

MACROECONOMIC VULNERABILITY: MANAGING PRO-CYCLICAL CAPITAL FLOWS

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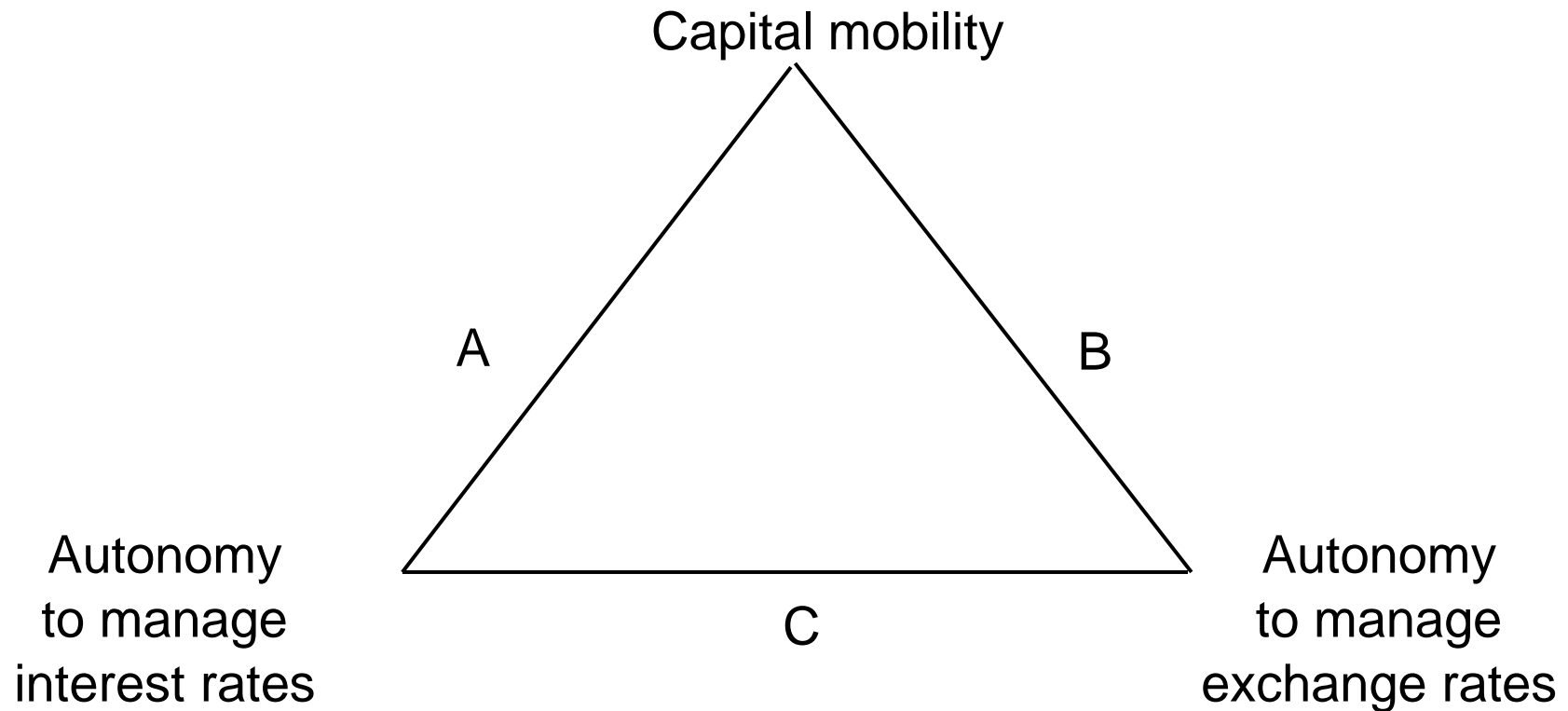
BASIC ISSUES (1)

- Broad view of macroeconomic stability: not only inflation and fiscal balance, but also:
 - ✓ Economic activity and employment
 - ✓ External sector balance
 - ✓ Balance sheets of financial and non-financial agents
- Developing countries are subject to strong cyclical shocks.
- Basic lesson from the past: following incentives generated by positive terms of trade and capital account shocks leads to crises.

BASIC ISSUES (2)

- So, need to develop counter-cyclical macroeconomic policies ...
- ... but limited “policy space” for them.
- This issue is generally ignored by in traditional policy debates:
 - ✓ The “trilemma” and polar exchange rate regimes.
 - ✓ Inflation targeting cum flexible exchange rates and open capital accounts.
- On the contrary, some “revealed preferences” of authorities make sense, particularly “self-insurance” through foreign exchange reserve accumulation and heavy interventions in foreign exchange markets.

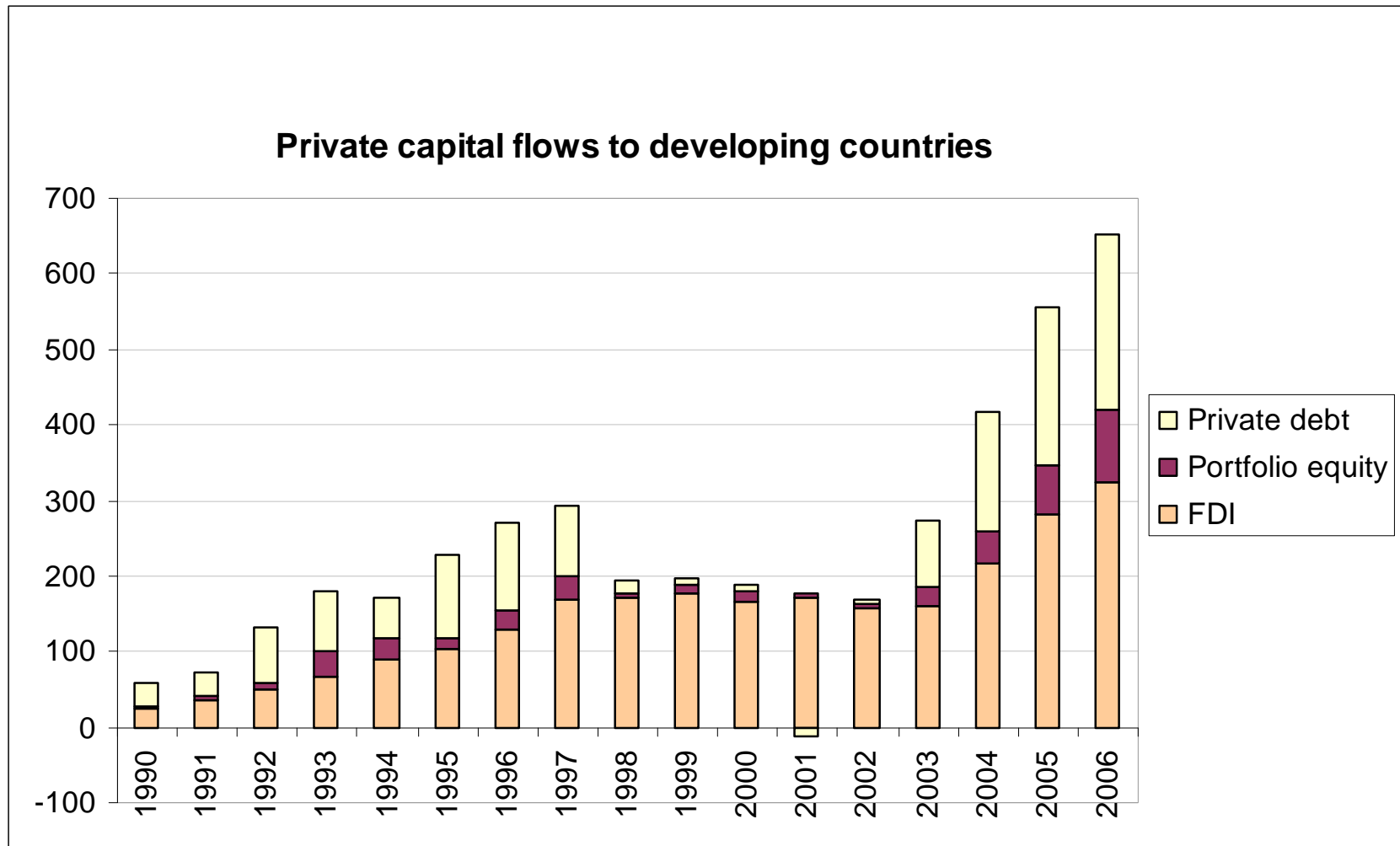
THE TRADITIONAL VIEW: THE IMPOSSIBLE TRINITY



MACROECONOMIC (IN)STABILITY

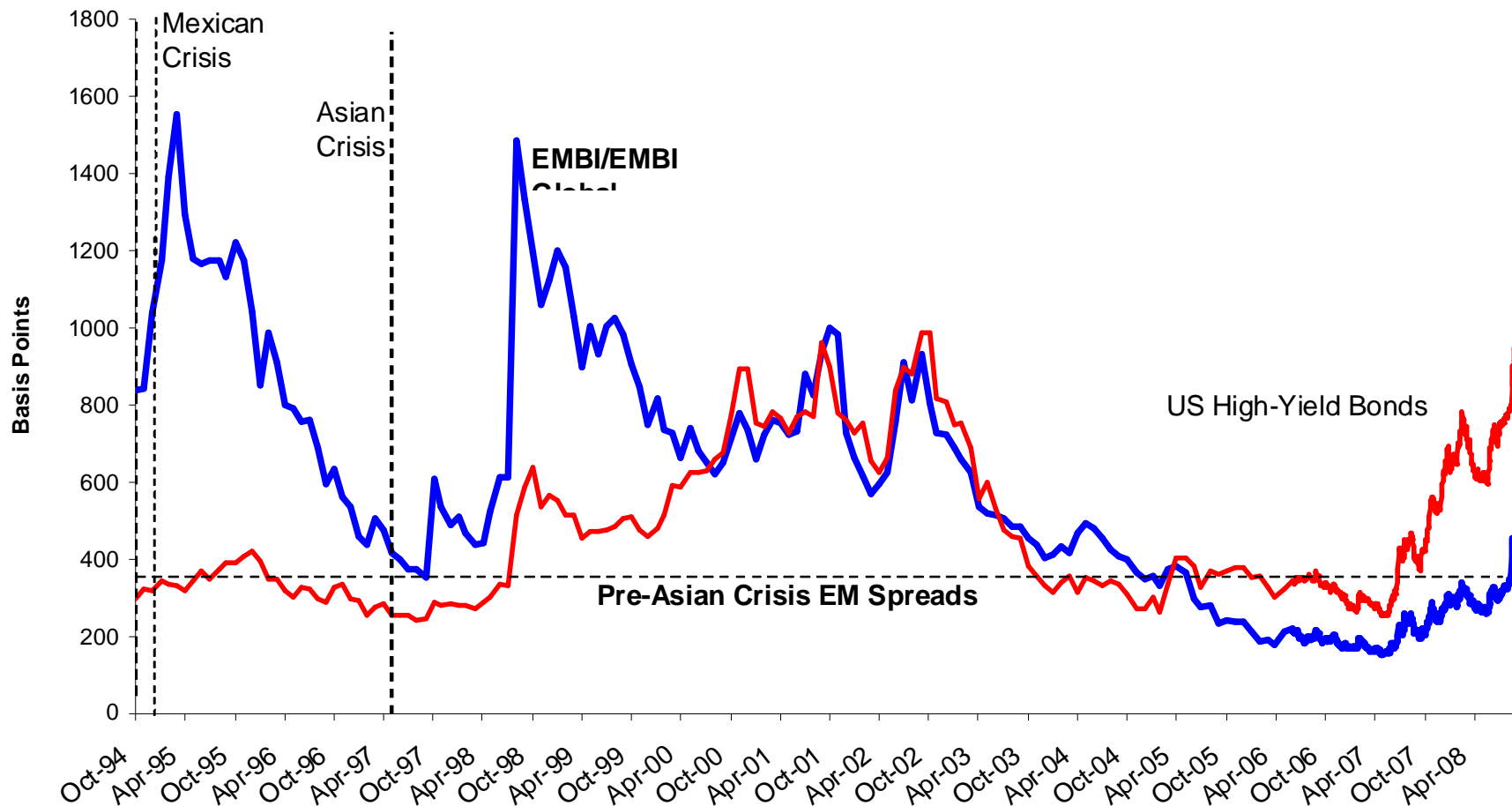
- Markets are inherently cyclical
- This is true of commodity markets ...
- ...but particularly of financial markets:
 - ✓ Alternation of high “risk appetite” and “flight to quality”
 - ✓ Rationing of credit, particularly during downturns
 - ✓ Contagion
- Features of financial cycles:
 - ✓ Variations in availability, price and maturities
 - ✓ Short-term but, particularly, *medium*-term fluctuations

UNSTABLE ACCESS TO EXTERNAL FINANCING...

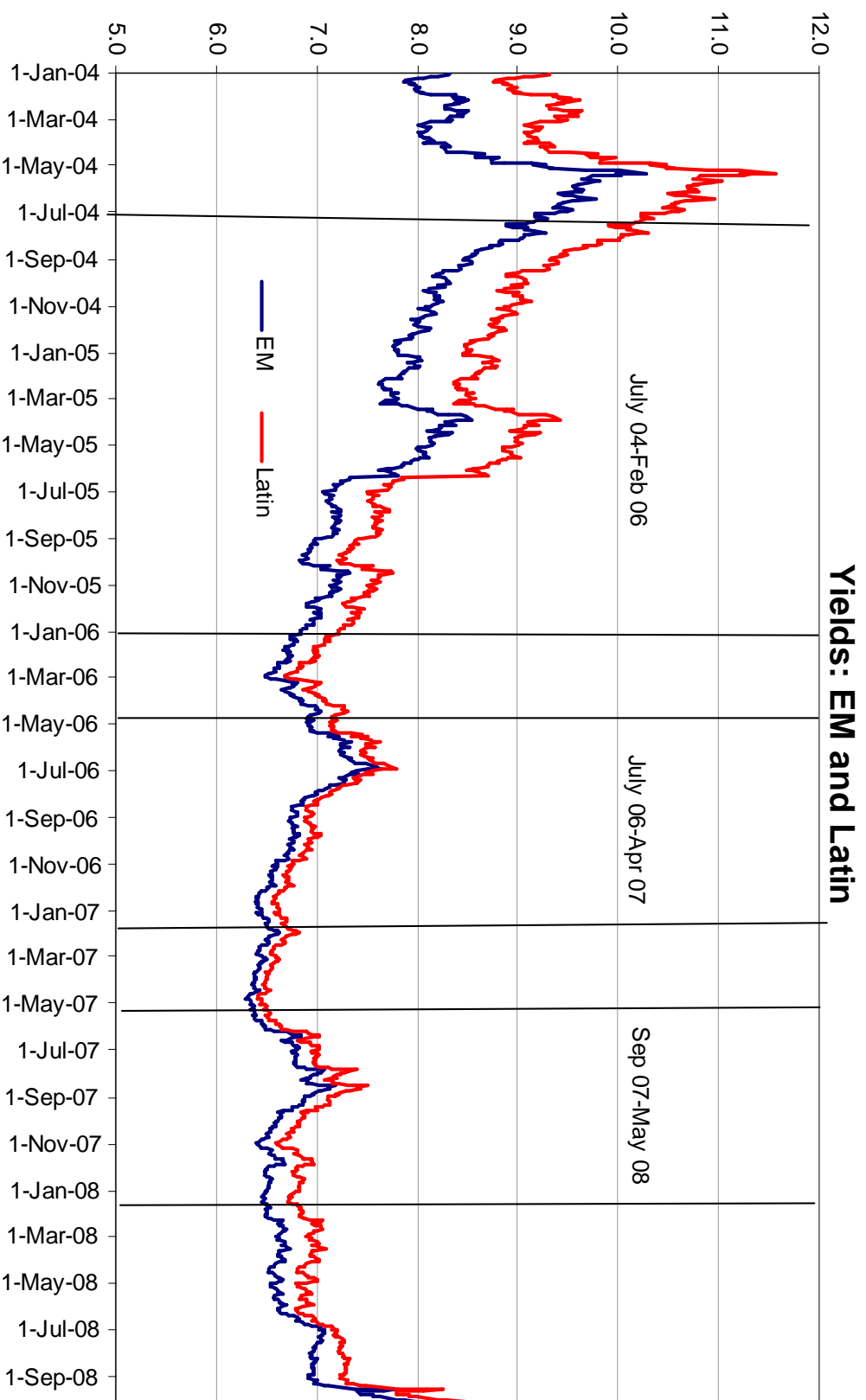


... AND VOLATILE SPREADS ...

EMBI Global and US High-Yield Bonds, October 1994 to 2008 YTD



... WITH SHORTER-TERM FLUCTUATIONS



COUNTER-CYCLICAL POLICIES

- Counter-cyclical fiscal policies
- Counter-cyclical monetary policies
- Foreign exchange reserve accumulation
- Development of domestic bond markets
- Capital account regulations
- Counter-cyclical prudential regulation.

FISCAL POLICY

- Fiscal policy can always play a counter-cyclical role.
- But markets push it in a different direction, as taxes and financing are pro-cyclical
- And there are political-economy pressures that push in the same direction:
 - ✓ If there was austerity during the preceding crisis, it is also difficult to justify it during booms
 - ✓ Compensating pro-cyclical booms of private spending is politically difficult
- Procyclical fiscal policy has adverse effects on the efficiency of public sector spending and on growth.

FISCAL POLICIES IN THE DEVELOPING WORLD TEND TO BE PRO-CYCLICAL

| REGION | CYCLICALITY OF FISCAL POLICY (INDEX) |
|--------------------------------------------|--------------------------------------|
| OECD | - 0.11 (countercyclical) |
| High-to-Middle Income Developing Countries | 0.28 (highly procyclical) |
| Middle-to-Low Income Developing Countries | 0.17 (moderately procyclical) |
| Low-Income Countries | 0.28 (highly procyclical) |
| Africa | 0.30 (highly procyclical) |
| Latin America | 0.25 (highly procyclical) |
| Asia | 0.16 (moderately procyclical) |

FISCAL POLICY OPTIONS

- Actively use stabilization funds
- Define a structural stance of the public sector.
- Automatic stabilizers (spending or taxes) may be preferable to discrete decisions.

COUNTER-CYCLICAL MONETARY POLICIES (1)

- A counter-cyclical rule is implicit in the inflation targeting paradigm ...
- ... but pro-cyclical capital flows generate swings in parity interest rates ($i = i^* + \theta + \hat{e}$) that have pro-cyclical effects...
- ... as well as supply shocks that run counter to expectations of the dominant paradigm.
- In sum, a succession of boom-cum price stability (“boombility”) and stagflation pressures.

COUNTER-CYCLICAL MONETARY POLICIES (2)

- So, authorities may have limited room to counter the pro-cyclical swings of markets.
- The attempt to do with through flexible exchange rates simply shifts the problem to the exchange rate ...
- ... generating risks of balance of payments crises ...
- ... and unstable incentives for international specialization.

FOREIGN EXCHANGE ACCUMULATION (1)

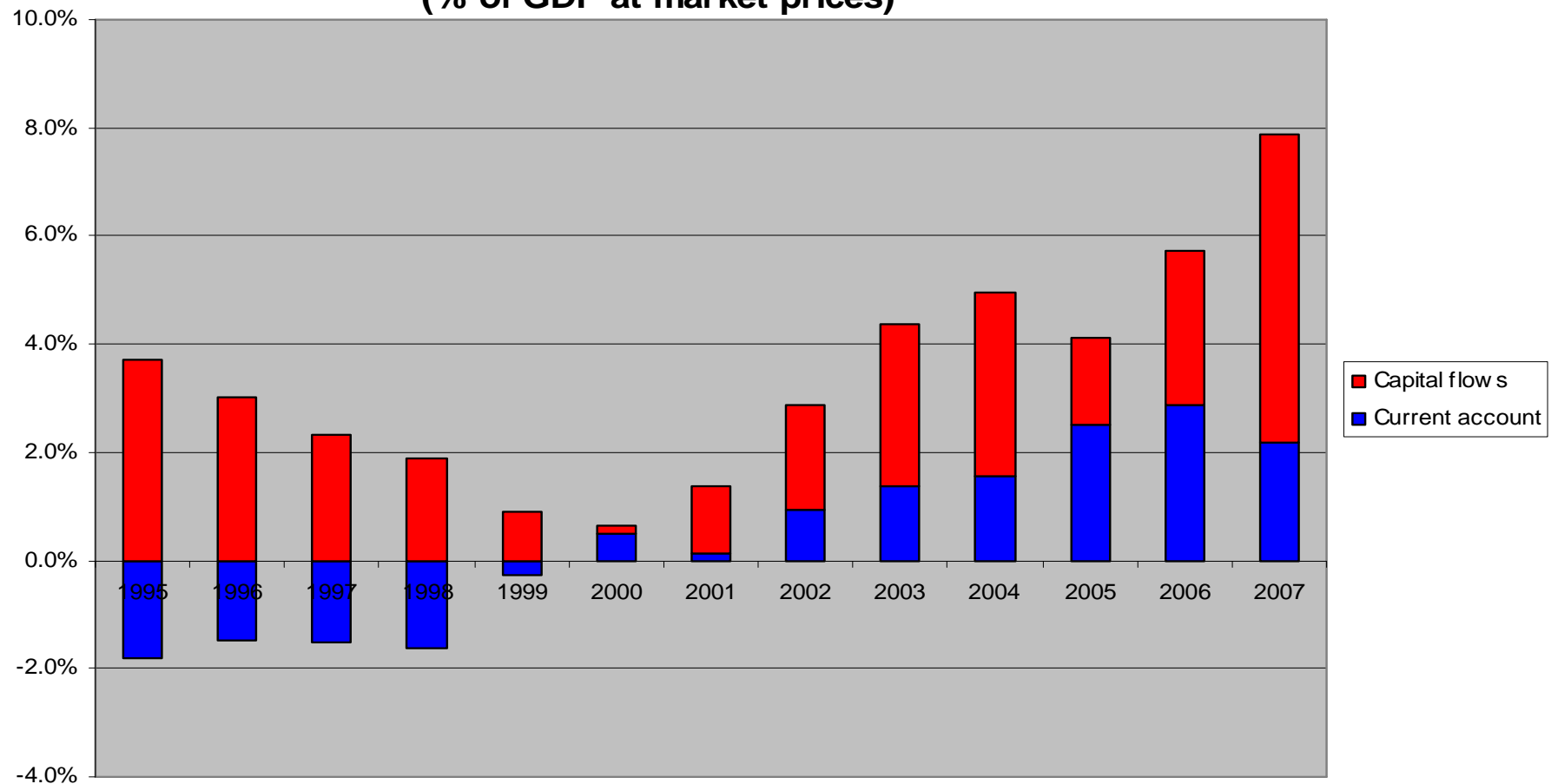
- If adequately sterilized, it is possible to target both the exchange and the interest rate.
- This resolves also the conflicting demands on the exchange rate regime:
 - ✓ Demand for stability (price stability, stable trade incentives, avoiding pro-cyclical wealth effects)
 - ✓ Demand for flexibility (room of maneuver to manage shocks)
- Some form of “exchange rate targeting” is the normal policy option: the “revealed preference” of the authorities has been to be inside the triangle of the “impossible trinity”.

THREE THEORIES OF RESERVE ACCUMULATION

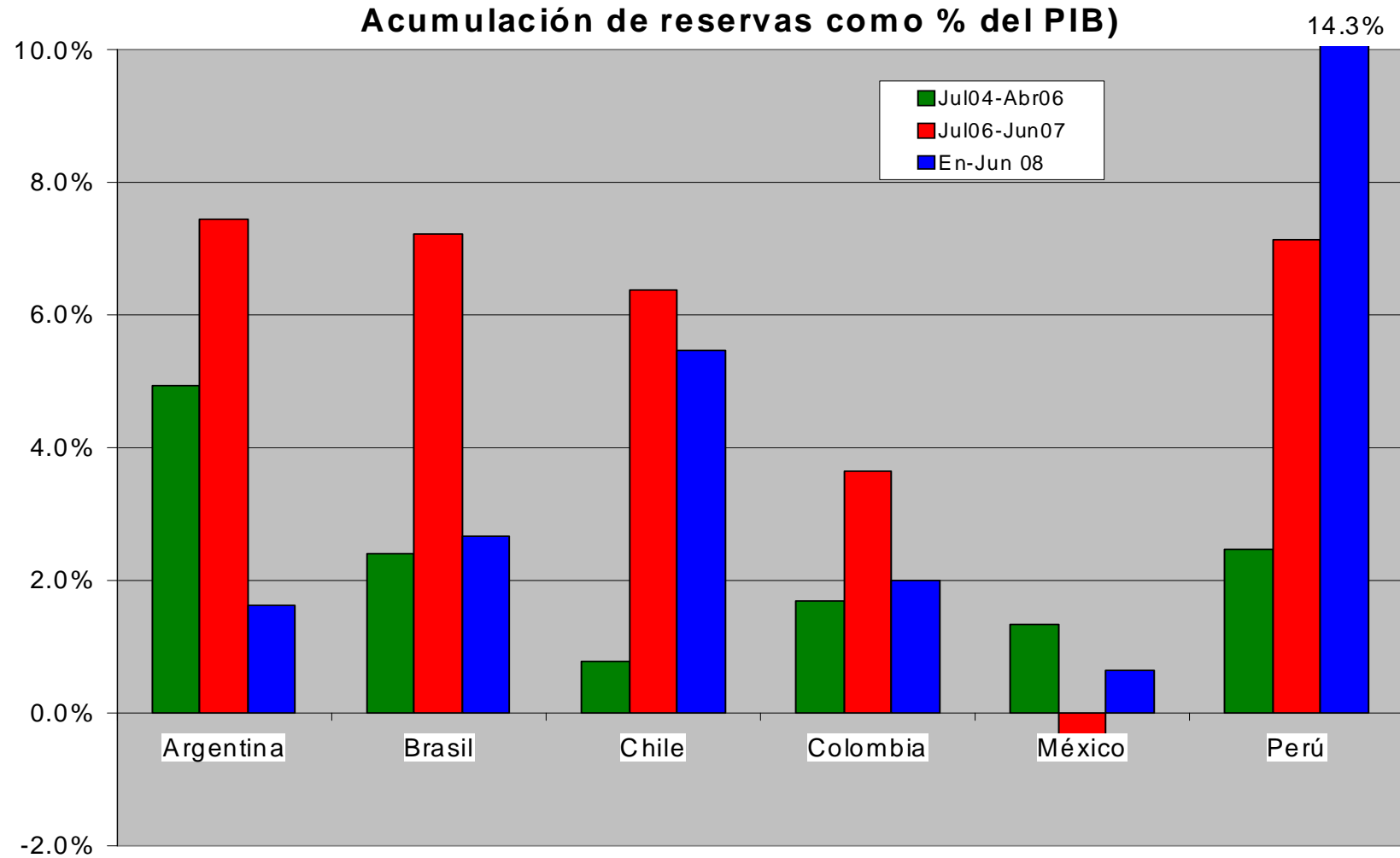
- Mercantilist: “Second Bretton Woods” literature.
- “Self-insurance”: protection against capital outflows. To the extent that medium-term cycles are important, reserves should be proportional to *total* external liabilities.
- “Financial stability” (Obstfeld, Shambaugh and Taylor): protection against capital flight.
- Magnitude and timing of reserve accumulation may be read as implying that “self-insurance” is the dominant motive.

DEVELOPING COUNTRIES HAVE ACCUMULATED PART OF EXPORT REVENUES AND ALL CAPITAL INFLOWS

Reserve accumulation by developing countries
(% of GDP at market prices)



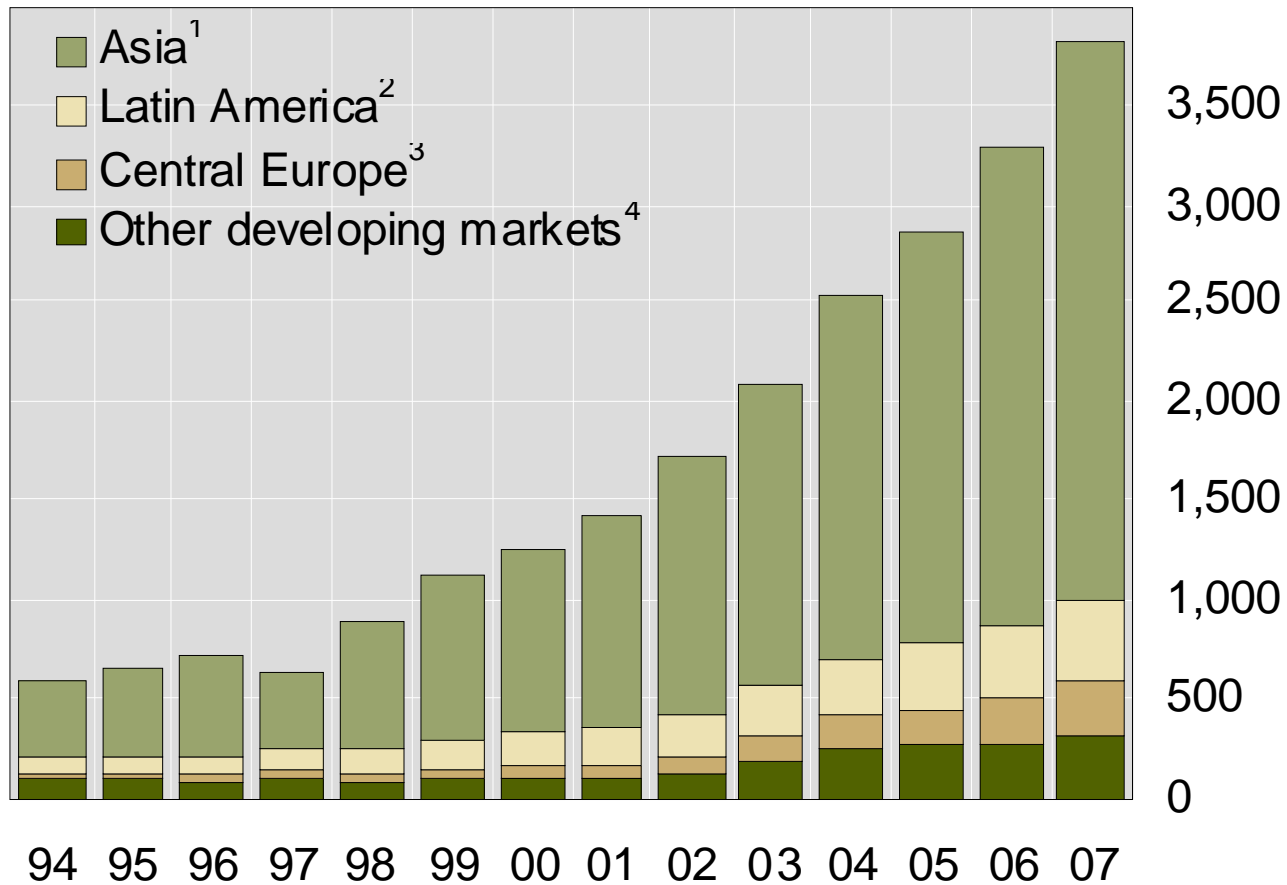
MASSIVE INTERVENTIONS IN FOREIGN EXCHANGE MARKETS



PROMOTE DOMESTIC BOND MARKETS

- Three key issues:
 - ✓ Trade-off between currency and maturity mismatches.
 - ✓ With open capital accounts, pro-cyclicality associated with exchange rate expectations.
 - ✓ Moving from a government bond market to one that also includes corporate bonds.
- Some policies may be useful to reduce these problems:
 - ✓ Taxation or reserve requirements on shorter term bonds
 - ✓ Minimum stay periods for foreign holdings
 - ✓ Avoiding domestic dollarized assets.

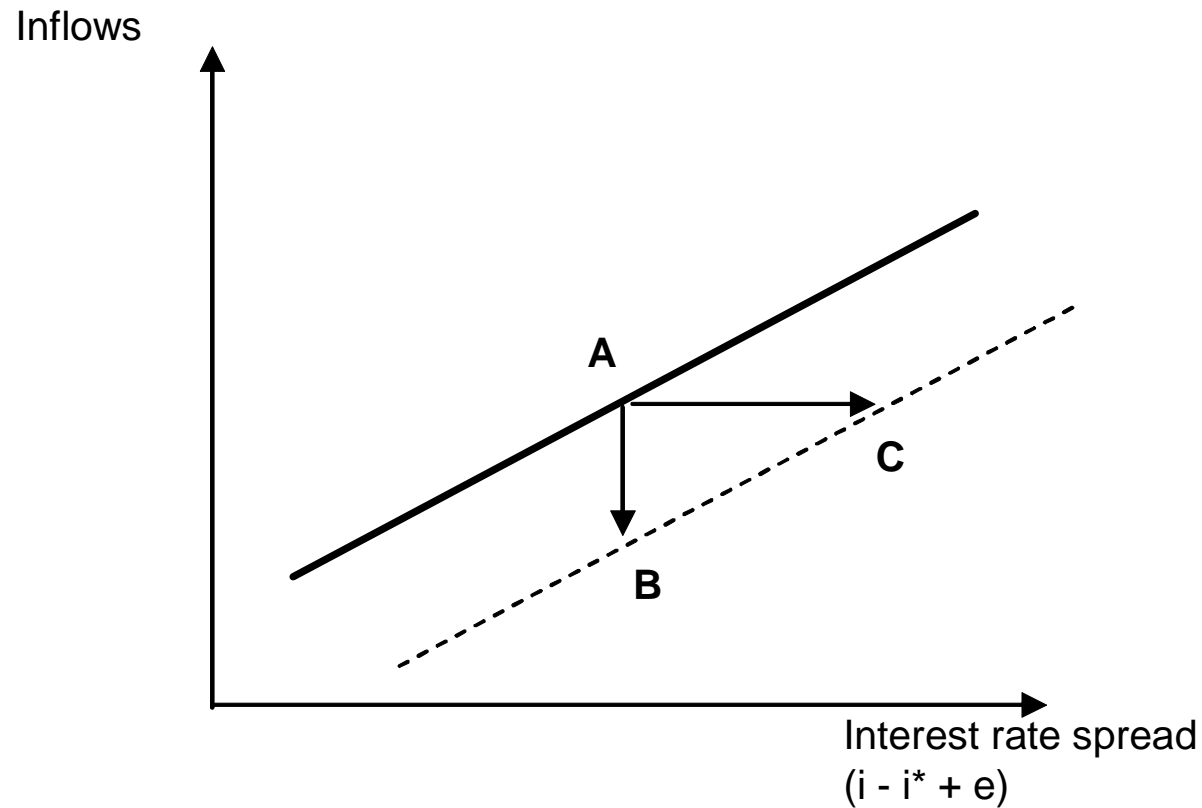
DOMESTIC BOND MARKETS HAVE BOOMED SINCE THE ASIAN CRISIS



CAPITAL ACCOUNT REGULATIONS (1)

- Two objectives:
 - ✓ Macro: increase space for counter-cyclical monetary policy
 - ✓ Debt management: improve debt profiles.
- Second best intervention: segment what is already segmented.
- Traditional regulations: segment according to residents and non-residents, and existing economic links.
- For countries already integrated in to world capital markets:
 - ✓ Temporary administrative controls
 - ✓ Price-based regulations (Unremunerated Reserve Requirements, URR).

THE EFFECT OF CAPITAL-ACCOUNT REGULATIONS



i : Domestic real interest rate

i^* : External real interest rate

e : Annual variation of of the real exchange rate

CAPITAL ACCOUNT REGULATIONS (2)

- Lessons from experience:
 - ✓ Both controls on outflows and inflows can work, but quantitative restrictions may be easy to administer
 - ✓ Dynamic adjustment is necessary to close loopholes, and in any case regulations are “leaky”
 - ✓ Traditional controls work better if the objective is to reduce procyclical flows.
 - ✓ Quantitative controls have stronger effects, but price-based regulations are also effective
 - ✓ Their effect may be temporary
 - ✓ Capital account regulations are a complement, not a substitute of adequate macro policy
- Despite positive lessons of the past, few countries used them during the recent crisis.

MACRO-PRUDENTIAL REGULATIONS

- Risks that financial sector faces have a large macroeconomic component:
 - ✓ Financial markets are pro-cyclical
 - ✓ Traditional regulation have a pro-cyclical bias
 - ✓ Mark-to-market and other price-sensitive risk management is also pro-cyclical.
- Essential tools:
 - ✓ Forward-looking provisioning (or capital)
 - ✓ Discretionary prudential provisioning, based on growth of credit (general, by sector, by agent)
 - ✓ Regulation of maturity and, particularly, currency mismatches.
 - ✓ Valuation of collaterals to avoid asset price bubbles from feeding into leverage.

CONCLUSIONS

- The essential problem of macroeconomic policy in the mix of pro-cyclical capital flows and the limited room of maneuver for counter-cyclical macroeconomic policies that they generate.
- Dominant frameworks are not always useful to analyze the dilemmas involved, as they don't look through the whole business cycle.
- Active counter-cyclical policies involve multiple instruments, including active foreign exchange reserve management, elements of exchange rate targeting, counter-cyclical prudential regulations and, possibly, capital account regulations.
- The support for counter-cyclical policies must be at the center of international (IMF) cooperation.

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