Policy panel 2: What tools can emerging economies use in an environment of rising rates?

Matthieu Bussière
Director, Monetary and Financial Studies
Banque de France

The Graduate Institue, Geneva

Coping with Spillovers from policy normalization in advanced economies

20 September, 2018

The views expressed in this presentation are those of the author and do not necessarily reflect those of the Banque de France or the Eurosystem

Monetary policy accomodation in AEs can have potentially destabilising effects on EMEs…

Three key questions:

- Are spillover effects large?
- Are they on balance negative?
- What can EMEs do to offset these effects?

➢ Focus on the last one.

The toolkit… (both preventive and curative measures)

- **OHIO**
- **Reserve accumulation**
- **Monetary policy**
- **Capital controls, macroprudential policy**
- **GFSN (RFA, IMF)**

OHIO (Own House In Order) principle, with a focus on fiscal issues

- Insights from Krugman (1979) still true: a country with a fixed exchange rate that monetizes its budget deficit is very likely to experience a currency crisis.
- Sound public finance is a great asset when interest rates increase (avoid fiscal dominance issues)
- Generally, fixed exchange rate arrangements expose countries to speculative attacks, although no consensus here.
- BUT reasonable fiscal policy is not a guarantee (see Obstfeld 1994 Generation II models: there are multiple equilibria for a range of fundamentals). Budget deficit often not a reliable early indicator.

➢ **"OHIO" principle is a necessary, not a sufficient condition.**

Reserve accumulation

- **Reserve ratio's** (to GDP, M2, short-term debt…) are a popular variable in most early warning signals.
  - Bussière & Fratzscher (2006), Bussière, Cheng, Chinn & Lisack (2015)
  - Frankel and Saravelos (2012), Rose and Spiegel (2011) are more critical
- **General perception that more reserves help in times of crisis** → a strong motive for accumulating more reserves
  - No clear benchmark: perpetual accumulation (Machlup problem)
  - There may be negative externalities for other countries (benchmarking)
- **Still, many Type I and Type II errors**
  - The example of Brazil and Mexico during the GFC is confounding.

➢ **Bottom line: it helps, but again not a sufficient condition.**

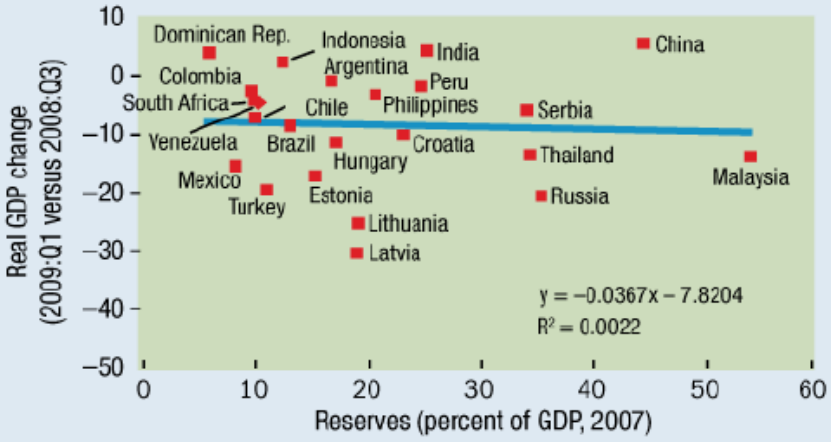
Reserve accumulation: the contrarian view

Chart 2

How much cushion?

Larger reserves did not lead to lower declines in economic activity at the peak of the crisis.

(selected emerging countries, in percent)



Sources: IMF, Global Data Source database and staff estimates.

Chart 3

Market perceptions

As the evolution of credit default swap spreads indicates, markets did not see Mexico as more vulnerable than Brazil despite lower reserves.

Sources: IMF, *World Economic Outlook* database; and Bloomberg L.P.

Monetary policy

- Is monetary policy **independent** in a small open emerging market economy?
- Dilemma's and trilemma's. See Helene Rey's work on the **global financial cycle**. Even with floating exchange rates, monetary policy is constrained (with an open capital account).
- Need for coordination? Mandates are national. Not clear that deviation from Nash equilibrium is an improvement.
- Role of the exchange rate: debate on **currency wars** at the ZLB (Caballero et al 2013 vs Jeanne 2018).
- Recent work on currency and trade wars (Bussière, Bénassy-Quéré and Wibaux 2018).
- BTW spillovers may not be that large (see third IBRN project, summarized in Buch, Bussière, Goldberg and Hills, 2018).

Capital controls, macroprudential measures (CFMs)

- Noticeable evolution of the IMF view on the capital controls (Ostry et al 2010). Further reflections on the issue in G20 and at the OECD.
- See Blanchard 2016: restrictions on capital flows are a more natural instrument for advancing the objectives of both macro and financial stability (than monetary policy coordination).
- Empirical evidence is mixed:
  - Forbes, Fratzscher and Straub (2013): “Capital controls and macroprudential measures: what are they good for?”.
  - Glocker and Towbin (2015): reserve requirements in Brazil. See also Camors and Peydro (2014), Vargas et al. 2011.
  - On bank-level capital requirements: Saurina 2009, Aiyar et al. 2014.
  - On LTV and DTI: Igan and Kang (2012)
  - On spillovers: see second IBRN projects in IJCB special volume, March 2017. Spillovers not that large.

Capital controls, macroprudential measures (CFMs)

- Few studies compare instruments
- Key exception is IMF (2012):
  - For EMEs the most efficient instruments are DTI and LTV
  - For AEs it is capital requirements and reserve requirements

Table 3. Effects of Macroprudential Measures on Credit Growth[1/]

All: 36 Countries	Credit Growth Rate (%, q-o-q)												
Credit Growth Rate (-1)	0.40	0.39	0.40	0.40	0.40	0.39	0.39	0.39	0.40	0.39	0.40	0.39	0.40
GDP Growth Rate	0.23	0.22	0.22	0.23	0.23	0.23	0.22	0.23	0.23	0.21	0.22	0.22	0.22
Interest Rate (-1)	-0.04	-0.04	-0.04	-0.04	-0.04	-0.05	-0.05	-0.05	-0.04	-0.04	-0.04	-0.04	-0.04
Credit Bust						0.88	0.44	0.56	0.48				
Recession										-0.61	-0.53	-0.56	-0.60
Capital Requirement (-1)	-0.51					-0.37				-0.59			
Limits on DTI Ratio (-1)		-0.21					-0.32				-0.22		
Limits on LTV Ratio (-1)			-0.13					-0.18				-0.15	
Reserve Requirements (-1)				-0.32					-0.36				-0.38
CR(-1)*Credit Bust					-1.38								
DTI(-1)*Credit Bust						1.60							
LTV(-1)*Credit Bust							0.16						
RR(-1)*Credit Bust								0.36					
CR(-1)*Recession									0.16				
DTI(-1)*Recession										-0.04			
LTV(-1)*Recession											0.14		
RR(-1)*Recession													0.16

EME: 21 Countries	Credit Growth Rate (%, q-o-q)												
Credit Growth Rate (-1)	0.42	0.42	0.42	0.41	0.41	0.40	0.40	0.39	0.40	0.41	0.41	0.40	0.41
GDP Growth Rate	0.28	0.28	0.26	0.26	0.28	0.24	0.21	0.22	0.24	0.26	0.25	0.24	0.26
Interest Rate (-1)	-0.04	-0.04	-0.04	-0.04	-0.04	-0.05	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04
Credit Bust						1.24	0.49	0.77	0.69				
Recession										-0.97	-0.92	-1.08	-1.12
Capital Requirement (-1)		-0.23				-0.19				-0.34			
Limits on DTI Ratio (-1)			-0.63				-0.80				-0.67		
Limits on LTV Ratio (-1)				-0.79				-0.73				-1.01	
Reserve Requirements (-1)					-0.40				-0.51				-0.51
CR(-1)*Credit Bust						-1.44							
DTI(-1)*Credit Bust							2.69						
LTV(-1)*Credit Bust								0.27					
RR(-1)*Credit Bust									0.21				
CR(-1)*Recession										0.17			
DTI(-1)*Recession											-0.01		
LTV(-1)*Recession												0.68	
RR(-1)*Recession													0.46

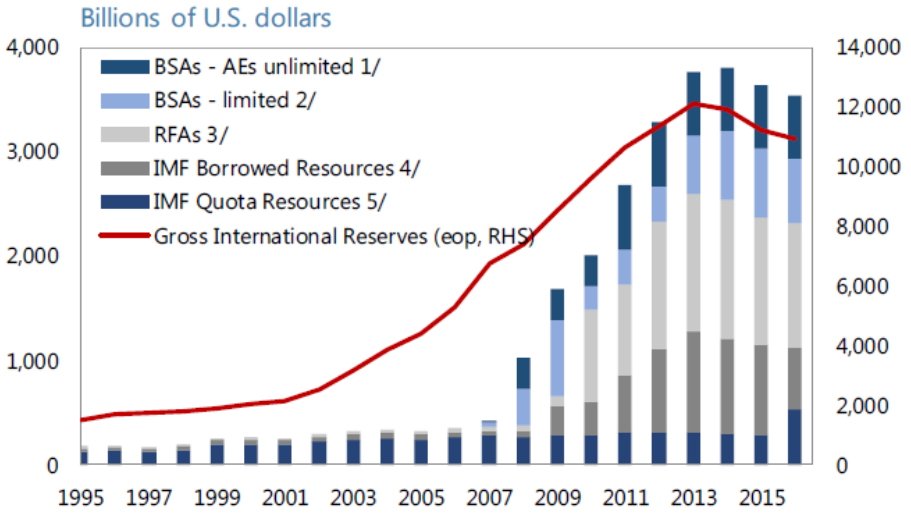
Source: IMF staff estimates.

1/ Green, orange, and yellow color in each cell indicate significance at 1, 5, and 10 percent level, respectively.

Role of RFA's / IMF

- Increasing size of RFA (compared to IMF resources)
- Fig. 1 from IMF Policy Paper, July 2017. Collaboration between regional financing arrangements and the IMF.
- See also ECB Occasional Paper, Strengthening the Global Financial Safety Net, 2018.

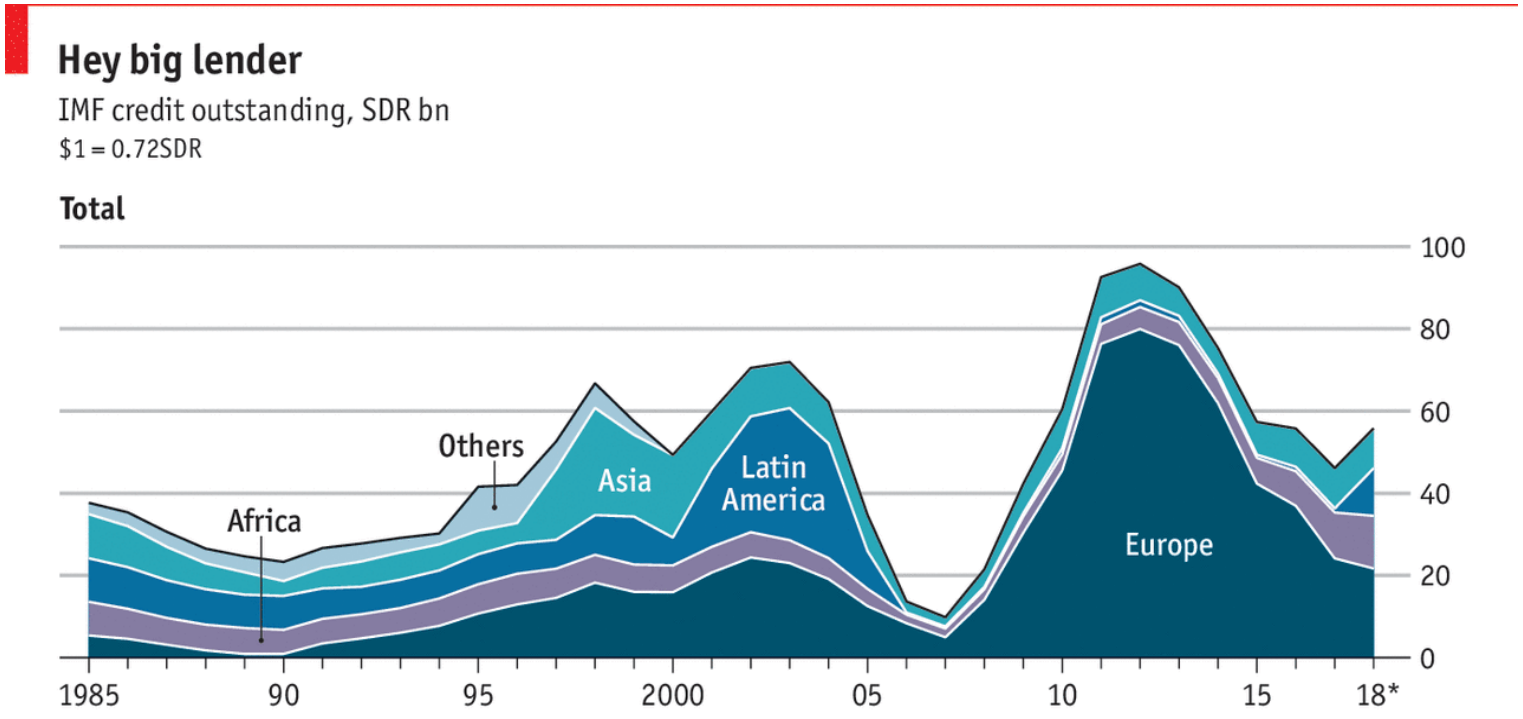
Figure 1. Evolution of the Global Financial Safety Net, 1995–2016



Sources: Bank of England; central bank websites; RFA annual reports; and IMF staff estimates.
1/ Estimated based on known past usage or, if undrawn, on average past maximum drawings of remaining central bank members in the network. Two-way arrangements are only counted once.
2/ Includes all arrangements with an explicit value limit and excludes CMIM arrangements, which are included under RFAs. Two-way arrangements are only counted once.
3/ Based on explicit lending capacity/limit where available, committed resources, or estimated lending capacity based on country access limits and paid-in capital.
4/ After prudential balances.
5/ For countries in the Financial Transaction Plan (FTP) after deducting prudential balance.

Role of RFA‘s / IMF

The Economist, 04/09/2018
The world’s lender of last resort is back in vogue (As the dollar strengthens and interest rates rise, more emerging-market governments are turning to the IMF)



Tentative conclusions

- Most available instruments have positive, but uncertain effects (this applies to preventive and curative measures)
- Necessary versus sufficient conditions (doing nothing is not an option)
- Instruments may reinforce each other (complementarity, e.g. between reserves and CFM, monetary and macroprudential measures)
- Still, crises cannot be averted, and their effects are difficult to attenuate
- Calls for strong GFSN and good articulation between the different layers (RFAs/IMF).
- For this we need to ensure that the IMF has adequate resources