Living with capital inflows

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Thank you very much. It is a pleasure to make my first presentation at this LACEA conference since we held it in Chile 12 years ago. It is also a bit ironic that the issue that seems to be relevant can change due to implementation lags. When we started discussing this panel with the BIS in June 2011 the main concern was with how to deal with capital inflows. But of course after August, and given all the surprises we have had from the Eurozone's risk escalation, it does not seem like this is the most pressing issue for policymaking in emerging markets today. We also do not know how or when the crisis in the Eurozone will end. The return to normalcy will probably come soon, but it may take a year, or a couple of years. Nevertheless, capital inflows remain a challenge because when normal times do return, such inflows to emerging markets should resume, because emerging markets are much stronger economies and offer better returns. It is as simple as that.

That capital should flow to emerging markets has a number of implications. It has implications for the business cycle, which it can amplify. It has implications for exchange rates, raising concerns about "Dutch disease" and the possible implications for financial stability. In the remaining time I have available, I will offer a perspective on capital inflows. Then I will talk about policy tools and challenges, and end with some concluding remarks.

Capital inflows resumed in the second half of 2010. The reason was that the global economy was recovering from the Great Recession and so there were a lot of investment opportunities in emerging markets. Investment in stocks and fixed income by mutual funds recovered significantly, and figures on capital inflows to emerging markets went up very sharply starting in the second half of 2010. This also had some price effects, such as exchange rate appreciation and increases in stock-market prices.

So the first question is what caused these inflows? They were in large part caused by interest rate differentials, as the gap between monetary policy interest rates in emerging market economies (EMEs) and advanced economies was about five percentage points. And this was very natural because we were in very different cyclical positions. Advanced economies are still striving to recover from the Great Recession and have eased monetary policy. In contrast, the emerging market recovery has been much stronger, and in order to keep this recovery sustainable authorities have had to tighten monetary policy and to control inflationary pressures. So the interest rate differential widened and attracted capital inflows to emerging markets, but I want insist, there was nothing abnormal from the historical perspective.

Growth prospects were also much better in EMEs, and we have seen advanced economies not growing, not closing the gap with emerging markets. So there were differential returns favouring emerging markets.

However, an important issue that has implications for policymaking is how capital inflows are absorbed. The answer seems to be different today than in the past.

Our understanding of capital inflows advanced a lot in the mid-1990s following a famous paper by Calvo, Leiderman and Reinhart on the surge of capital inflows in EMEs and the

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[1] This note draws on remarks prepared for the BIS-sponsored high-level panel "Responding to capital flows: what have we learned?" at the LACEA meetings in Santiago, Chile in November 2011. At the time, José De Gregorio was Governor, Central Bank of Chile.

potential for sudden stops.[2] But if we look at the data from that time, capital inflows were financing increasing current account deficits. In the case of Chile, we had a current account deficit close to five per cent of GDP, close to the average in Latin American countries. Asian countries had also accumulated large current account deficits before the Asian crisis of the second half of the 1990s. But the situation over the past decade was very different, because while there were a lot of gross inflows there were also large gross outflows. On average, EMEs have had current account surpluses, so capital inflows were not financing unsustainable expenditure growth, but resulted in portfolio diversification. In some economies this occurred via foreign reserve accumulation, and in others through private sector investment abroad. Many governments invested in sovereign wealth funds.

These differences have been observed in Chile. In Chile in the early 1990s, we had large gross and net inflows, and a current account deficit of nearly five per cent of GDP in some years. More recently, we have had a current account surplus. Most inflows were domestic corporations borrowing abroad, taking advantage of very low interest rates, so it was not the same story. We suffered one thing that all the emerging markets have been experiencing, an exchange rate appreciation, but in our case it was not the result of capital coming in, but rather was much more related to a strong economy with very strong terms of trade, in which case the natural thing is to expect an appreciation.

We may worry about appreciation, but we also have to be very careful in the diagnosis, because if the cause was not capital inflows, the appropriate solution to achieve a reversion in the exchange rate would not be found by looking at the capital account.

Challenges and policy implications

It is difficult to try to separate policies to deal with capital inflows, but we must consider at least two dimensions. One is that of the impact of capital inflows on the business cycle; we know from experience that our economy can become addicted to capital inflows, and if for some external reason there is a sudden stop (in such inflows), we suffer a very costly crisis. The lesson is that we have to be very careful on the upturn. However, the issue is not necessarily, as they say, a sudden stop, but that the inflows might be financing unsustainable expansion.

If capital inflows lead to an economy that is extremely overheated, we may end up with a sharp downturn. Headwinds in financial markets may deepen the downturn, so the sudden stop may be seen as an amplification of the business cycle. Thus, appropriate policy responses to the impact of capital inflows on the business cycle have much more to do with countercyclical policies – that is, with fiscal policies and policies related to the exchange rate and inflation – than with the financial system.

The other dimension is financial stability. Capital inflows create vulnerabilities such as excessive credit growth – I will not define “excessive”, because it is very debatable – vulnerabilities in the financial system, currency mismatches, excessive dependence of the financial system on foreign financing, and potentially asset price bubbles. All these concerns regarding financial stability represent an important mandate for central banks.

[2] See G A Calvo, L Leiderman and C M Reinhart, “Inflows of capital to developing countries in the 1990s”, *Journal of Economic Perspectives*, vol 10, no 2, pp 123–39, spring 1996, and G A Calvo, L Leiderman and C M Reinhart, “Capital inflows and real exchange rate appreciation in Latin America: the role of external factors”, *IMF Staff Papers*, vol 40, no 1, pp 108–51, March 1993.

What are the appropriate tools?

If the concern is with unsustainable macroeconomic conditions, we have to use our traditional macroeconomic tools. The first tool and the first line of defence in response to capital inflows would be exchange rate flexibility. Why? Because we eliminate one-sided bets on our currency that create incentives for capital inflows. And I will focus on exchange rate flexibility because it is extremely important from the policy point of view. Of course, this may not be enough, and I will comment on that.

With exchange rate flexibility, monetary and fiscal policies can help limit the risk of unsustainable macroeconomic conditions. In particular, an inflation targeting regime tends to lean against the wind because as the exchange rate appreciates – because of capital inflows, or, in our case, because of strong terms of trade – there is less pressure on inflation. If the exchange rate appreciation is persistent, it gives room for some monetary easing or less tightening, which in turn reduces the pressure for exchange rate appreciation. Countercyclical fiscal policy also reduces pressures for currency appreciation, higher inflation or higher interest rates.

All this may be insufficient because the exchange rate may be subject to extreme tensions that may lead to a bubble. The traditional problem in emerging markets is that we do not have the typical housing bubble like in advanced economies. What we have in emerging markets are bubbles in all our assets. If an exchange rate bubble leads to appreciation it makes all our asset prices volatile. You can try to fight the appreciation by tightening monetary policy, but this could just create more incentives for carry trades, which would, of course, make thing worse.

In Chile, we are very careful when evaluating the exchange rate because we have to be careful to see whether it is not a bubble. However, you cannot call all deviations from trend misalignments; many times the exchange rate movement is due to market forces. But still you may want to affect the exchange rate, and here you have some tools.

The tool that we have been using in Chile is foreign exchange market intervention. Of course, this is a deviation from a pure float, but there are reasons for doing it. We initiated the last round of intervention at the beginning of 2011. We announced that we wanted to do two things: first, to accumulate reserves, because it is always good to have reserves (I will make some comments on this), and second, to smooth changes in the exchange rate. The exchange rate will appreciate because we are a strong country, but the intervention provides some time for adjustments to take place in the economy.

So, foreign exchange intervention has these dual roles. One role is to provide insurance, because as you accumulate foreign reserves you are better prepared for sudden stops. What is surprising is that we have not seen massive use of reserves during the global crisis because there were no massive sudden stops. This does not mean that reserves are useless, because having enough foreign reserves may serve as a deterrent for sudden stops by making it unprofitable to attack your currency. So, accumulating reserves is useful to protect your economy from financial and boom-bust cycles. Another role of exchange rate intervention is exchange rate stabilisation.

The insurance role explains why the IMF has implemented flexible credit lines (FCL, or the original contingent credit line, which was basically contingent reserves). It is much cheaper than accumulating foreign reserves, and the funds can be drawn down very quickly if needed. But this approach has been unsuccessful. Just four countries have requested the FCL. The reason is that although the FCL is good insurance, it may not dampen exchange rate appreciation. First, you do not intervene anymore, and second, financial markets will think that you have problems, which could increase speculative capital inflows.

Having said that, exchange rate intervention has to be consistent with monetary policy in terms of the inflation targeting regime. This means it has to be exceptional – otherwise you become addicted to intervention. Also, in order to preserve monetary policy stability, it has to be consistent with the inflation target. In particular, you cannot look for a target in the exchange rate because your target is inflation. Also, you want to keep all the monetary independence so intervention has to be sterilised.

Of course, sterilised intervention is not as effective as unsterilised intervention, such as that being implemented by the Swiss National Bank. They just create money to intervene, and this is much more effective than if they sterilised. Sterilised intervention is also more costly, but is consistent with the inflation targeting regime.

Finally – and this is what we have learnt – in order to make intervention more credible and more exceptional we do it in a very mechanical and transparent way. We do not want to fight with the market; we just say that we will do some intervention of a fixed amount on a daily basis.

I have talked about macroeconomic policy and foreign exchange intervention. Let me turn now to the third tool, financial regulation to preserve financial stability. I will focus on currency mismatches. The experience of late 2008 shows that currency mismatches were not severe in most emerging markets because currencies fluctuated a lot and markets and the financial system remained strong. There were some problems in some countries, such as Mexico, Brazil and Korea, because corporations were highly exposed to risks of domestic currency depreciation through foreign exchange derivatives positions. However, you can also include foreign currency risks in provisioning requirements and design rules so the financial system provides funding for hedging currency risks at the corporate level.

In Chile, currency mismatches are limited, in part because of regulations. We have liquidity requirements in different currencies, provisioning policies, and also restrictions on the use of derivatives. Other measures can further limit risks of currency mismatches. For example, in Korea they have imposed capital requirements on foreign debt because they think that the levels of foreign debt in the banking system threaten financial stability.

And then there is the most debatable tool, capital controls, which can also be used if needed. The big issue is whether they are effective. They may be more effective (and this is what experience shows) in economies with low degrees of financial integration. In economies like Chile, however, we could seek to impose capital controls in response to anxiety about foreign investors bringing in money from abroad. But while this might address the capital inflows of foreigners, it would not address the possible repatriation of capital from abroad by local investors For example, in Chile capital controls cannot be applied to pension funds if they want to repatriate their quite sizeable investments abroad.

There is also the issue of how to apply capital controls, and this also depends on the depth of the financial system and how easily foreign investors can find loopholes. In a sense it is a bit cynical or incoherent to, on the one hand, say, “Please come to my country; it is great and we want to grow. Welcome, investors!” and on the other say, “But we have to control them”. This kind of schizophrenia is also bad from the point of view of applying the right policies. For that reason, I think taxation or plain controls on all types of capital movements, without distinction, may be more effective if the purpose of authorities is to reduce capital inflows.

Experience shows that the outcome in different economies did not depend on whether or not they applied capital controls; the soundness of the financial system and the strength of financial policies were much more important. And this is what I would like to focus on in my closing remarks.

Closing remarks

There is a traditional distinction made between push and pull factors of capital inflows. The push factors were things from abroad, such as the foreign interest rate. Pull factors were domestic characteristics.

However, the distinction might not help fully clarify the underlying drivers of capital flows. For example, push factors might include a very weak global economy. And pull factors might be thought to be high real domestic interest rates. However, experience has shown that the pull factors or high interest rates are sometimes the result of policy distortions, such as trying to control or target the currency.

For example, in Chile during the 1990s a high domestic interest rate was associated with attempts to avoid appreciation, or to make appreciation smoother and more gradual. This, however, was a stimulus to capital inflows, because as an investor you would want to get in because of high interest rates and before they give up defending the currency. The weak defence of the currency may gradually create incentives for more capital inflows, for financial vulnerability. The implication for policymaking is that when thinking about capital inflows we should look first at the source of the appreciation, the source of the capital inflows and the coherency of the policy framework to deal with the resulting tensions.

Thank you very much.