Policy panel 2: What tools can emerging economies use in an environment of rising rates?

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Coping with Spillovers from policy normalization in advanced economies

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Monetary policy accomodation in AEs can have potentially destabilising effects on EMEs…

Three key questions:

- Are spillover effects large?
- Are they on balance negative?
- What can EMEs do to offset these effects?

➢ Focus on the last one.

The toolkit… (both preventive and curative measures)

- **OHIO**
- **Reserve accumulation**
- **Monetary policy**
- **Capital controls, macroprudential policy**
- **GFSN (RFA, IMF)**

OHIO (Own House In Order) principle, with a focus on fiscal issues

- Insights from Krugman (1979) still true: a country with a fixed exchange rate that monetizes its budget deficit is very likely to experience a currency crisis.
- Sound public finance is a great asset when interest rates increase (avoid fiscal dominance issues)
- Generally, fixed exchange rate arrangements expose countries to speculative attacks, although no consensus here.
- BUT reasonable fiscal policy is not a guarantee (see Obstfeld 1994 Generation II models: there are multiple equilibria for a range of fundamentals). Budget deficit often not a reliable early indicator.

➢ **“OHIO” principle is a necessary, not a sufficient condition.**

Reserve accumulation

- **Reserve ratio's** (to GDP, M2, short-term debt…) are a popular variable in most early warning signals.
  - Bussière & Fratzscher (2006), Bussière, Cheng, Chinn & Lisack (2015)
  - Frankel and Saravelos (2012), Rose and Spiegel (2011) are more critical
- **General perception that more reserves help in times of crisis →** a strong motive for accumulating more reserves
  - No clear benchmark: perpetual accumulation (Machlup problem)
  - There may be negative externalities for other countries (benchmarking)
- **Still, many Type I and Type II errors**
  - The example of Brazil and Mexico during the GFC is confounding.

➢ **Bottom line: it helps, but again not a sufficient condition.**

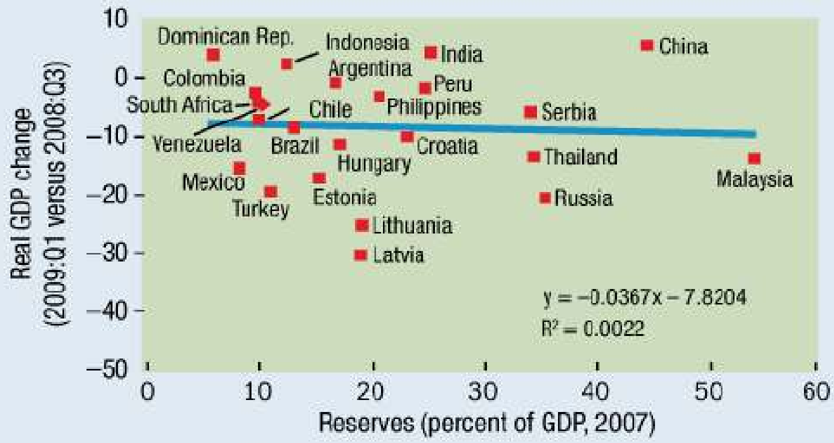
Reserve accumulation: the contrarian view

Chart 2

How much cushion?

Larger reserves did not lead to lower declines in economic activity at the peak of the crisis.

(selected emerging countries, in percent)

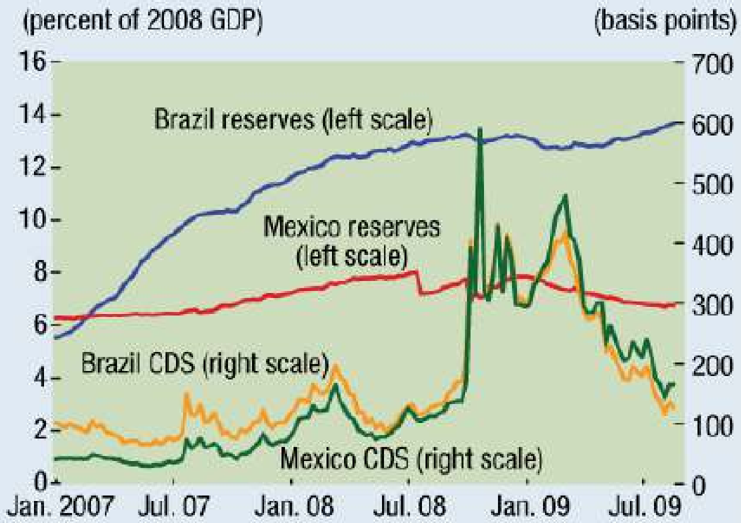


Sources: IMF, Global Data Source database and staff estimates.

Chart 3

Market perceptions

As the evolution of credit default swap spreads indicates, markets did not see Mexico as more vulnerable than Brazil despite lower reserves.



Sources: IMF, *World Economic Outlook* database; and Bloomberg L.P.

Monetary policy

- Is monetary policy **independent** in a small open emerging market economy?
- Dilemma's and trilemma's. See Helene Rey's work on the **global financial cycle**. Even with floating exchange rates, monetary policy is constrained (with an open capital account).
- Need for coordination? Mandates are national. Not clear that deviation from Nash equilibrium is an improvement.
- Role of the exchange rate: debate on **currency wars** at the ZLB (Caballero et al 2013 vs Jeanne 2018).
- Recent work on currency and trade wars (Bussière, Bénassy-Quéré and Wibaux 2018).
- BTW spillovers may not be that large (see third IBRN project, summarized in Buch, Bussière, Goldberg and Hills, 2018).

Capital controls, macroprudential measures (CFMs)

- Noticeable evolution of the IMF view on the capital controls (Ostry et al 2010). Further reflections on the issue in G20 and at the OECD.
- See Blanchard 2016: restrictions on capital flows are a more natural instrument for advancing the objectives of both macro and financial stability (than monetary policy coordination).
- Empirical evidence is mixed:
  - Forbes, Fratzscher and Straub (2013): “Capital controls and macroprudential measures: what are they good for?”.
  - Glocker and Towbin (2015): reserve requirements in Brazil. See also Camors and Peydro (2014), Vargas et al. 2011.
  - On bank-level capital requirements: Saurina 2009, Aiyar et al. 2014.
  - On LTV and DTI: Igan and Kang (2012)
  - On spillovers: see second IBRN projects in IJCB special volume, March 2017. Spillovers not that large.

Capital controls, macroprudential measures (CFMs)

- Few studies compare instruments
- Key exception is IMF (2012):
  - For EMEs the most efficient instruments are DTI and LTV
  - For AEs it is capital requirements and reserve requirements

Table 3. Effects of Macroprudential Measures on Credit Growth[1/]

All: 36 Countries	Credit Growth Rate (%, q-o-q)												
Credit Growth Rate (-1)	0.40	0.39	0.40	0.40	0.40	0.39	0.39	0.39	0.40	0.39	0.40	0.39	0.40
GDP Growth Rate	0.23	0.22	0.22	0.23	0.23	0.23	0.22	0.23	0.23	0.21	0.22	0.22	0.22
Interest Rate (-1)	-0.04	-0.04	-0.04	-0.04	-0.04	-0.05	-0.05	-0.05	-0.04	-0.04	-0.04	-0.04	-0.04
Credit Bust						0.88	0.44	0.56	0.48				
Recession										-0.61	-0.53	-0.56	-0.60
Capital Requirement (-1)		-0.51				-0.37				-0.59			
Limits on DTI Ratio (-1)			-0.21				-0.32				-0.22		
Limits on LTV Ratio (-1)				-0.13				-0.18				-0.15	
Reserve Requirements (-1)					-0.32				-0.36				-0.38
CR(-1)*Credit Bust						-1.38							
DTI(-1)*Credit Bust							1.60						
LTV(-1)*Credit Bust								0.16					
RR(-1)*Credit Bust									0.36				
CR(-1)*Recession										0.16			
DTI(-1)*Recession											-0.04		
LTV(-1)*Recession												0.14	
RR(-1)*Recession													0.16

EME: 21 Countries	Credit Growth Rate (%, q-o-q)												
Credit Growth Rate (-1)	0.42	0.42	0.42	0.41	0.41	0.40	0.40	0.39	0.40	0.41	0.41	0.40	0.41
GDP Growth Rate	0.28	0.28	0.26	0.26	0.28	0.24	0.21	0.22	0.24	0.26	0.25	0.24	0.26
Interest Rate (-1)	-0.04	-0.04	-0.04	-0.04	-0.04	-0.05	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04
Credit Bust						1.24	0.49	0.77	0.69				
Recession										-0.97	-0.92	-1.08	-1.12
Capital Requirement (-1)		-0.23				-0.19				-0.34			
Limits on DTI Ratio (-1)			-0.63				-0.80				-0.67		
Limits on LTV Ratio (-1)				-0.79				-0.73				-1.01	
Reserve Requirements (-1)					-0.40				-0.51				-0.51
CR(-1)*Credit Bust						-1.44							
DTI(-1)*Credit Bust							2.69						
LTV(-1)*Credit Bust								0.27					
RR(-1)*Credit Bust									0.21				
CR(-1)*Recession										0.17			
DTI(-1)*Recession											-0.01		
LTV(-1)*Recession												0.68	
RR(-1)*Recession													0.46

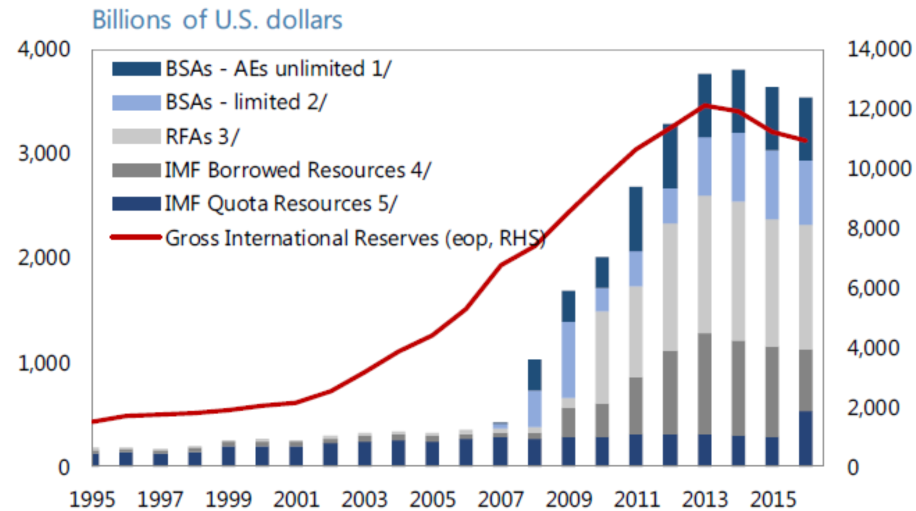
Source: IMF staff estimates.

1/ Green, orange, and yellow color in each cell indicate significance at 1, 5, and 10 percent level, respectively.

Role of RFA‘s / IMF

- Increasing size of RFA (compared to IMF resources)
- Fig. 1 from IMF Policy Paper, July 2017. Collaboration between regional financing arrangements and the IMF.
- See also ECB Occasional Paper, Strengthening the Global Financial Safety Net, 2018.

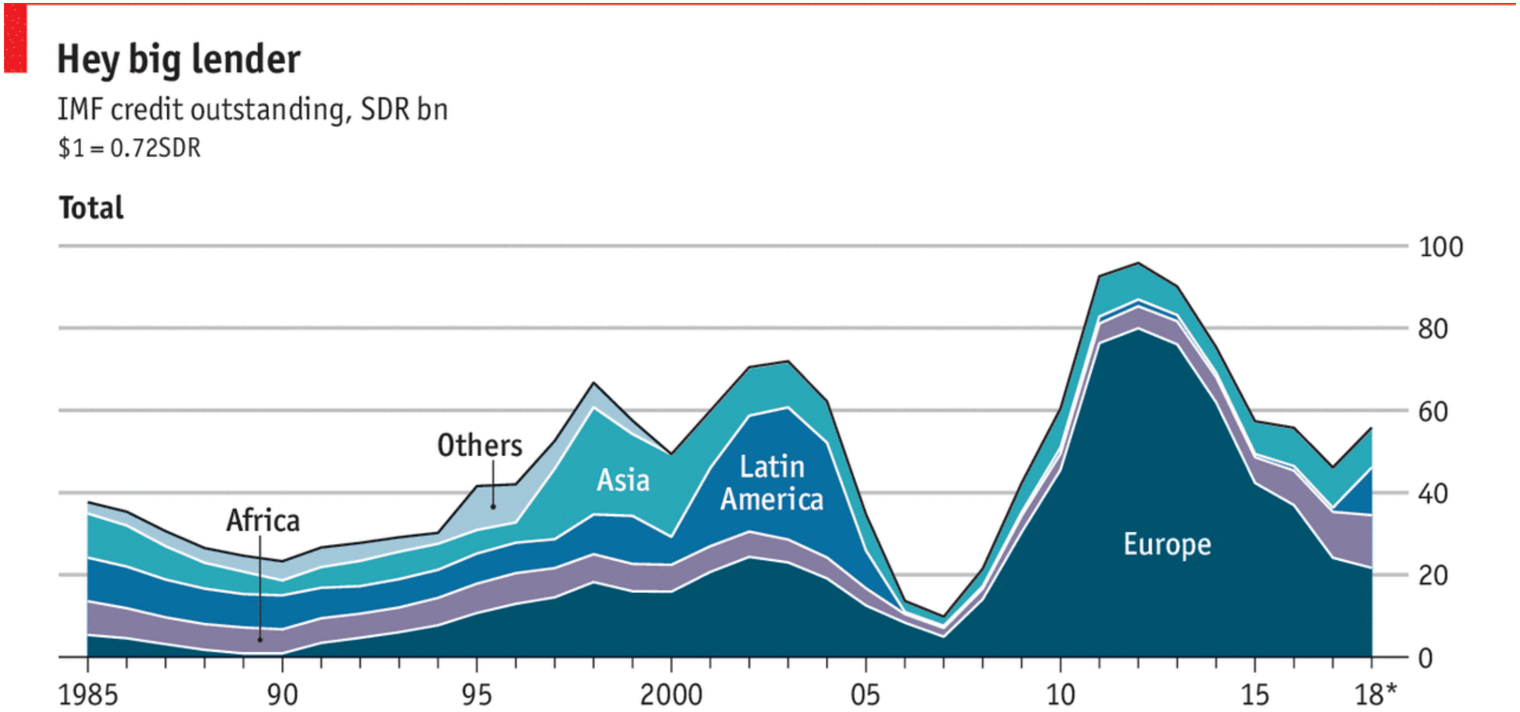
Figure 1. Evolution of the Global Financial Safety Net, 1995–2016



Sources: Bank of England; central bank websites; RFA annual reports; and IMF staff estimates.
1/ Estimated based on known past usage or, if undrawn, on average past maximum drawings of remaining central bank members in the network. Two-way arrangements are only counted once.
2/ Includes all arrangements with an explicit value limit and excludes CMIM arrangements, which are included under RFAs. Two-way arrangements are only counted once.
3/ Based on explicit lending capacity/limit where available, committed resources, or estimated lending capacity based on country access limits and paid-in capital.
4/ After prudential balances.
5/ For countries in the Financial Transaction Plan (FTP) after deducting prudential balance.

Role of RFA's / IMF

The Economist, 04/09/2018
The world's lender of last resort is back in vogue (As the dollar strengthens and interest rates rise, more emerging-market governments are turning to the IMF)



Tentative conclusions

- Most available instruments have positive, but uncertain effects (this applies to preventive and curative measures)
- Necessary versus sufficient conditions (doing nothing is not an option)
- Instruments may reinforce each other (complementarity, e.g. between reserves and CFM, monetary and macroprudential measures)
- Still, crises cannot be averted, and their effects are difficult to attenuate
- Calls for strong GFSN and good articulation between the different layers (RFAs/IMF).
- For this we need to ensure that the IMF has adequate resources