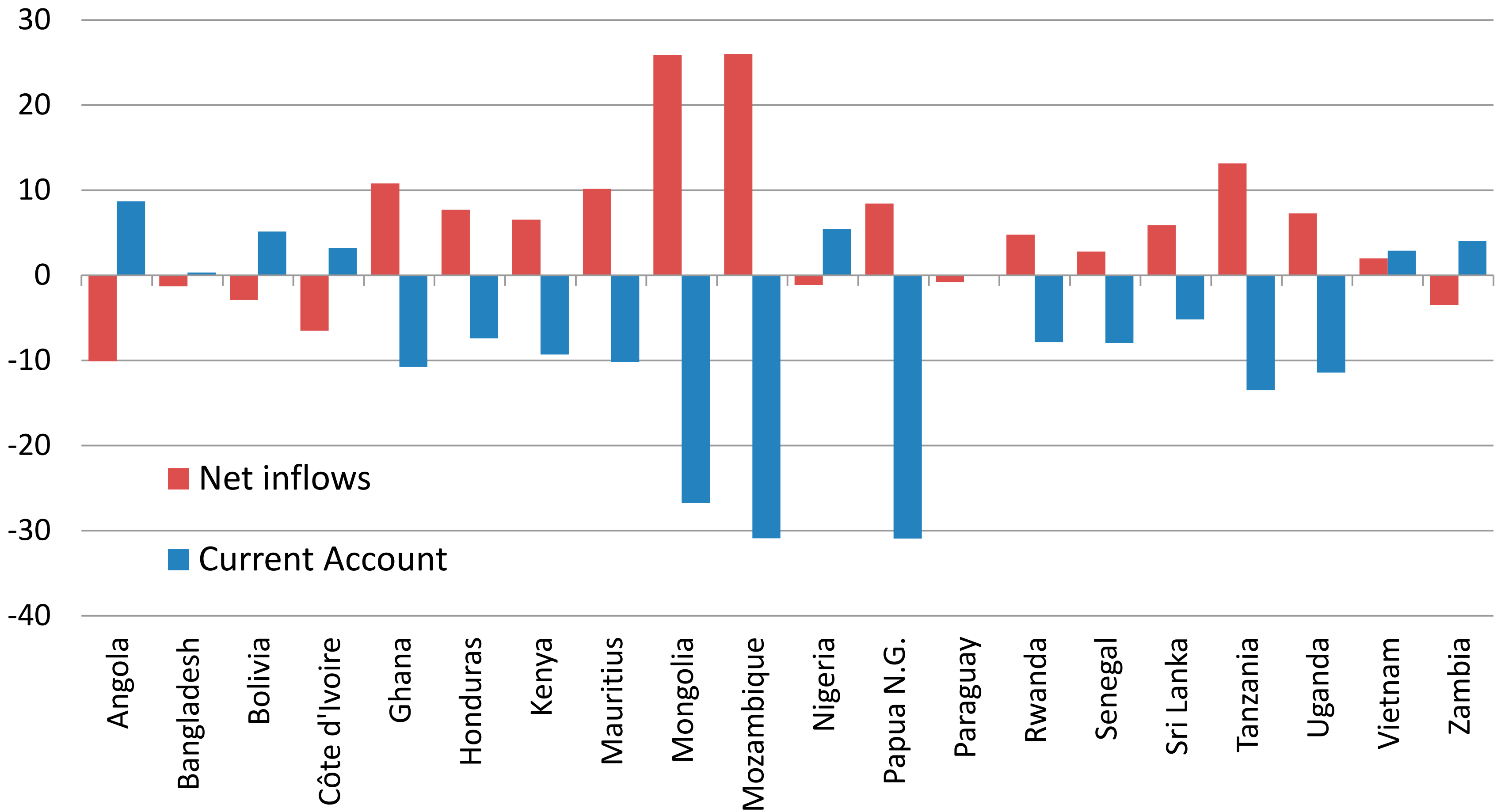
- They may create financial vulnerabilities making the financial system more prone to sudden stops, credit booms, and financial crisis.
- They may induce excessive exchange rate appreciation, resulting in some form of **Dutch disease**
- They can make the economy too sensitive to the global credit cycle (produced in the center economies) reducing the ability to conduct independent monetary policy. "Trilemma versus dilemma"

## Why we care about capital flows? Important to distinguish net from gross flows (lot of confusion)

- Gross flows: financial stability – vulnerabilities. The type of capital flows matter.
- Net flows: macroeconomic stability (PS-IT) and mainly exchange rate.
- Both gross and net. Monetary policy independence. Net -> excess expenditure and gross -> different type of flows may have different forms to propagate.
- There are interactions between FS and PS.
- **Goal: How to manage capital flows to secure environment to sustain long tem growth.**

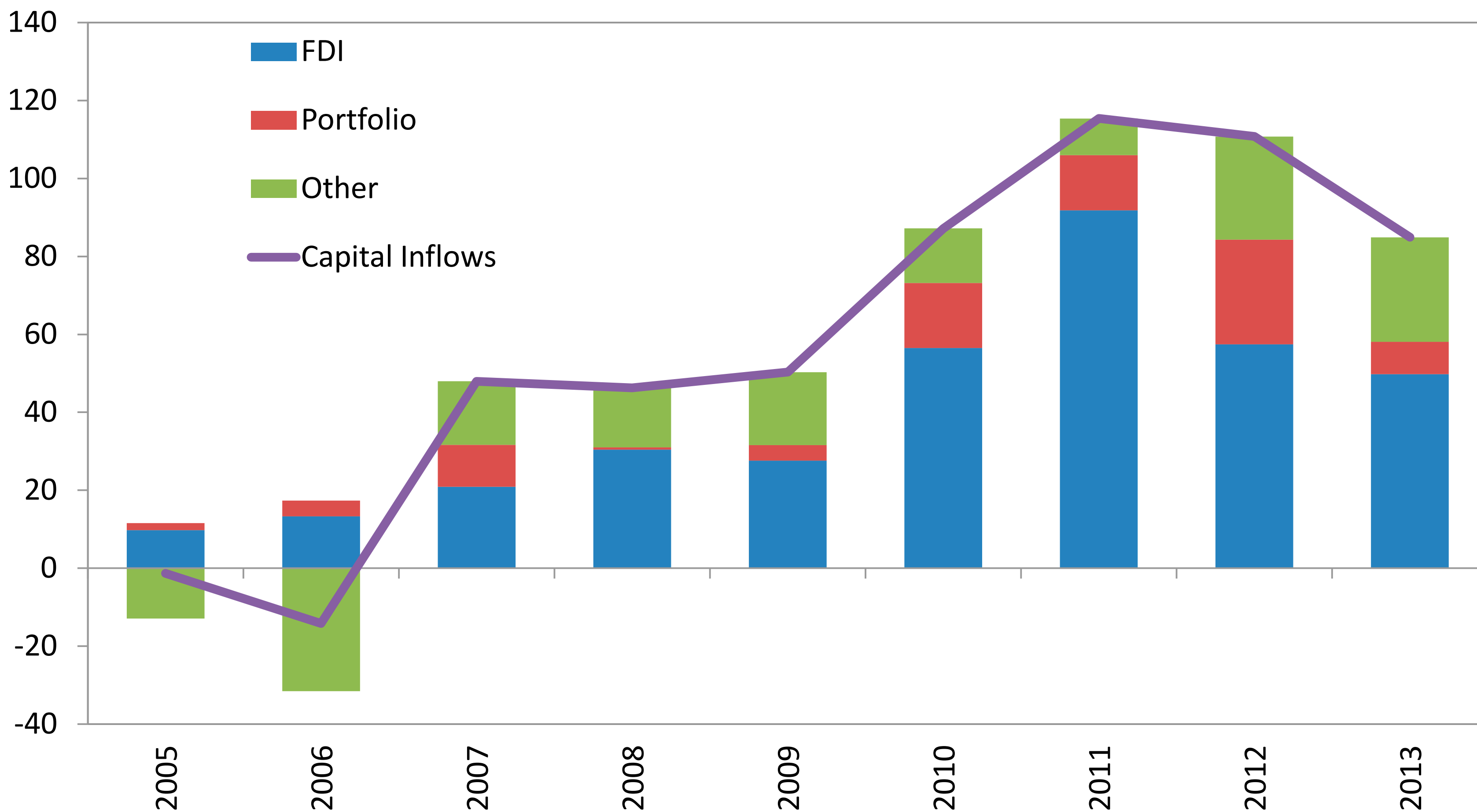
**A look at frontier economies:**

**1. Capital flows and current account in Frontier Economies** (% of GDP). In some cases have been financing very large current account deficits. Are they sustainable? Do they concentrate in investment or consumption?




Source: IMF-WEO and World Bank.

**2. Composition of Gross Capital inflows to Frontier Economies** (billions USD). FDI flows are the more secure from a point of view of sustainability (they are investment. In tradables?) and vulnerability (difficult to run and risk-sharing)




Source: IMF-IFS.

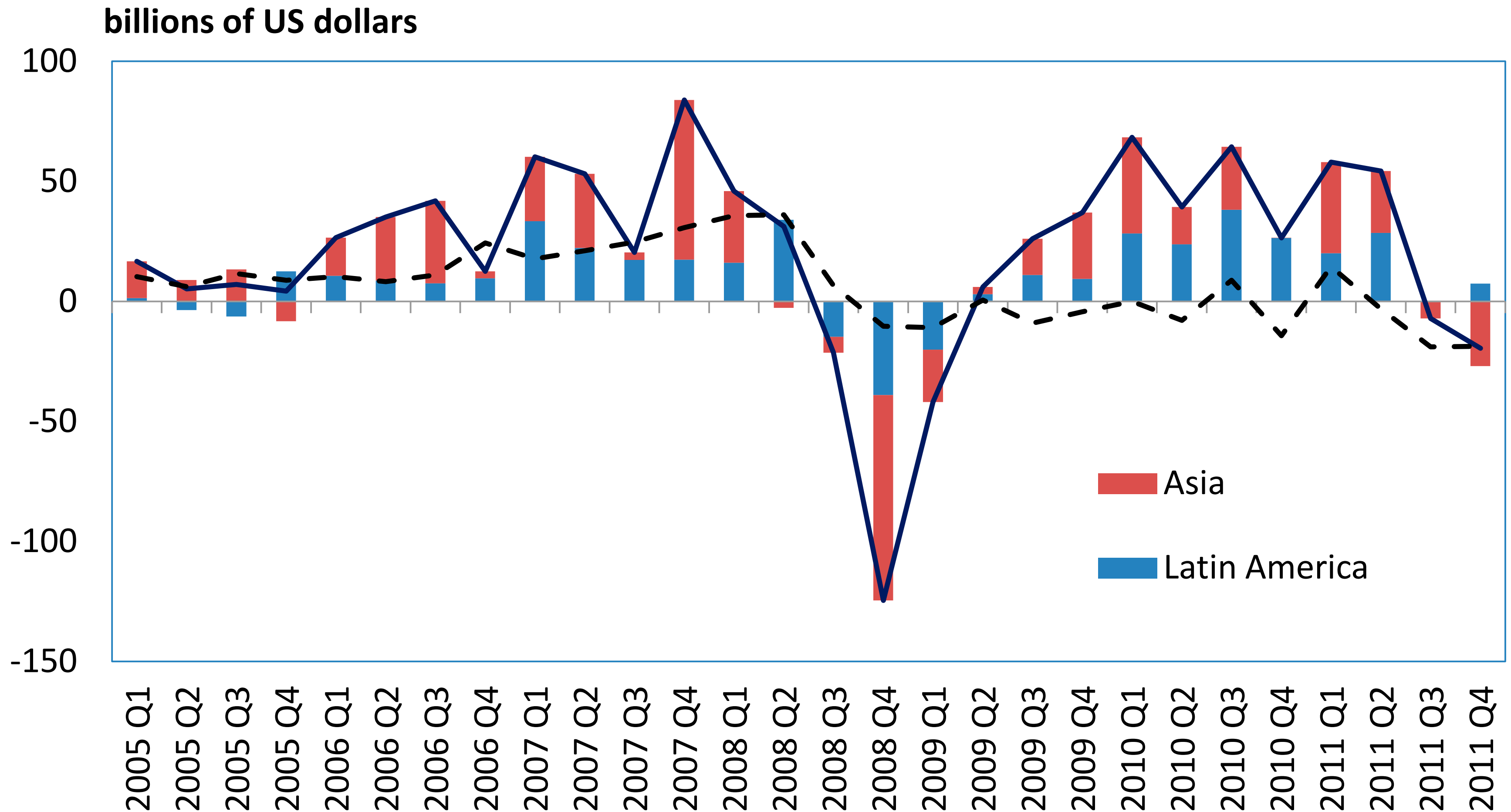
# The Problems with capital flows

- It is not only capital account management, but how to manage the economy in the face of high demand for domestic asset.
- It involves issues such as:
  - Financial liberalization and regulation
  - Fiscal and monetary policy
  - Macroprudential tools
  - Specific capital controls.
- I will discuss these issues (further details in De Gregorio, 2014)

# On financial liberalization and regulation (Financial stability)

- What come first: domestic or international financial liberalization. First to have a strong domestic financial system. In capital markets important to have a large basis of domestic savers. They are less subject to run to safe heavens and more home bias (institutional investors).
- The composition of flows matter: FDI then Portfolio the Credit.
- The perils of cross-border credit flows have to be handled properly:
  - Do not allow foreign denominated debt, in particular in the non-tradables sector (mortgages in emerging Europe).
  - How to treat foreign banks operating locally: it is preferable subsidiaries over branches. Responsibility at the local level with constraints in operations with mother company.
  - Equal treatment to local and foreign banks.
  - Be careful with public banks. They may be helpful, but also a source of fragilities when operations and more politicized than technical.

**Quarterly change in cross-border banking claims, 2005Q1-2011Q4.**
Cross-border banking credit is the most volatile form of flows.




*Source*: Bank for International Settlements, Consolidated Banking Statistics (immediate borrower basis).

# On macroeconomic policies

- First of all a flexible exchange rate is the first line of defense for capital inflows. The increased valuation of domestic assets should temper inflows. Sustaining, or attempting to, an artificially weak currency may encourage inflows, specially when interest rates are high.
- This does not prevent from intervening to avoid extreme misalignments. Intervention allows to have a strong position of international liquidity. Having reserves is key to avoid extreme exchange rate volatility and acts as a deterrent of speculation against the home currency.
- How to avoid fear of floating? Currency-mismatches and credible low inflation reduces the pass-through from exchange rates to prices.

# On macroeconomic policies

- What is the effect of exchange rate flexibility on inflows? They reduce incentives for speculative capital as risks are higher. Short tem inflows, and portfolio, could be the ones that have the largest effects on the real exchange rate (Combes et al., 2012).
- A credible low inflation rate regime should help to mitigate the inflationary effects of inflows and exchange rate volatility.
- Fiscal policy must be supportive. Excess expenditure, financed externally, may have greater effects on the real exchange rate. Countercyclical fiscal policy is advisable.

## Capital controls or prudential policies?

- Many reasons to justify capital controls. Avoid appreciation of the exchange rate and affect volume and composition of flows.
- But, empirical evidence: small effects if any at all.
- Currency, maturity mismatches and excess borrowing: prudential regulation on exchange rate exposure and liquidity management and taxation.
- Sudden Stops: reserve accumulation (also could help with the exchange rate). Or FCL?.

# Capital controls or prudential policies?

- The current theory 1: pigouvian taxes on all inflows to reduce externality from excessive borrowing. But this in general does not happen. To foster FDI in general it is not affected by controls.
- But sectors without controls can do arbitrage. Large corporations can borrow in international capital markets and then behave as surrogate financial intermediaries (shadow banks). This has happened in some Asian countries with controls, but not in the US (Shin and Zhao, 2013), and Brazil, but not Chile (Caballero et al. 2014).
- FDI can also become a surrogate financial intermediary by increasing the initial committed investment, or by anticipating flows and leave them deposited in the domestic financial market.
- The current theory 2: excessive credit expansion, bubbles and booms, but this can be addressed with prudential regulation to stem the credit boom rather than controls cross-border flows.

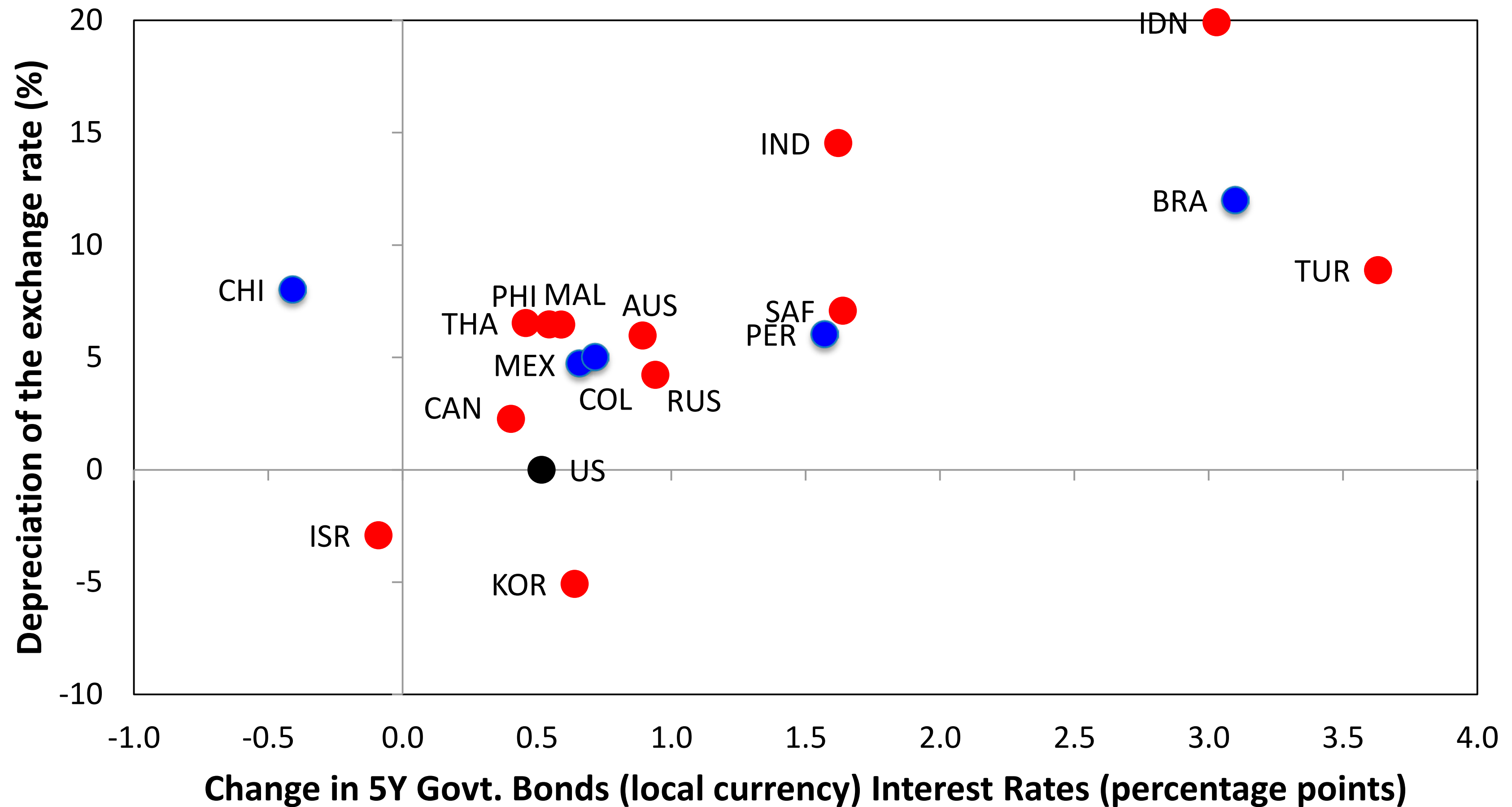
# Capital controls or prudential policies? Summing up

- There are better instruments for financial stability and to avoid financial crisis. Prudential regulation (micro and macro). Currency mismatches to be avoided, or properly prcied, not only in banking, but also in the corporate sector.
- If the problem are banking flows: banking regulation.
- For macro purposes (exchange rate) all flows should be controlled, “good” and “bad”. Unfeasible and not clear that it is effective to affect the exchange rate or to provide monetary independence.

# Capital controls or prudential policies? Summing up

- Most emerging markets weathered the financial crisis successfully, with unprecedented performance and use of appropriate macro policies.
- No example of a single country that succeeded because had capital controls.
- But, unfettered financial markets is unwise. After many crisis, financial markets in emerging markets are quite conservative, heavily regulated, and hence, more resilient.

# Change in interest rates and depreciation after tapering (may 2013-November 2013)




Source: Bloomberg

## On Monetary Policy Independence

- It is high interest rate the problem or capital inflows? Do capital controls provide false idea of independence. Incentives for carry trade: Chile in the 90s and Brazil in the 2000s.
- To have monetary independence a flexible exchange rate helps and regulation on the financial system to avoid excessive volatility (macroprudential)
- Role of foreign investors in domestic capital markets.

## Conclusion

- There are direct instruments to protect financial stability. However, **open capital account does not mean unfettered financial systems**.
- Effectiveness of capital controls is at most weak. **But do not open the capital account without strong financial system.**
- The first line of defense for macro stability is good policies: **IT, strong fiscal and flexible exchange rates**.