Managing Capital Flows in a Globalized World: Policy Challenges

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Agenda

I. What do we know about the benefits of financial integration?
II. Why we worry about capital controls?
III. What to do?
IV. Final comments on the Chilean experience

I. What do we know about the benefits of financial integration?

- There is no strong evidence that international financial integration spurs growth (neither is harmful).
- Many cases are associated to financial crisis that offset positive effects.
- Evidence from two eras of financial globalization (late 19th c. and 1980-2000): in modern times there are no effects on growth but in first episode financial integration was positive for growth. First era: Financial integration increased aggregate investment. Capital-poor countries were able to tap the global pool of savings due to its effect on investment. In recent times, financial integration may have financed decline in savings and not more investment (Schularick and Steger, 2010 ReStat).

I. What do we know about the benefits of financial integration?

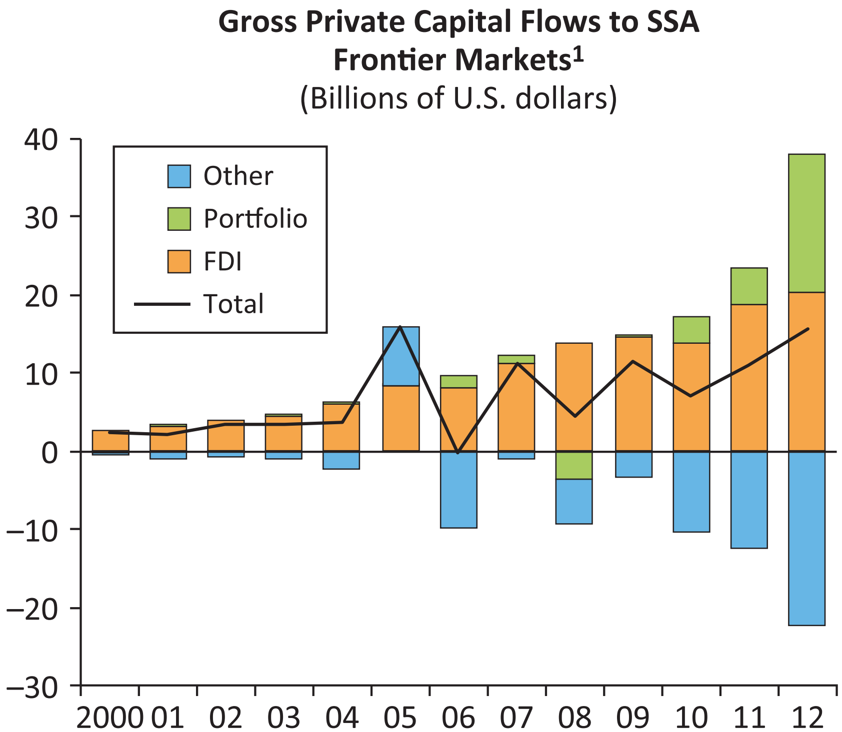
- There may be indirect effects of financial integration on financial sector development, institutions, governance and macroeconomic stability (Kose et al., 2009, IMF Staff Papers). However, to benefit from financial opening, a strong institutional framework is needed, mainly in terms of financial regulation, human capital, and macroeconomic development.

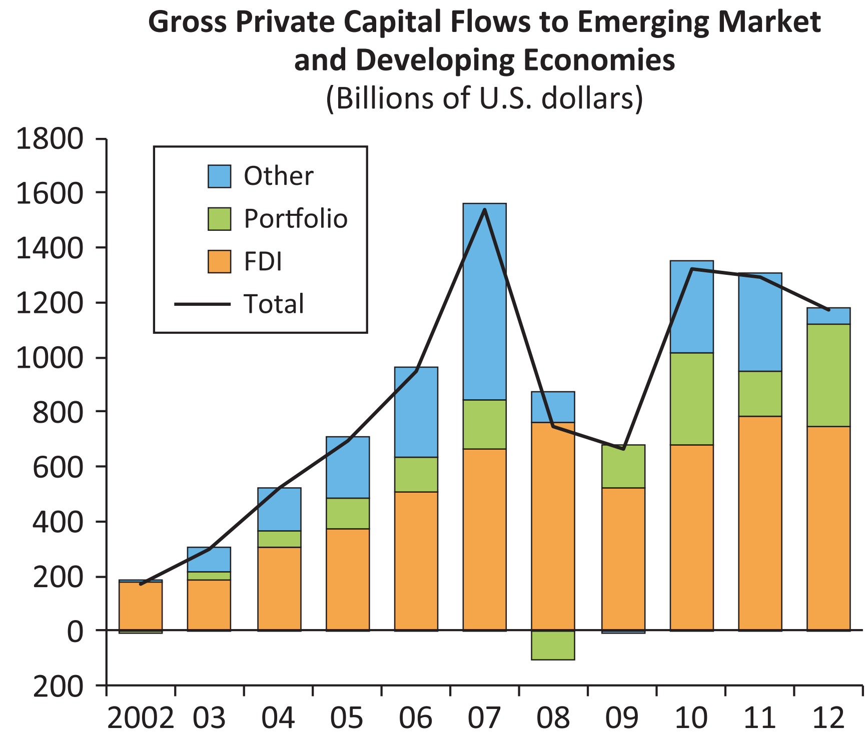
- Not all capital flows are the same:

  - The contribution of FDI depends on having reasonable levels of human capital, and more in general institutional development. Increase absorptive capacity by investing in human capital and strengthen domestic institutions.

  - Equity market liberalization also have positive effects on growth.

I. A preliminary look at Sub-Sharan Africa





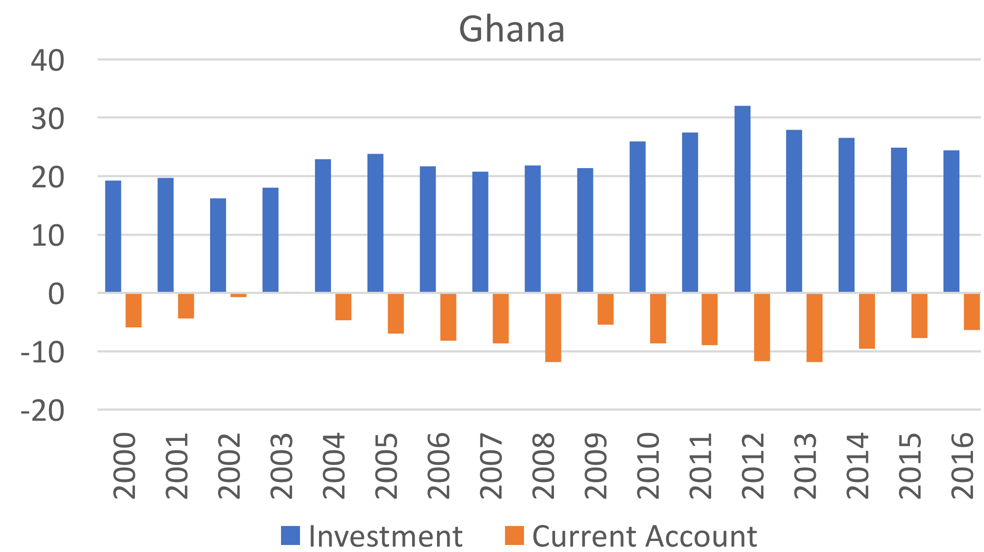
Source: IMF (2014) Managing Volatile Capital Flows.

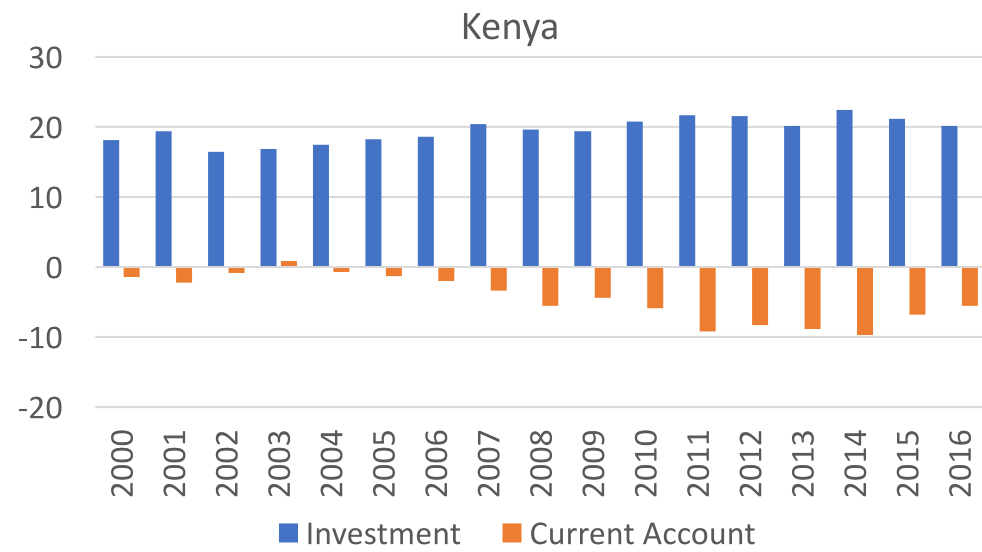
- Most flows take the form of FDI and it is good, it has a direct effect on investment, but this should not crowd out domestic efforts. It should add to domestic investment
- However, FDI flows may also generate macroeconomic tensions.

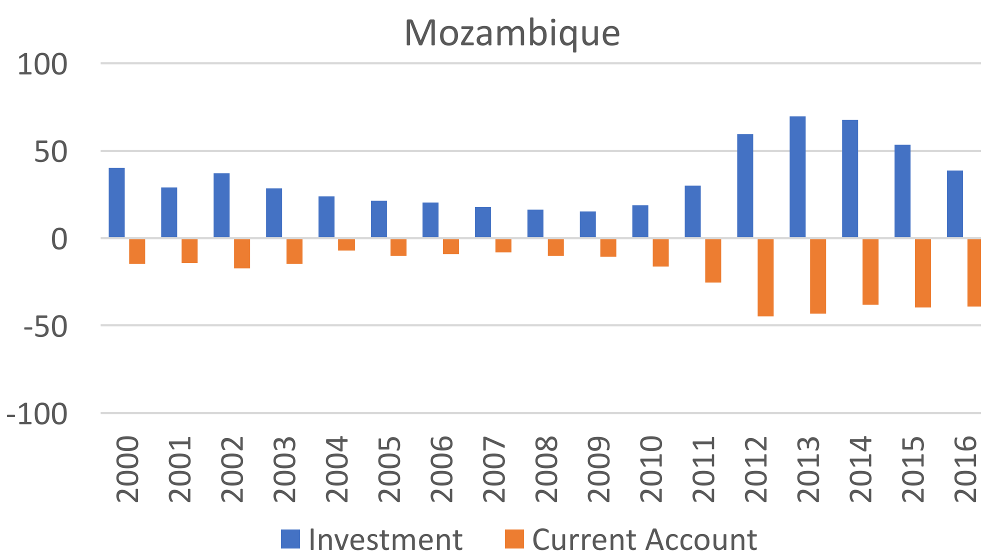
Sub-Saharan African Frontier Markets: Average Private Flows
(Average percent of GDP)

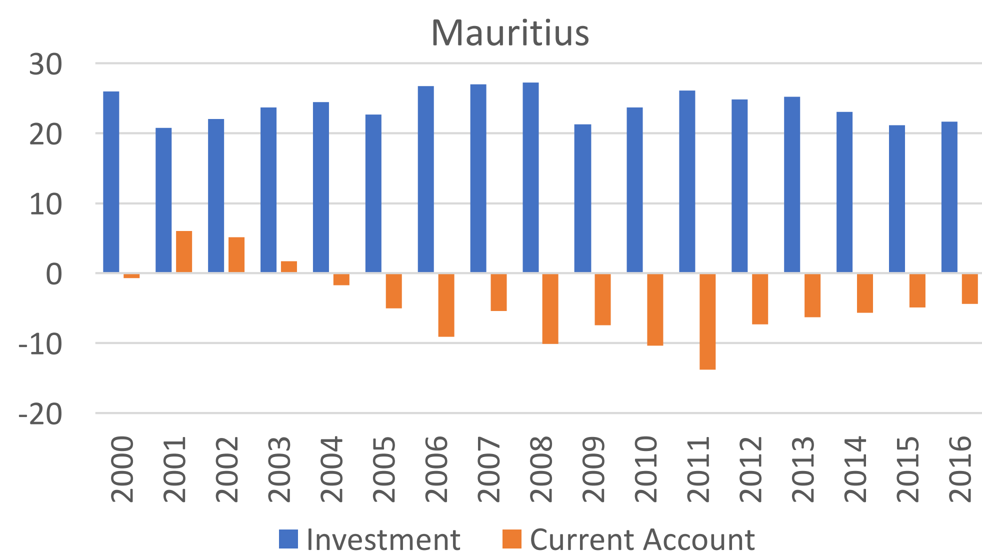
	2000-07			2010-12		
	Total Inflows (% GDP)	FDI (% GDP)	FDI/ Total Inflows (%)	Total Inflows (% GDP)	FDI (% GDP)	FDI/ Total Inflows (%)
Ghana	-3.1	1.4	**--**	7.3	8.1	**111**
Kenya	1.9	1.2	**63**	8.2	2.3	**28**
Mauritius	2.0	1.4	**70**	10.7	2.4	**22**
Mozambique	8.2	4.8	**59**	23.8	23.8	**100**
Nigeria	1.1	4.0	**364**	-2.5	2.5	**--**
Senegal	4.3	1.2	**28**	3.0	2.0	**67**
Tanzania	4.7	3.9	**83**	6.9	5.3	**77**
Uganda	4.1	3.9	**95**	7.2	5.4	**75**
Zambia	9.9	6.4	**65**	2.2	4.4	**200**
SSA-FM	2.0	3.2	**160**	2.2	4.2	**191**
Other EME	2.0	2.2	**110**	2.1	1.9	**90**

Source: IMF (2014) Managing Volatile Capital Flows.

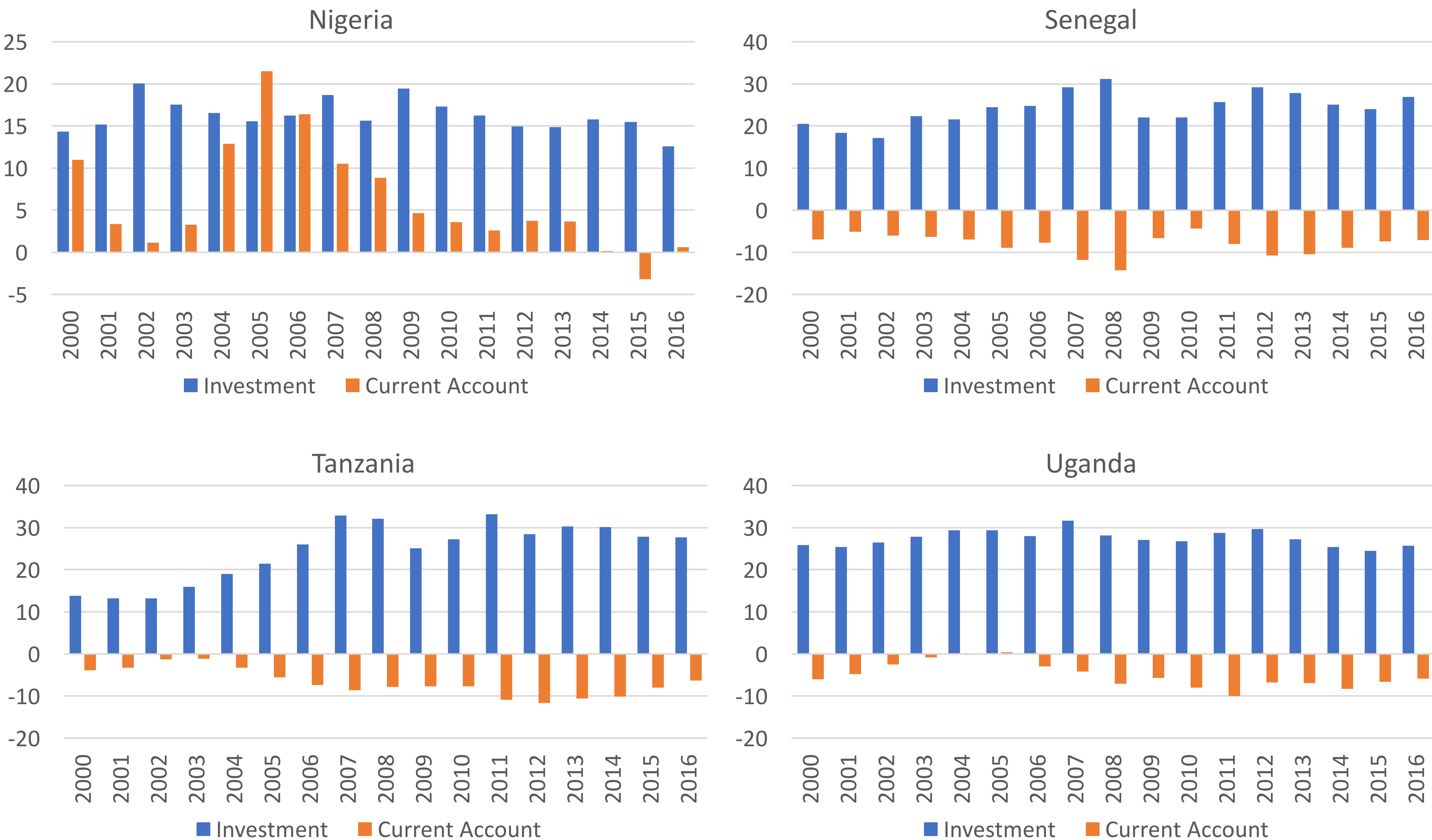








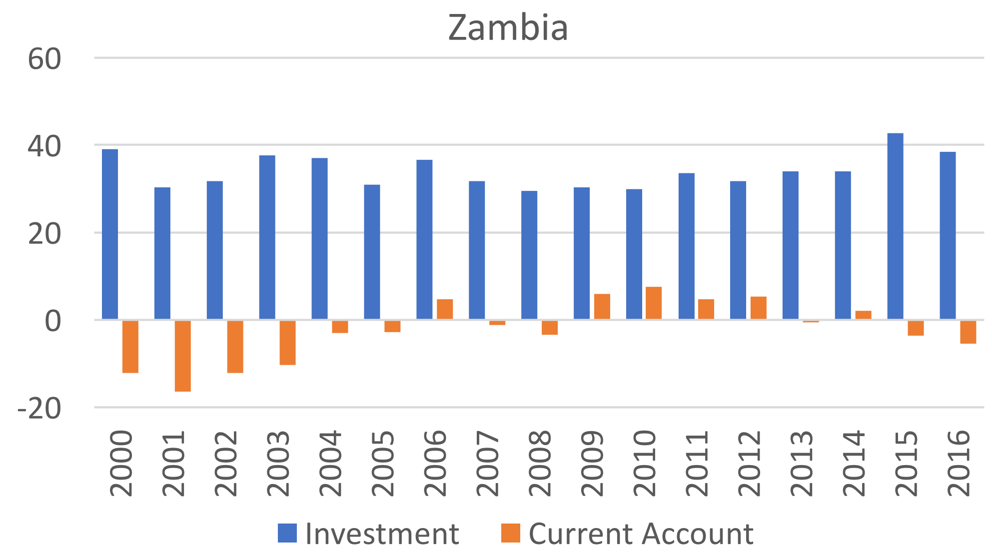
Source: IMF-WEO April 2017. All figures are percent of GDP.



Source: IMF-WEO April 2017. All figures are percent of GDP.

Current account:

- Some countries have large deficits, with consequent large capital inflows
- What are these flows financing?
  - Investment?
  - Government spending?
  - Consumption



- We see in some countries that indeed widening deficits have coincided with investment surges: Ghana, Mozambique, Senegal, Tanzania, Zambia (recently).

- But also the widening of the current account may be compensating for term of trade decline, most notably Nigeria.

- It is important to monitor these developments to avoid costly reversals.

II. Why we worry about capital controls?

- Inflows: they may induce credit booms, overheating and "excessive" exchange rate appreciation (Dutch disease and loss of competitiveness).

- Outflows: *It is not speed that kills, but sudden stops*. Reversal of capital flows may generate serious imbalances, recessions and potential for financial crisis.

- Beyond the problems with inflows, moderating them also reduces the likelihood of sudden stops.

- However, not all inflows are the same in terms of volatility. From more to less stable:
  - FDI
  - Portfolio flows (bonds and equity)
  - Bank flows

II. Why we worry about capital controls?

However we have to be careful in the problems and the sources:

- Gross flows: financial stability – vulnerabilities. The type of flows matters. Financial stability requires financial regulation. Problems of currency mismatches and excessive reliance of banks on short term foreign debt.

- Net flows: macroeconomic stability (PS-IT) and mainly the exchange rate. The exchange rate depends on the current account balance and, hence, on net flows.

III. What to do?

- First of all capital account opening has to be done in the context of strong financial regulatory framework, specially in the banking sector. It has to be gradual and partial: walls versus gates.

- What is the purpose: Financial stability or exchange rate, or both.

- Policies (Ghosh et al., 2017, IMF/WP/17/69):
  1. Tightening macroprudential regulation.
  2. Intervening in the foreign exchange market (reserves accumulation).
  3. Deploying capital controls.
  4. Tightening monetary policy.

III. What to do?

1. Tightening macroprudential regulation: the main concern should be to avoid credit booms. Crisis could come from mortgages or corporate sector (See Dell'Ariccia et al., 2016, Economic Policy).
   - Reserve requirements.
   - Limits to credit growth.
   - Limits to debt to income ratios.
   - Dynamic provisioning.

2. Reserves accumulation. It may stem currency appreciation and it is a buffer for times of capital outflows and sudden stops. It is costly to hold them. Reserves accumulation can fulfill two objectives: self-insurance against volatile capital flows and limit the appreciation at times of large inflows. But its effects are limited:
   - They may induce additional capital inflows: not full offsetting.
   - The exchange rate effects are limited, specially when thy are sterilized.

3. Capital controls

- Many reasons to justify capital controls. Avoid appreciation of the exchange rate and affect volume and composition of flows.
- But, empirical evidence on effectiveness is elusive: small effects if any at all.
- For macro purposes (exchange rate) all flows should be controlled, “good” and “bad.” But good flows promote growth and increase welfare (FDI). Leaving some “uncontrolled” flows could change composition to those unrgeulated without effects on total flows. For example if there are incentives for carry trade, foreign investors can park their cash in the economy by overestimating their financial needs.
- Most emerging markets weathered the financial crisis successfully, with unprecedented performance and use of appropriate macro policies (Alvarez and De Gregorio, 2014 IMF Economic Review). No example of a single country that succeeded because it had capital controls.

4. Monetary Policy

- In periods of large capital inflows, monetary policy may face serious trade off: Tightening monetary policy may be needed to limit overheating.

- However it may also increase incentives for carry trade inducing more capital inflows. Indeed the most likely outcome with be an appreciation and increase in inflows (Direct implication of Mundell-Fleming).

- If investment and consumption depend on inflows because of some credit constraint, monetary policy tightening could be expansionary. In summary it may be expansionary and increase inflows: contrary to the original purpose.

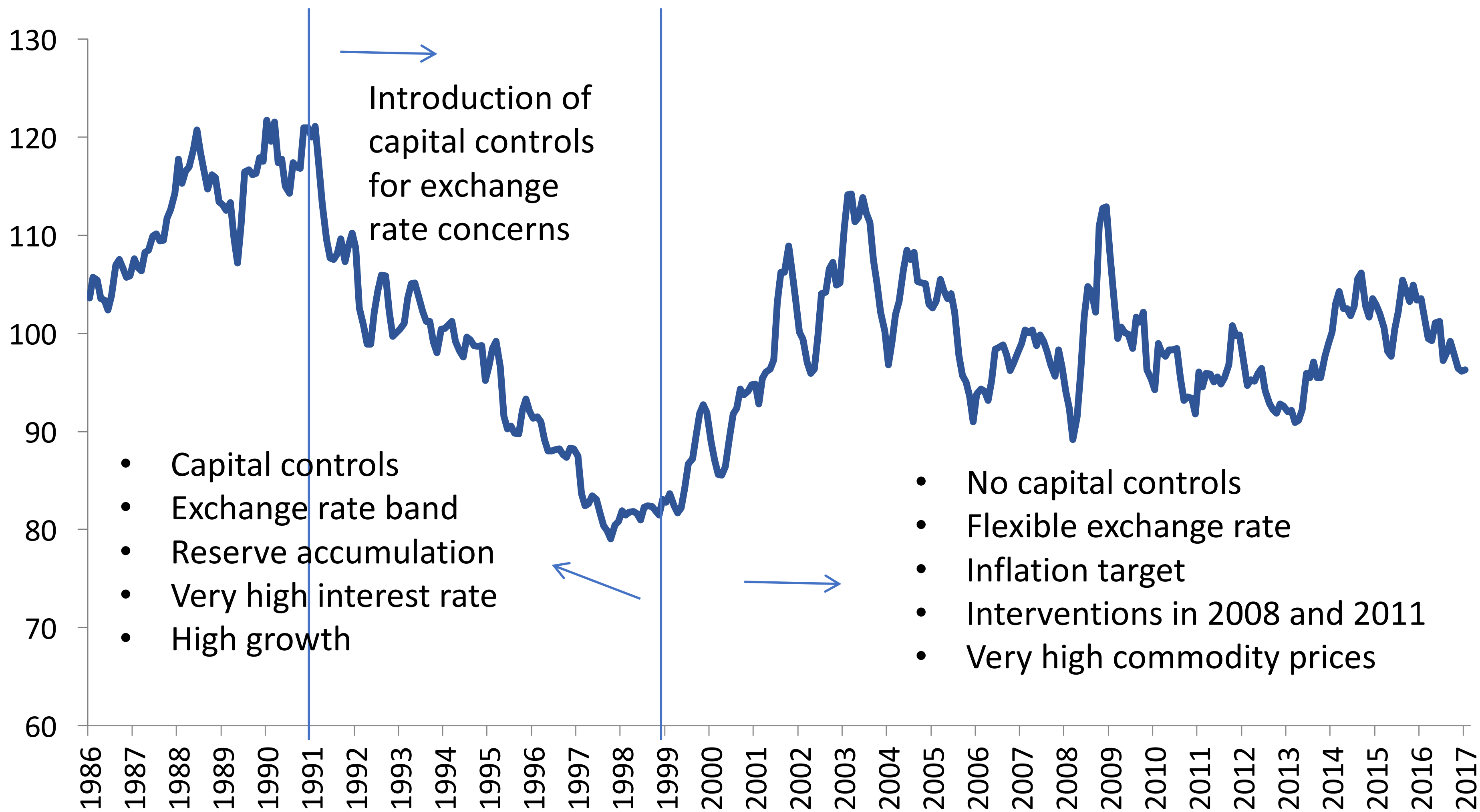
- The points made above are relevant as interest rate differentials are high (on this more below).

IV. On the Chilean Experience

- Support from fiscal policy is desirable. It may help to contain overheating without inducing capital inflows. Fiscal policy needs cannot an additional source of inflows.

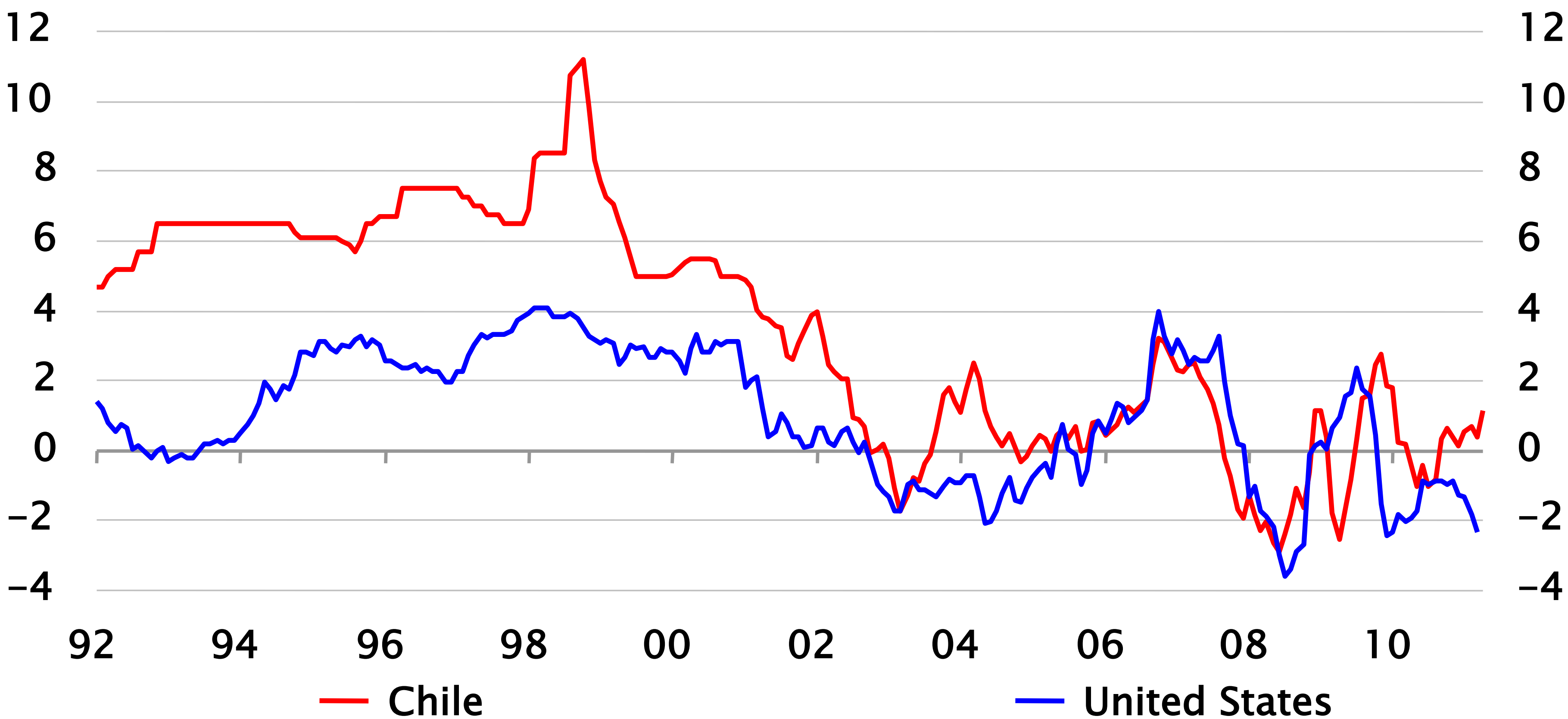
- Flexible exchange rate important. Carry trade is exacerbated with exchange rate rigidities.

Chile: Real Exchange Rate (1986-2016=100)



Source: Banco Central de Chile.

Chile: Real Monetary Policy Rates



(*) Estimation of the of the real MPR, calculated as the nominal MPR minus CPI inflation for the U.S from January 1992 to February 2011. CBC used a real MPR up to August 2001. From that date onwards the real rate is calculated as the nominal MPR minus CPI inflation. For the U.S. figure for March 2011 based on Bloomberg median consensus market survey. For Chile, figure for April 2011 shows the CPI estimated in April's Economic Expectations Survey. Sources: Central Bank of Chile and Bloomberg.