International financial spillovers: policy responses and coordination

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Abstract

The monetary and exchange rate policies of some economically significant countries – especially those whose currencies are accepted as international reserves – have large external effects over the rest of the countries who must take great care in designing their domestic policies to address changes in external conditions. We have seen in recent years that a significant portion of the financial spillovers resulted from the impact on global risk aversion and the evolution of commodity prices – which show a negative correlation with emerging economies (EEs) sovereigns amplifying business cycles.

In spite of having more sensitivity to financial volatility, after the outbreak of the subprime crisis, most (EEs), remained relatively unharmed due the implementation of policies characterized by more flexible exchange rate regimes; commercial surpluses; sound fiscal policies; less dependence on capital flows; more solid financial systems; abundant levels of international reserves; and macroprudential policies to avoid the negative impact of short-term capital flows. That was the case of Argentina that before the 2007´s outburst implemented a policy scheme which included a reserve requirement for short-term financial capital flows, regulations on capital outflows and inflows and a currency-managed float regime aimed at moderating exchange rate volatility and avoiding a leveraging process. It also included an international reserves accumulation precautionary policy, accompanied by an adequate sterilisation of any surplus resulting from monetary issues.

The recent global reversal of short-term capital flows has confirmed once again that even when the appetite for EE risk is a function of both international (push) and domestic (pull) factors, the former have a decisive weight. In fact, there is a strong asymmetry between, on one hand, the spillover effects from monetary policy in major advanced economies and, on the other, the focus strictly on domestic fundamentals. Thus, attributing capital surges and sudden stops in EEs to internal (pull) factors is a view that can be considered at least misleading, especially in the case of short-term flows.

In the current scenario, monetary policy coordination between EEs and advanced economies is essential to avoid the potentially deleterious effects of abrupt changes in short-term flows and the potential side effects of the first stages of tapering and should play a key role in facilitating a timely and smooth exit from expansionary and unconventional monetary policies in order to avoid jeopardising the global economic recovery. Capital flow reversal and greater financial and

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exchange rate volatility could cause a tightening of domestic demand and thereby affect economic activity. A good example of international coordination was seen in 2009 when, in the G20 framework, the IMF issued two rounds of Special Drawing Rights (SDRs), and in the currency swaps agreements signed among trading partners to enhance trade and financial cooperation.

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1. Effects of financial spillovers

The monetary and exchange rate policies of some economically significant countries – especially those whose currencies are accepted as international reserves – have large external effects. Countries experiencing those effects, and who do not issue currency accepted as international reserve, must take great care in designing their domestic policies to address changes in external conditions. This is the case for most emerging economies (EEs), characterised as medium-sized economies generally open to trade and capital flows.

In recent decades, trade openness, and the emergence of certain low-cost manufacturing economies (primarily those of China and Southeast Asia), have had a generally positive transmission effect on prices. By reducing costs, these countries – aided by the buoyancy of international commerce – have helped to lower global industrial prices, regardless of local monetary and fiscal policies. As a consequence, increased international trade has helped to keep inflation low and to boost international capital flows.

The literature relating to financial spillovers, policy responses to them, and the need for international coordination is extensive. The International Monetary Fund (IMF) has pointed out on several occasions that the results of financial spillovers depend significantly on the nature of the policy. Direct purchases of long-term government assets have been the main source of spillovers from the United States and the United Kingdom, while in the euro area, bank intervention mattered.[2] The results also suggest that a significant portion of the spillovers resulted from the impact on global risk aversion and the evolution of commodity prices. By and large, spillovers entailed a rise in equity prices and exchange rates, consistent with the view that they both buoyed domestic activity and involved capital inflows.

In its 2012 *Annual Report*, the BIS stated that:

While prolonged monetary easing probably has only limited potency to rekindle sustained growth in the advanced economies, its global spillover effects may be substantial. Persistently large interest rate differentials … support capital and credit flows to fast-growing emerging market economies and have put upward pressure on their exchange rates. This makes it more difficult for emerging market central banks to pursue their domestic stabilisation objectives. Interest rates have been raised only hesitantly in response to buoyant domestic macroeconomic and financial conditions out of concerns that this would widen interest rate differentials and further boost capital inflows. …

The growing relevance of monetary policy spillovers suggests that central banks need to take better account of the global implications of their actions. In a highly globalised world, a more global monetary policy perspective is also called for to ensure lasting price and financial stability.[3]

[2] See IMF, *2011 Spillover Report* and *2012 Spillover Report*, various issues; and IMF, *Global Financial Stability Report,* April 2013, Chapter 3, "Do central bank policies since the crisis carry risks to financial stability?", pp 93–126. See also Tamim Bayoumi and Andrew Swiston, "Foreign entanglements: estimating the source and size of spillovers across industrial countries", *IMF Working Paper*, no 07/182, 1 July 2007.

[3] See BIS, *82nd Annual Report,* June 2012, pp 45 and 47.

After the outbreak of the subprime crisis, the EEs, especially in Latin America, remained relatively unharmed. This was because of several factors: more robust fundamentals and better commodity prices and terms of trade together with more flexible exchange rate regimes; commercial surpluses; sound fiscal policies; less dependence on capital flows; more solid financial systems; and abundant levels of international reserves. Indeed, a large number of countries have implemented a currency-managed float regime[4] along with a policy of accumulating international reserves. It is said that this combination generates costs associated with the monetary sterilisation process. However, in the absence of an international lender of last resort, it has been proven that these countries correctly chose these policies as insurance against eventualities, since the benefits might outweigh the costs.

In particular, prior to the 2007–10 crisis, Argentina implemented a multifaceted monetary policy scheme. It includes a reserve requirement for short-term financial capital flows, regulations on capital outflows and inflows and a currency-managed float regime aimed at moderating exchange rate volatility. It also includes an international reserves accumulation precautionary policy, accompanied by the sterilisation of any surplus resulting from monetary issues, so that it is compatible with the liquidity needs of the economy.

The accumulation of international reserves acts as insurance when a country is faced with temporary changes in international financial conditions. It promotes macroeconomic stability, which has a number of important advantages – it increases financial independence; raises confidence in the domestic currency; helps to avoid asset bubbles; and, in some EEs, helps to reduce the impact of foreign shocks and the cost of public and private financing. In addition, it reduces sovereign risks and foreign financing costs, making it possible to meet external payments in times of crisis, when such funding is non-existent or prohibitively costly.

The managed float exchange rate regime also helped to mitigate fluctuations not associated with macroeconomic fundamentals. This is important because, in an economy with some level of currency substitution, excessive volatility could severely affect financial stability.

In addition, the introduction of measures to discourage short-term capital inflows and reduce sudden outflows is an alternative way of reducing foreign exchange market volatility in EEs. In order to diminish the negative effects of short-term capital flows and avoid a leveraging process, Argentina since mid-2005 has successfully taken a series of measures tending, directly or indirectly, to regulate and discourage short-term capital flows:

- New financial borrowing or trading in the domestic foreign exchange market, as well as rollovers of residents' nonfinancial private sector and financial sector external liabilities, must be made and kept within the system for at least 365 consecutive days (under the earlier regulation, the term was 180 days). These loans cannot be paid before the maturity date, regardless of the settlement modality and whether or not it involves access to the domestic foreign exchange market.
- In response to the increasing amount of capital inflows, the Central Bank of Argentina established a one-year interest-free deposit equivalent to 30% of

[4] Among advanced economies, Switzerland provides an example of exchange rate intervention.

certain capital inflows (financial sector and nonfinancial private sector financial liabilities).[5] This deposit applies basically to portfolio investments in secondary securities markets and foreign loans allocated to investments in financial assets; it is aimed at reducing part of the yield of local assets in order to discourage short-term financial investments.

Furthermore, the macroprudential measures regulating capital flows significantly limited the external risk of the Argentine economy. They were supported by a number of other policies, such as external debt reduction with the private sector policy and the previously mentioned prudential accumulation of international reserves.

Finally, in reviewing capital flows, it is critical to differentiate foreign direct investment (FDI) from speculative short-term capital flows. The former has a permanent positive effect, leading to more robust economic growth with more solid fundamentals; the latter boosts the economy only in the short term and, moreover, increases asset volatility and weakens the local economy's ability to withstand external shocks. Hence, prudential regulations should be focused on deterring speculative short-term flows without affecting those associated with FDI and import and export financing.

2. Policy responses and coordination

Determining a country's actual economic outlook and the relationship of that outlook to the country's fundamentals is the starting point for assessing the potential effects of their chosen policies.

A key question, especially for EEs and small advanced economies, is the relationship between short-term interest rates and exchange rates. With US monetary conditions becoming less expansionary,[6] keeping the policy rate unchanged could put upward pressure on the exchange rate. Although this may provide some stimulus to the economy, a very sharp depreciation could be unwelcome for reasons of both macroeconomic and financial stability. Large swings in exchange rates could heighten financial risks in the presence of currency and maturity mismatches, especially in EEs. Another constraint that central banks could face is the degree of maturity transformation and, as a consequence, the credit growth that a widening term spread could entail. In highly dollarised economies, this effect is even more heightened.

The ability to decouple is diminished in EEs when financial deregulation is excessive, especially when it coincides with full capital account openness and within a framework of asymmetric financial architecture.

It is precisely the difference between advanced economies and EEs in respect to development and depth of the financial systems in advanced economies that makes EEs highly sensitive to financial volatility. Thus, the recent global reversal of short-

[5] In response to Executive Order no 616/2005, issued by the Ministry of Economy; and Central Bank of Argentina communication no A 4359.

[6] The Federal Reserve has already begun the reduction of its large-scale asset purchase programme.

term capital flows has confirmed once again that even when the appetite for EE risk is a function of both international (push) and domestic (pull) factors, the former have a decisive weight. In fact, there is a strong asymmetry between, on one hand, the spillover effects from monetary policy in major advanced economies and, on the other, the focus strictly on domestic fundamentals. Thus, attributing capital surges and sudden stops in EEs to internal (pull) factors is a view that can be considered at least misleading, especially in the case of short-term flows.

From a medium-term perspective, the consolidation of EE financial instruments as attractive assets during the past decade initially reflected a scenario of decreasing interest rates in international markets and, until 2008, a rising appetite for higher yields. With EEs recording high growth rates, this in turn supported a strong rising trend in commodity prices during the period 2002–08. In fact, a recent working paper by the Central Bank of Argentina describes a growing negative correlation between EE sovereign spreads and commodity prices and shows that it is mainly explained by the international financial framework.[7]

This result poses serious challenges for commodity exporters like Argentina and illustrates the additional dangers created by financial integration in countries with a non-diversified export structure. In these cases, financial and commercial shocks would tend to be positively correlated and amplify business cycles. This is so because, first, during the upside phase of the economic cycle, commodity prices tend to improve markedly and EE sovereign spreads tend to reduce sharply; then, in the downside phase, EE sovereign spreads would probably increase at the precise moment when commodity prices start to fall. However, financial markets have not paid enough attention to the possibility that, under this framework, financial and commercial shocks might be positively correlated, for various reasons. Among these are a better international environment along with a general improvement in EE macroeconomic fundamentals (a strengthened fiscal situation, better debt profiles, increased international reserves); this leads to a perception of lower risks that allows for a sustained increase in EE asset prices.

Rising asset prices were accompanied by increasing capital flows to EEs, led by both FDI and a volatile contribution of portfolio flows. Even though these flows were interrupted at the peak of the international crisis, in 2008–09, they eventually resumed, this time with more dynamic portfolio flows in relative terms. More significantly, portfolio flow dynamics in recent years have shown a higher correlation with push factors, as evidenced by periods of outflows mainly related to episodes of high volatility in international markets.

All these concerns emphasise the fact that unregulated financial openness amplifies financial volatility in EEs. Since variables such as growth rates, employment and GDP sector composition in these countries continue to be more sensitive to financial volatility, it is necessary for them to establish the prudential regulation of cross-border capital flows.

The hint in mid-May 2013 of less US monetary accommodation (tapering of bond purchases) initiated a reversal of capital inflows, which affected mainly some emerging market and advanced economies that were significantly dependent on

[7] See Diego Bastourre, Jorge Carrera and Javier Ibarlucía, "Commodity prices: structural factors, financial markets and non-linear dynamics", Central Bank of Argentina Economic Research Department, *BCRA Paper Series*, no 201050, 2010.

market-based external financing. A scenario of capital flow reversal and greater financial and exchange rate volatility could cause a tightening of domestic demand (reducing current account deficits) and thereby affect economic activity. The impact would be worse for countries with fragile macroeconomic conditions and large current account deficits.

In this scenario, a failure by some major economies to overcome the obstacles to external financing might reduce their domestic demand and the growth rate of the global economy. This effect would be greater now that emerging economies have a greater weight in the global production of goods and services.

Monetary policy coordination between EEs and advanced economies is essential to avoid the potentially deleterious effects of abrupt changes in short-term flows and the potential side effects of the first stages of tapering. However, coordination alone is not enough. It is also important to regulate short-term capital flows with a special focus on avoiding carry trade flows.

When the next round of exit policies are implemented, the resulting interest rate shock will most likely have an asymmetrical effect on EEs, since external positions have a significant impact on borrowing conditions. Also, most EEs have decreased their levels of foreign debt exposure over the past decade, which significantly reduces the potential negative effects of financial shocks. Countries with large current account deficits and low export dynamism might be severely hit by an interest rate shock, but many other EEs, even a majority, might not be so affected. In particular, countries with large stocks of international reserves may not necessarily be as deeply affected by an interest rate shock. Whether they have current account deficits or current account surpluses with low private sector indebtedness in foreign currencies, the large stocks of international reserves will act as a safeguard against interest rate shocks.

From the point of view of EEs, some important progress has been made. Nonetheless, it is still very important to monitor excessive increases in current account deficits, especially when they are the counterpart of short-term financing and are correlated with real exchange rate increases and consumption booms or asset bubbles.

3. Some thoughts for the next couple of years

In the short and medium term, it does not seem highly probable that there will be a sudden reversal in credit flows attributable to an abrupt hike in interest rates. This is because, according to the latest projections, the major advanced economies will not raise their target interest rates at least until early 2015.

International coordination should play a key role in facilitating a timely and smooth exit from expansionary and unconventional monetary policies in order to avoid jeopardising the global economic recovery. Until now, EEs have been instrumental in helping to lead the way out of the crisis, and a disorderly deployment of exit strategies could potentially be harmful to the current level of activity.

A good example of international coordination was seen in 2009 when, in the G20 framework, the IMF issued two rounds of Special Drawing Rights (SDRs) – a general allocation and a special one – for a total of SDR 161.2 billion, equivalent to

$244 billion. The issue and allocation of SDRs emerged as one of the main tools for strengthening the financial capabilities of small and medium-sized economies, supporting their domestic activities and expanding global demand; the result boosted economic growth worldwide. Moreover, the issue and allocation of SDRs is an important mean for liberating reserves from the security nets that EEs have been building, thus freeing assets to finance production, investment and consumption, or to reduce their debt.

This behaviour is also consistent with the IMF's original purpose, namely that of being an international coordinator capable of assisting its members in the event of balance of payments crises. In this regard, to help countries that may be suffering from sudden capital flow reversals, the IMF could consider establishing automatic mechanisms that would help to avoid unnecessary fluctuations in these economies. Such mechanisms could take the form of special direct credit lines, which should not be subject to conditionality.

Another coordination mechanism that has gained importance throughout the world is the use of currency agreements between countries, mainly to promote the trade of goods and services in local currencies. One of the principal instruments of such agreements is currency swaps among trading partners. China has been a key player in promoting such arrangements, not only among its main trade and geographical partners but around the world.

China has recently promoted the use of its currency as a monetary unit in the world's main financial centres, seeking to establish the renminbi on an equal footing with the US dollar, sterling and the yen. But the conditions under which a currency gains international stature still exist. One of those conditions is that the home economy must be large and stable enough to absorb external shocks without affecting the rest of the international financial system. This is a necessary condition to avoid relinquishing the reserve currency requirement in pursuit of domestic goals. During the last international financial crisis, some countries that were issuers of currencies with international stature rapidly abandoned that implicit role in order to address domestic difficulties. In some cases, this had undesirable side effects for the rest of the international financial system. Also, an incomplete and disorderly process of economic and financial integration could be another source of instability for these countries' currencies, diminishing their ability to become widely accepted as reserve currencies and sparking instability in the global economy.