Managing Capital Flows in Emerging Markets

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Capital will keep flowing to Emerging Markets in the foreseeable future

Emerging markets are perceived as less risky because of:

1. Their growth prospects are good.
2. They have run current account surpluses and accumulated substantial stocks of foreign exchange (FX) reserves.
3. They use more flexible exchange rate regimes than in the past.
4. The IMF has increased its financial resources and made its programs more flexible.

Do these external conditions pose threats for South America?

- Current account deficits (CAD) are widening in most countries and they are likely to persist.
- In the past, persistent CAD preceded external and financial crises with high real costs.
- But the composition of CAD has changed: now the bulk is explained by the dividends of FDI. CAD is financed with FDI inflows, with a high proportion of retained utilities.
- As a result, the threat of external and financial crises is currently low.

Should we be concerned about capital inflows to Latin America?

- YES!
- First, even if in current conditions crises are unlikely, they can occur. In face of uncertainty, governments need to be cautious and avoid excessive capital inflows.
- Second and most importantly, because current capital inflows are leading to excessive real exchange rate appreciation and Dutch Disease.

Why we need to be concerned about Dutch Disease

- In practice, it is very difficult to distinguish between an "equilibrium" appreciation and a transitory appreciation (or misalignment).
- A transitory real exchange rate (RER) appreciation can have long-lasting effects on the industrial sector in the form of a permanent destruction of physical, organizational and human capital.
- These effects are largely irreversible.
- Evidence overwhelmingly shows that RER overvaluation hurts long-run growth.
- Thus, governments in Latin America need to be cautious about current RER appreciation pressures.

We know very little about "equilibrium" real exchange rates

- On the theoretical front, disagreement prevails: there are several models of RER determination and concepts of equilibrium RER.
- On the empirical side, different econometric models reach a similar result: the estimated equilibrium RERs move around a time-trend of the observed RER series. Misalignments are movements away from these time-trends.
- Given our little knowledge, to assess the threat of Dutch Disease we need additional information to the rough estimations of equilibrium RERs.

Governments should act quickly to prevent Dutch Disease

- In practice, it is difficult to assess whether there are symptoms of Dutch Disease.
- In the short-run, a RER appreciation is typically expansive and thus politically appealing.
- However, aggregate demand gradually starts shifting away from domestic production and tradable firms substituting labor and domestic inputs for imported capital and intermediate goods.
- The resulting contraction of employment and closure of firms -typically SMEs- take time to be visible.
- Given that these effects are largely irreversible, it is essential that governments act in anticipation of their manifestation.

Governments need to use all their instruments simultaneously and coordinately

- Given the large magnitude of capital inflows compared to domestic financial markets, sterilized FX interventions are limited.
- Similarly, governments may have little space to use fiscal policy to influence the behavior of the exchange rate.
- Capital controls are not completely effective.
- Thus, using all these policies coordinately is essential.
- Central banks can effectively intervene in the FX market, making clear their will to manage the trend of the exchange rate.