Managing Capital Inflows in Emerging Markets

José Darío Uribe

Governor

Banco de la República – Colombia

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Capital inflows to Emerging Markets are again on a remarkable surge…

Capital flows to LATAM jumped from USD 65 billion in mid-2009 to more than USD 260 billion in 2010…

… with larger shares as portfolio investment or external debt, instead of the FDI that prevailed before 2008.

These implies serious risks for macroeconomic and financial stability…

- Possible overheating in the economies.
- Sharp growth in credit and asset prices… even under flexible exchange rate regimes.
- Excessive over-evaluation of currencies.

- Raise liquidity risks and currency mismatches

⇒ Financial and real vulnerabilities increase.

⇒ More painful the adjustment after a “sudden stop”.

Concerns are critical in countries with an intermediate level of financial development…

- Liquid financial markets and instruments exist and attract foreign capital, but…
- The capacity for absorbing and benefiting from capital flows is limited.
- The financial system excessively amplifies the impact of capital flows on the economic cycle, the exchange rate, assets prices and credit.

What can authorities do?

Policy actions should minimize costly distortions for the economy and ensure sustainable growth.

An adequate policy mix should include…

1. **Keeping aggregate demand on a sustainable growth path.**

Measures in three dimensions…

✓ A fiscal policy that increases public savings.

✓ A monetary policy that keeps inflation on target and smooths out the business cycle.

✓ A flexible exchange rate regime.

2. Keeping financial stability through micro and macroprudential policies... because they…

- ✓ Reduce local financial distortions (e.g. agency problems and maturity mismatches).

- ✓ Enhance the financial system's ability to intermediate foreign capital in a sustainable fashion.

- ✓ Improve the economy's ability to absorb external shocks.

But… prudential policies should not always be regarded as “measures of last resort”…

Depending on the size and speed of the external shocks, there could be a role for **simultaneous** policies, including capital controls… All will depend on the policymakers concerns and a cost-benefit analysis.

In Colombia, FX regulation and capital controls are used to…

- Enable flexible exchange rate regime and countercyclical monetary policy.
- Contribute to curb leverage and external liquidity risk of the private sector.

- To float and facilitate countercyclical monetary policy, we use regulation with **indefinite** duration.
- To limit leverage and external liquidity risk, we use **transitory** instruments, like the Unremunerated Reserve Requirement (URR).

These instruments are always utilized following a cost-benefit analysis and with clearly defined purposes.

Of course, it is not always easy to perform a cost-benefit analysis:

- Some costs are difficult to measure and refer to medium and long term effects.
- Some benefits are subject to a high degree of uncertainty and the evidence about its effectiveness is controversial.

▪ Indefinite FX regulation

Perception that benefits are larger than costs on a permanent basis…

Benefits

- Helps countercyclical monetary policy
- Helps financial stability

Costs

- Development of long term capital markets and other undefined costs.

Instruments

- Financial intermediaries (FI) are not allowed to borrow in FX currencies to lend in domestic currency.
- FI are not allowed to have maturity mismatches in FX currency.

Other instruments (costlier)

- Limits to the FX net asset position on a cash basis

  (reduce external leverage of local banks)

- Limits to the gross leverage position in derivatives

  (reduce counterparty risk of banks in OTC FX derivative markets)

These instruments have proven useful in due to:

- FI are (by far) the main players in the spot and derivatives markets for foreign exchange.

- FI are closely monitored and strictly regulated by Banco de la República and the Government.

High effectiveness

- **Transitory** FX regulation

Perception that in some particular circumstances the expected benefits are larger than the costs…

- Tend to lose their effectiveness over time (Costs > Benefits).

Instrument

- URR on foreign loans (private and public).

Highly effective for…

- Changing the maturity structure and the nature of capital inflows (towards longer term debt and other types of inflows).

Controversial…

- Regarding its effect on total inflows, and hence on the exchange rate and the autonomy of monetary policy.

The advantages of this instrument seem to become larger when there is a strong need to:

- Reduce the risk on external liquidity (by increasing the maturity and nature of the flows).
- Reduce total leverage (complementary to reserve requirements and other macroprudential measures)

In some cases it can contribute to increase financial stability.

Conclusions

- FX regulation and capital controls are a **complement** of the basic pillars of the macroeconomic policy (monetary, fiscal and financial supervision).
- The use of FX regulation and capital controls should be decided on the basis of a cost-benefit analysis.