Global Liquidity and Financial Contagion

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The Chairperson of this panel, Dr. Usha Thorat, asked from participants to focus on five key topics. I will concentrate my remarks on one of them: How do emerging markets protect themselves from excessive exchange rate volatility when faced with changes in global liquidity and contagion? I will refer to the other questions, which are very much related to this key issue, as I go along. The stylized fact is that capital flows to emerging markets are largely exogenous. When capital is flying towards emerging markets, it is usually not going to one of them but it is going to be a whole set of them at the same time. In the same fashion, when there are sudden stops in capital inflows, it is often in the context of sudden stops being experienced by several countries at the same time. There is something in the international financial system that broadly accounts for capital inflows and capital outflows from emerging economies.

When interest rates are low in developed markets after the crisis, financial agents "discover" the virtues of emerging economies, where interest rates are normally much higher. In 1990s, it was the Asian miracle and the Latin American liberalizations that allegedly were making Latin America the land of the future. In the 2000s, it was the so-called BRICs and the discovery of Brazil, Russia, India, and China, as the economic powers of the 21st century; now we know that the miracle didn't last very long. Brazil is in deep trouble; Russia, China and India have experienced slowing growth rates.

We can call these co-movements in flows to emerging economies "contagion", if you will. There is contagion in the upside of the capital flow cycle and in the downswing. In addition, as my research shows, excessive capital inflows create fundamental imbalances in the recipient country (appreciated exchange rates, current account deficits, asset price bubbles), which sow the seeds of future sudden stops. This is what we saw in Asia, what we saw in Latin America, and what we are seeing in several countries (including India) right now. When capital flows out of an important country, investors begin to look at other countries that may exhibit the same disequilibria; or it may be that hedge funds and other investors have to sell good assets in order to meet collateral on assets that have gone bad. So there may be several reasons for contagion.

This is something that happens at the level of international financial markets. I found something very interesting: when interest rates in developed countries go down, the spread, the EMBI spread on emerging markets, they all go down at the same time; and when interest rates in financial centers are going up (for example, now we are seeing an uptick in the long rates in the US), then all the EMBI spreads in emerging countries rise at the same time. This is not a matter of one country or another country. My country, Chile, as one of the best pupils of the Washington Consensus, is pretty solid in its economic policies; nonetheless, the spreads on its sovereign debt (as well as the CDS on sovereign debt) are very sensitive to interest rates in international markets. When international interest rates are going up, as they are now owing to the uptick in US long rates, Chilean and other emerging market borrowers are faced with even sharper increases, as their spreads rise in tandem with international rates.

Therefore, central banks need additional tools. One of the questions that Usha asked us was should central banks just worry about inflation targeting or should they need to worry about other things as well. They should obviously keep an eye on the exchange rate, which is extremely important for emerging markets. Exchange rates are much more important than for the US or Europe, simply because, if they are to grow, emerging markets have to produce newer tradables. They have to diversify their tradables. And if the exchange rate is very volatile or if it is appreciating during long periods of time, those new tradables simply will not emerge.

And central banks should also keep an eye for prudential purposes on the leverage of banks. They should keep an eye on domestic asset markets, particularly real estate. In my own country, there is a real estate bubble at this moment, largely because banks were intermediating between international markets and domestic markets. So real estate prices are certainly an important indicator for central banks to watch. Other indicators include stock market prices, and household and corporate indebtedness.

Since the world financial crisis, there has been a lot of interest in macro-prudential regulation. This interest is appropriate, but in emerging markets it should be designed with their characteristics in mind, which are quite different from those of developed markets. As noted below, most of the borrowing of banks from money markets takes the form of capital inflows. Therefore, macro-prudential regulation in emerging economies necessarily takes the form of some kind of prudential capital controls.

Is monetary policy enough? I translate this question the following way: Is central bank intervention in foreign exchange markets enough to stabilize the economy? Exchange-market intervention is clearly a monetary policy tool. Clearly, there is a lot more that can be done. To begin with, emerging markets can adopt exchange rate regimes that are not free floats, and several have tried that. Many have tried different regimes (crawling pegs, crawling bands, dirty floating, pegging to a currency basket) with varying degrees of success. One can understand perfectly well why central bankers prefer to keep things simple, like sticking to inflation targeting by moving the interest rate and forgetting about the exchange rate. However, this does not do their countries a lot of good. When capital inflows and outflows are transitory, the most flexible alternative is dirty floating. However, we never know how transitory "transitory" is. It could last a long time, and I will argue that in fact capital inflows usually come in long waves and retreat in long waves. This is what the data has shown from the 1970s onwards, and when this happens, it is very difficult to do dirty floating. You simply have to buy up too many reserves during the inflow periods, and you may run out of reserves during the outflow period. In fact, that is what I show here. I won't bother you with the numbers (they come from some research I did), but the point of the graph is that net capital inflows as a share of M2 are very large in emerging markets. They can represent between 10% and 25% during periods of inflows and they can fall to between -10% and -25% during periods of outflow. And these periods are normally quite long.

In developed markets, net capital flows as a percentage of M2 are much smaller. So in developed markets, intervention is certainly easier to bring about. In emerging markets net capital flows can be very large relative to the size of their financial markets. I took the M2 metric as representative because I had data for practically all the countries that I was studying. Here you have that capital inflow can be really huge relative to M2 during inflows and it can be huge during outflows as well. Therefore one needs more than monetary policy; i.e., more than exchange-market intervention. It certainly can be used, but it really needs to be supplemented with other policy tools.

When capital inflows are taking place, and they are sustained and large, this can be quite pleasant for a lot of people (except for producers of new tradables). Times are good, demand is expanding, asset prices are rising, and people feel rich. Tax revenues may also be going up. So governments don't feel any particular pressure to do much of anything rather than let the good times roll. However, when capital is flowing out, things can get very messy: the exchange rate is depreciating, unemployment is increasing, asset prices and output are falling. At this point, the government has to do something but it has few policy tools to do it. This is the reason why intervention must take place when times are good and capital is flowing in. This intervention can take the form of foreign exchange purchases by the central bank, but should not exclude other measures.

As I show in another paper, large inflows always precede future sudden stops. Moreover, the longer the period of large inflows, the higher is the probability of a sudden stop. So it is good to have additional tools to moderate inflows. What can be done? Several countries have attempted capital controls. Jose Antonio made a very good summary of these measures yesterday and I won't repeat what he said or what is known about capital controls. My view is that the simpler the measures the better are the chances that they will be successful, and the easier they are to apply. Let's remember that in emerging markets applying measures is not a simple thing. You need very proficient people to do that, and the more complicated the measure, the easier they are to avoid or to evade. I will give you an example from my own country. In Chile, we had an unremunerated reserve requirement on everything but FDI. What happened? Many prospective foreign financial investors disguised their flows as FDI. They set up companies complying with Chilean law and brought in capital to invest short, not to invest in machinery and equipment and create new real assets.

Recently, Shin (2010) has suggested that, in a domestic context, banking crises really arise from the liabilities side: banks finance the creation of assets by borrowing from money markets. During boom periods, the share of such borrowing in total bank liabilities goes up sharply. When this is happening, he suggests that the boom can be moderated by a tax on bank borrowing from the money market. Now for emerging markets, this translates into a tax on borrowings from *foreign* money markets, because domestic money markets are pretty undeveloped. Banks in emerging markets are major participants in the carry trade. When interest rates in the international markets are as low as they have been since the international financial crisis, the temptation to borrow for lending on the domestic market must be very hard to resist, and the potential risks of depreciation are easily underestimated. When you can borrow at, say a rate of 1% or 2%, and lend in Brazil at 10% and 15%, then there is a big incentive to engage in this carry trade, especially because most agents also expect currencies to appreciate rather than depreciate.

The flows themselves will appreciate the currencies of the recipient countries. So agents engaged in the carry trade could easily make a killing both on the interest rates and potential appreciation. Before any crisis emerges, there will be a long period of appreciation. There is also recent evidence that big corporates in emerging markets are increasingly participating in this trade through bond placements. The creditors are no longer banks; they are asset managers. Therefore, the potential problem in the carry trade is really not only bank lending, but also corporate bond placements or borrowing from banks by corporates. The problem of excessive capital inflow may arise not only from short-term borrowing, but also from longer-term borrowing from banks and non-banks.

Banking regulation is particularly important as a capital-account prudential measure. This is part of macro-prudential measures, which are particularly relevant to emerging markets. Asset-liability mismatches in foreign exchange can be extremely dangerous at the moment of a financial crisis. We have seen many companies going bankrupt owing to their foreign-exchange denominated debts, and many domestic banks having to be rescued by the authorities. So asset-liability mismatches in foreign currency are something to watch, particularly an important aspect of prudential banking regulation in emerging markets. Also, mismatches in foreign exchange derivatives that are intermediated by banks may also be extremely important. The increasing use of derivatives to move capital is something of concern and one has to keep an eye on this phenomenon. The Korean Central Bank has required banks to match assets and liabilities on foreign-exchange denominated derivatives.

A word on the current situation. We are witnessing a reversal in capital flows to emerging markets, and this has been accompanied by a change in appetite for assets that are viewed as being riskier, including those of emerging markets. Financial markets have soured on Brazil, Russia, India, and even on China, whose growth has decelerated and nobody knows whether that deceleration will deepen in the near future. Therefore, US long-term interest rates are going up and emerging market spreads are going up at the same time. Thus emerging markets are getting hit twice. Some emerging markets are better equipped than others to deal with the situation. Those with large current account deficits are clearly more vulnerable than those that have more reasonable current account deficits or have surpluses. Countries with large reserves can withstand a period of capital outflow. Again, the problem is that we don't know how long will it be.

These distinctions we love to make as economists between transitory and permanent phenomena, between short-term and long-term, are really quite fictitious because they are very hard to identify. Some countries have accumulated reserves not by running current account surpluses but by the central bank buying up short-term capital inflows. They will certainly experience a combination of real exchange rate depreciation and foreign currency reserve losses. Other countries with large reserves are better equipped to handle capital outflows over a certain period of time. China is a biggest exception among emerging economies. My own country is experiencing capital outflow this moment, again with high reserves and with a fairly resilient policy framework. Some countries have not been sufficiently disciplined during the good times.

When there is a boom, agents tend to catch the "this-time-is-different "syndrome. In other words, people tend to justify why real estate and stock prices are rising and assume that the trend will go on, even when it has reached irrational levels. In my own country, we have been experiencing a boom in real estate prices, which may be abating with the downturn in economic activity. But until recently, banks were willing to provide mortgage financing without any down payment and without asking too many questions about the borrower's creditworthiness.

In good times, the easy availability of cheap credit has allowed governments to incur fiscal deficits and the private sector to borrow in excess, both of which have led to high current account deficits that are financed with the capital inflow surge. Since these surges reverse themselves, in spite of the belief that they never will, there is a day of reckoning. At this point, crisis management is the only thing a government or central bank can do.

To conclude, you prepare for the bad times during the good times. I think that is very important, and part of the policy framework must be an anti-cyclical fiscal policy (or at least an acyclical policy). This helps to cushion the cycle, and a flexible target for the cyclically adjusted balance helps. Again, I refer to my country where we have a target for the cyclically adjusted balance, but during the financial crisis, the Minister of Finance simply went overboard and ran a large nominal and cyclically adjusted deficit (the latter to the tune of 3.5% of GDP, when the target was for cyclically adjusted balance). This was possible because the country had accumulated resources in a sovereign wealth fund during the preceding commodity price and capital inflow boom.

Protecting the exchange rate from appreciation during the upswing with flexible but permanent capital account measures such as those that have been suggested in this meeting is also an important ingredient in the policy toolkit. An additional one is to engage in dirty floating during booms and accumulate additional foreign exchange reserves. Finally, the central bank needs to give some guidance to the market as to where the long-term equilibrium exchange rate is likely to be. There is a proposal by John Williamson to have the central bank announce a band in which it believes the equilibrium rate to be. This band is soft in the sense that the bank may decide to defend it, but it is not committed to do so. Exchange rates tend to overshoot their equilibrium, owing to so-called chartist (i.e., speculative) behavior. Having a band to tell the market where the exchange rate is likely to be is a good idea.

In conclusion, I do believe that, in emerging economies, central banks have a lot more to do than just worrying about inflation even if the exchange rate regime is a formally a floating one.