Introduction – Challenges related to capital flows: Latin American perspectives

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Abstract

This *BIS Paper* (No. 68) is a collection of essays focusing on the drivers and effects of capital flows and the challenges they pose for the implementation of monetary and other policies. The collection draws on selected presentations made at the BIS-sponsored sessions at the Latin American and Caribbean Economic Association (LACEA) meetings in 2010 in Medellín, Colombia and in 2011 in Santiago, Chile.[2]

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JEL classification: E52, E58, F31, F32, F41, G28

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2 The previous collection is BIS Paper 51, Perspectives on inflation targeting, financial stability and the global crisis.

Capital flows and other external shocks pose important challenges for Latin America. Some of these challenges were discussed at two BIS-sponsored panels at the November 2010 and November 2011 meetings of the Latin American and Caribbean Economic Association (LACEA). This volume compiles a number of papers based on the presentations made by Jose Darío Uribe, Governor, Bank of the Republic (Colombia); José De Gregorio, then Governor, Central Bank of Chile; José Sidaoui, Deputy Governor, Bank of Mexico; Ramon Moreno, BIS; and Charles Engel, Professor of Economics at the University of Wisconsin. Uribe's presentation was made at the LACEA meetings in Medellín, Colombia in 2010, and the remaining presentations were made in Santiago, Chile in 2011.

To put the papers in context, this introduction highlights the distinct cycles in capital flows as revealed by capital flows and costs of financing, and concerns that may arise. A discussion of policy responses follows.

Capital flows

Capital flows play a large role in policy setting in Latin America and other emerging market economies, and are a key source of vulnerability. A key issue is their volatility: Graph 1 shows that following a period of inflows, bank and portfolio inflows to Latin America reversed late in 2008, recovered in 2009, and then declined or reversed sharply in late 2011, with another round of recovery and reversal in the first part of 2012. Capital flows are more volatile than economic activity, which has broadly recovered in advanced and emerging economies since around mid-2009.

The capital flow volatility and related volatility in the cost and availability of financing raise several concerns.[3] One is that capital flows could finance *unsustainable spending* – as reflected in large current account deficits – during periods of expansion, resulting in much sharper downturns. Another is that they could contribute to domestic financial imbalances (excessive credit growth and risk-taking, currency and maturity mismatches and asset price bubbles) that amplify the boom and bust cycle and impose much larger costs should capital inflows suddenly reverse.[4] In Latin America these concerns were mitigated over the past decade because current account surpluses were maintained and financial imbalances such as currency mismatches or maturity mismatches were reduced. In line with this, Latin American economies have displayed a great deal of resilience in response to external financial stress.

3 After 2007, external costs of financing faced by Latin American countries and other EMEs remained low for extended periods and then rose sharply during episodes of financial stress. In spite of the greater attractiveness of Latin American assets since the outbreak of the global financial crisis, cycles in capital flow and external financing costs have recurred because of changes in global investor risk aversion reflecting continued fragility in the financial systems of some advanced market economies.

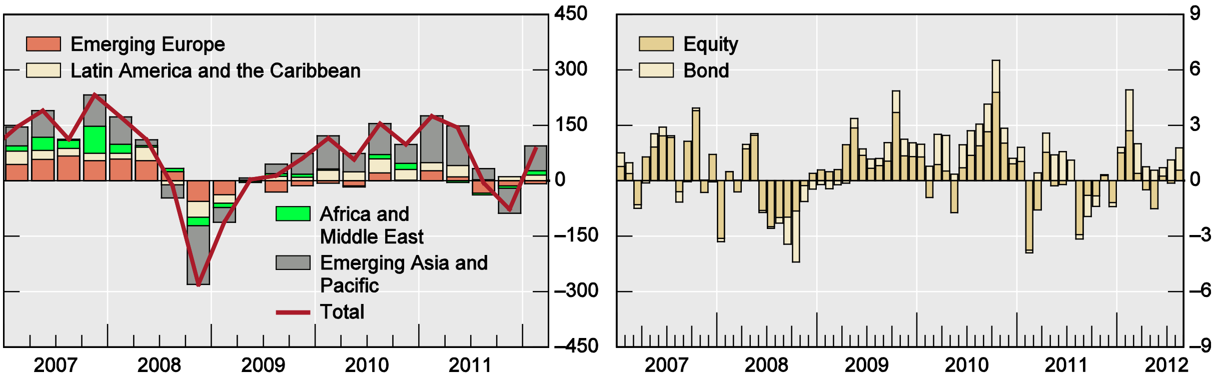
4 See related discussions in this volume by De Gregorio and Uribe.

Graph 1

International bank lending and fund flows into emerging market portfolio funds

In billions of US dollars

Changes in cross-border lending by BIS reporting banks[1] | Flows to Latin American funds[2]



[1] Estimated exchange rate-adjusted changes. [2] Monthly sums of weekly data up to 3 September 2012. Sum of flows across Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Data cover all net portfolio flows (adjusted for exchange rate changes) of equity and bond funds to individual emerging market countries and to emerging market funds for which country, or at least regional, decomposition is available.

Sources: EPFR; BIS locational banking statistics by residence.

Dealing with capital flows

Contributors to this volume note that policymakers should respond to capital flows only if they reflect distortions or externalities, but not if they reflect fundamentals.[5] For example, capital inflows and exchange rate appreciation resulting from improvements in the terms of trade should be allowed, but policymakers should take steps to dampen such flows or mitigate their effects if they are associated with aggregate demand or real exchange rate externalities, if they amplify domestic boom and bust cycles because of bubbles or excessive risk-taking by financial institutions, if they reflect carry trades resulting from policy distortions originating from abroad, or if they are associated with currency misalignment.[6]

The contributions give insights into issues that arise in the use of instruments in response to capital flows, including: (i) foreign exchange market intervention; (ii) monetary policy and financial regulation for financial stability; and (iii) capital controls.

Foreign exchange market intervention. Although the central banks contributing to this volume maintain inflation targeting regimes with flexible exchange rates, they all have intervened in foreign exchange markets to dampen exchange rate volatility (but not to target the exchange rate level) or to accumulate foreign reserves during periods of capital inflows that can be deployed in times of financial stress or capital inflow reversal. Since the goal is to prevent panics or bankruptcies during episodes of financial stress, foreign reserves (and other foreign currency resources) should be large enough to reassure investors that foreign currency

5 See contributions by De Gregorio and Sidaoui.

6 Engel's contribution to this collection discusses distortions and currency misalignment as possible reasons for capital controls.

obligations can be met.[7] Still another issue is to what extent there could be greater reliance on financial markets to hedge risks. On the one hand, the existence of well developed markets for hedging foreign currency risk probably explains why there traditionally has been much less reliance on foreign reserves in advanced financial markets. At the same time, problems with the use of derivatives did arise in two Latin American countries, and further development of financial markets could possibly help deal with these types of problems. A final issue is how foreign exchange market intervention is to be reconciled with monetary policy. With an open capital account, dilemmas inevitably arise. For example, in his contribution Sidaoui notes that because of high inflation, there was no leeway to lower interest rates in Mexico to reduce incentives for carry trades. Given that it has maintained an open capital account, Mexico then relies on intervention to ensure orderly exchange rate adjustment and to accumulate foreign reserves to enhance resilience. This illustrates the practical issues that arise in dealing with the well known “impossible trinity” or policy trilemma, which states that a country cannot simultaneously maintain an open capital account, target the exchange rate and maintain domestic monetary control (see my contribution to this volume).

Monetary policy and financial regulation for financial stability.[8] Since the outbreak of the global financial crisis, a consensus seems to have emerged that relying on a single policy instrument (such as the interest rate) is not enough because monetary authorities should be concerned with financial stability as well as monetary stability. A combination of policy tools is needed. The papers in this volume offer insights on what this means in practice. At least one contributor (Uribe) sees a need to take financial stability into account in the design and implementation of monetary policy. This includes lengthening the policy horizon beyond one to two years to take financial stability considerations into account, to consider the impact of policy on credit and asset prices while targeting inflation. Conflicts may arise between monetary and financial stability goals that can be reconciled through appropriate communications. In addition, financial regulation may be used, allowing policymakers to target specific areas where systemic risks are particularly large. The potential toolkit is large, including macroprudential and microprudential regulation, supervision and monitoring, and analysis to identify and deal with financial imbalances. Regulations may seek to limit currency or maturity mismatches, the use of derivatives, excessive credit growth, leverage and asset price bubbles. However, the role and weights to be assigned to various instruments and their relative costs and benefits remain unclear because the effects and transmission mechanisms of many supplementary policy instruments are not fully understood.

Capital controls. The dilemma cited above between setting monetary policy and stabilising the exchange rate can be reconciled by imposing capital controls. In his contribution, Charles Engel cites the theoretical arguments for capital controls and related empirical evidence. However, there are a number of issues, particularly in more developed and integrated financial systems. One is that controls on inflows may be of limited effectiveness, in part because they will not prevent domestic residents from repatriating funds held abroad (see also the discussion by De Gregorio). Another is that capital controls may be counterproductive because they send mixed signals (discouraging capital inflows in the short run even if more foreign financing is desired over the medium term) and because the presence of foreign investors has in many cases improved financial infrastructure and access to financing (see eg Sidaoui).

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7 However, there were differing views on the role of supplementary resources such as the IMF Flexible Credit Line (FCL). See contributions by De Gregorio and Sidaoui.

8 Both Sidaoui and Uribe highlight the need for more than one instrument, while De Gregorio cites the role of financial regulation in improving financial sector resilience in Chile. Uribe also describes the rationale for the use in Colombia of marginal reserve requirements, foreign exchange regulation or capital controls, limits on foreign exchange maturity and currency mismatches of financial intermediaries, and foreign exchange market intervention.