Managing Capital Flow Volatility[1]

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Abstract

This note discusses the challenges that emerging markets face in managing capital flow volatility. The note lays out a conceptual framework for evaluating deviations from a first-best world in which capital flows have desirable characteristics, and then categorises the reasons that might explain these deviations.

Keywords: Capital flow volatility, policy spillovers, monetary policy

JEL classification: E5, E6, F4

[1] This note is based on remarks made by the author at the BIS-Bank of Russia High-Level Seminar held in Moscow on 19 July 2013. The remarks are to some extent based on the research summarised in: M Ayhan Kose, Eswar S Prasad, Kenneth Rogoff and Shang-Jin Wei, "Financial globalization: a reappraisal", *IMF Staff Papers* 56(1), 2009, pp 8–62.

[2] Cornell University and Brookings Institution.

In this note, I briefly discuss a framework for confronting the challenges to emerging market policymakers posed by capital flow volatility. The note covers three aspects. First, what capital flows might look like in an ideal frictionless world with well functioning markets, why the existing situation diverges from that scenario, and how to make progress in terms of framing the problems that might enable progress towards solutions.

In principle, from the point of view of theory, capital flow volatility is not a bad thing. In fact, theory tells us that capital flows should be volatile. They should be volatile from the aspect of offsetting domestic business cycle conditions. If an economy is in fact sharing risk with the rest of the world, then it should receive capital inflows when it is performing poorly. When the economy is doing very well, it should not be receiving as many inflows. The problem, of course, is that capital flows are very volatile and they are volatile in exactly the wrong direction. Flows tend to be procyclical rather than countercyclical.

One needs a benchmark to think about two issues – first, how would capital flows look in an ideal world, and second, how to measure excessive rather than conventional volatility. I will consider these issues mainly from the vantage point of policymakers in emerging markets.

An ideal world with capital account openness should have the following features. First, relatively stable capital flows that have the right sort of characteristics. In some of my research, I have argued that while money is important when it comes to capital inflows received by emerging markets, the indirect collateral benefits that come with the money – technological expertise, expertise in corporate governance, the ability to deepen financial markets. – are just as important as the money itself, if not more so.

Second, in an ideal world capital flows would be driven mainly by macroeconomic fundamentals, such as output growth, employment productivity and interest rates. Third, capital flows should cushion domestic business cycle conditions, as referred to earlier. This implies that net inflows should be countercyclical. Fourth, capital flows would be mediated through a relatively well regulated environment, for both domestic and international financial markets. And fifth, from the perspective of emerging markets, there would be relatively well functioning policies in the advanced economies.

Measured against this set of criteria, where do things stand? In fact, there has been some progress. If one examines the nature of capital flows into emerging market economies, over time the characteristics have become much better.

What led many emerging markets into crisis in the 1980s and 1990s, of course, was the fact that a lot of the money coming in was in the form of short-term foreign currency-denominated debt. And debt, as is well known, is not the ideal type of flow, especially when it is of relatively short maturity and denominated in foreign currencies. Not only does it bear a lot of risks, it does not have many of the indirect benefits I referred to earlier.

Over the last decade, there has been a dramatic shift in the external balance sheets of emerging markets. Foreign direct investment now accounts on average for more than 50% of the external liabilities of emerging markets. Adding in portfolio equity raises the share to about 60%. That is a fundamental shift that has not only made capital relatively more stable, but has the right sort of risk-sharing characteristics.

In other words, when an economy is not doing so well from a cyclical perspective, and if the exchange rate depreciates as it should, then direct investors and portfolio investors from abroad share in the losses in addition to the domestic investors. Of course, one should not make too much of this distinction. After all, many emerging markets have also been beset by highly volatile capital inflows in the form of portfolio equity inflows. But still, even those inflows don't make these economies vulnerable to the sort of very painful crisis that emerging markets were subject to in the past due to their previous dependence on debt. So there has been progress on that front as well.

Unfortunately, that's where the progress largely ends. Capital flows to emerging markets still tend to be largely procyclical. Third, if one looks at whether these capital flows have been driven by macroeconomic fundamentals, it seems to be the case that there is a considerable divergence, at least in the short run, between what one might think of as core long-term macro fundamentals and very short-term fundamentals that are still very much driven by market sentiments. These are constantly in flux, difficult to pin down clearly and not easily influenced by shifts in policies.

And of course, with financial market regulation, there has been progress but probably not enough to buffer emerging markets effectively. Additionally, from the point of view of the emerging markets, advanced economy policies have become a source of risk rather than a source of stability in the world economy.

Having set out a benchmark and having characterised the discrepancies between this benchmark and the way things are, one needs to think about policy solutions. But before doing so, it necessary to reflect on what the sources of failures are relative to this benchmark.

I would suggest that there are three types of failures. One is market failures. The second is policy failures. And the third is institutional failures. The distinction among these three types of failures is not as clear as I suggest below, but the coarse typology still has its uses.

Market failures are in a sense the easiest for academic economists, at least, to pin down. These failures can occur, for instance, when there is herding behaviour because of information asymmetries in markets or because of the way incentives are set up for investment managers in financial institutions. Those are issues that we can relatively easily grapple with and where at least we understand what needs to be done, even if it's very difficult to actually implement those changes given the enormous pushback from those who have an interest in maintaining the status quo and not changing regulatory regimes.

Then there is the issue of policy failures. Undisciplined macroeconomic policies and inconsistent or ineffectual financial regulatory policies can heighten the risks associated with volatile capital flows. Here again, the solutions are not difficult to discern, even if they are not straightforward to implement. One can think about specific types of policies, say, financial regulatory policies, which could in fact make capital flows, once they enter an economy, flow to productive uses. Macroprudential requirements are essentially a device for trying to direct capital inflows into the most productive channels and helping domestic investors attain the benefits of risk-sharing through capital outflows that help them diversify their portfolios.

Here again, it is a little harder but one can think about specific policies that improve the benefit-cost trade-off from capital flows. The policy issues are not just about regulatory policies but also about getting macro policies right, about getting financial markets working much better, both by encouraging financial market development and by making sure there is adequate regulatory capacity, and getting fiscal policy right.

The third source of the discrepancies between theory and reality is the crux of the matter. I label this third category as institutional failures, which in turn have two dimensions – domestic and international.

First, on the domestic front, the critical issue is the balance of policies. Most central bankers now face multiple, and indeed expanding, mandates. I view this as a real failure at the institutional level within countries. The problem is that monetary policy has become the be-all and end-all in terms of where policy measures ought to be. In the advanced economies, in particular, a lot needs to be done in the area of fiscal policy and structural policies, but instead the relatively easy crutch of monetary policies is what policymakers are relying on both to prevent financial meltdown and to support growth.

So I view this, in a sense, as an institutional failure. It's not that monetary policy is getting it wrong, but monetary policy is hemmed in by the configuration of other policies. And this requires change at the institutional level, in order to get the mix of policies right.

The second aspect is the institutional framework at the international level. The difficult reality is that, with increasing financial integration, there are going to be spillovers of policy measures from the advanced economies to the emerging markets, and indeed the other way around as well. There is at present no good governance mechanism in place to cope with these spillovers. Asking central banks to take on an additional mandate to look at the spillover effects of their policies seems logical but would make an already complicated life for these institutions even more complicated.

But ultimately there is little choice but to confront these issues, by thinking more formally both about spillover effects and about the governance structure of international institutions, whose legitimacy has to be rebuilt if they are to be effective at helping solve collective action problems related to macroeconomic policies.

The lack of effective global governance has major implications for capital flows. Emerging markets feel that they have to accumulate more reserves, which forces them to buy advanced economy debt as safe assets that provide a layer of protection from volatile capital flows. The reality of the financial crisis in particular, and indeed even before, is that the demand for safe assets for emerging markets has been rising. In the aftermath of the financial crisis, conventional norms of reserve adequacy have gone out of the window. The sense that more reserves are only good despite the costs they entail is creeping more and more into the minds of emerging market policymakers.

At the same time that demand for safe assets is rising, the availability of such assets has declined considerably. It is now clear that not all euro zone bonds are exactly the same in terms of their default risk and other characteristics. Moreover, countries like Japan and Switzerland are in fact demanding safe assets right now rather than supplying them. The private sector demand for safe assets has gone up, perhaps for the right reasons, but this is coming on top of rising sovereign demand. And indeed, a small group of advanced economies have become the major providers of safe assets, the United States, of course, being the prime example. This is not a tenable situation, where the institutional setup in the international arena leaves emerging markets feeling that they don't have any recourse to a safety net other than self-insurance through reserve accumulation.

Solutions such as capital controls can create a buffer in the short term, but ultimately it will be necessary to get a good grasp on the underlying mix between these three types of failures and not try to use one set of policies that may end up misdiagnosing the real problem. When the relevant failures are really domestic policy failures, they need to be confronted as such rather than viewing the problem as being an external one that needs to be dealt with through a mechanism like capital controls. Ultimately, unless the domestic and foreign institutional weaknesses are fixed, both the domestic policy measures as well as measures to improve the functioning of financial markets, while necessary, might end up being futile.