

Global Spill Overs and EMEs

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Monetary and Financial Spill overs

The current global debate on monetary policy is centred on whether it should target financial stability in addition to the domestic business cycle. With relatively tightly regulated financial markets, where concerns presently are more developmental than regulatory, the counterpart debate in EMEs centres on reconciling two widely held economic policy formulations, namely the Mundell-Fleming 'Impossible Trinity' and the 'Taylor Rule'. The problem has become all the more compelling in a rapidly globalizing world where large, volatile capital flows lead to misaligned and volatile exchange rates that threaten macro-economic stability. The recent currency crisis which constrained Brazil, Turkey, Indonesia and India to tighten policy rates amidst collapsing growth, makes the case for reconciling the 'impossible trinity' with the 'Taylor Rule' of monetary policy all the more compelling.

Ceteris paribus, if a country runs a current account deficit, its currency should depreciate against those of its trading partners. There are, however two major circumstances, one emanating from the current account (the 'dutch disease syndrome'), and the other from the capital account ('southern cone syndrome') under which this reasoning does not hold. The latter is more germane here because large and volatile capital inflows into EMEs have become a far more frequent phenomenon as a result of loosening of financial regulation, innovation, globalization and monetary policy spill overs. Cross-border flows capital to EMEs have increased manifold since the seventies following the oil price hikes and export-led growth strategies adopted by several East Asian economies. The first manifestation of this syndrome in developing economies was the wave of financial liberalization which led to a debt fuelled recycling of petrodollars by American banks in the 'southern cone' in Latin America.

While large capital inflows can sustain large current account deficits for some time, over the medium to long-run they tend to magnify external imbalances and lay the ground for external payments crises. There are also large capital flows into

countries running account surpluses. Once the capital surge abates, and particularly in the event of a sudden stop, there is a likelihood of a sudden, rapid and accelerated correction in exchange rates, with the nominal exchange rate depreciating sharply, and the Real Effective Exchange Rate (REER) overshooting its neutral (long term 'fundamental') rate. This can cause short term macro-economic instability, such as higher inflation, a loss in international confidence and credit downgrade that could compound the reversal in capital flows and even precipitate an external payments crisis.

What pushes capital into EMEs, and what triggers sudden stops? While fundamentals and the prospects of higher returns are certainly contributory factors, it is now becoming increasingly clear that the major factor driving flows in and out of EMEs has little to do with the fundamentals of recipient countries but yields in the source countries, in particular the US which has the biggest and deepest financial market in the world. While the asymmetry in flows -- particularly outflows -- can to some extent be explained by differing fundamentals, the inflows, and outflows, seem to come in waves, and across a wide swathe of countries.

Large global imbalances themselves should not result in destabilizing flows. They are nothing new, and capital account flows have traditionally been simply the counterpart of current account balances. However, the cocktail of loosening of financial regulation, innovation, globalization and the extant international monetary system have combined to open up a growing gap between gross capital flows and net flows that reflect current account balances. It is not entirely coincidental that the capital stop in the southern cone in the early eighties, in East Asia in the late nineties, and across a broad sweep of EMEs since May 2013, followed a tightening of monetary policy by the United States Federal Reserve. With the integration of financial markets and globalization the spill overs of US Fed monetary policies are only increasing because of the overarching dominance of the Dollar in the international monetary system. It policies therefore hugely determine the direction and velocity of cross border capital flows. No other central bank comes even close to exercising this influence across its own borders.

Over the years the US dollar has effectively become the global reserve currency. As a result US monetary policy has a determining influence on the direction and quantum of global capital flows. This in effect gives the issuer of the global reserve currency the flexibility to soak up capital when it needs it most, and to export it out when it suffers from excessive domestic liquidity. Through this mechanism the US can fund literally unlimited amounts of external and internal deficits without being penalized by markets as happens in the case of other countries. Open capital accounts, espoused by the IMF, only facilitates this funding and magnifies the 'exorbitant privilege' of the US dollar.

It has long been argued, from the days of John Maynard Keynes, that the extant international monetary system has a structural flaw in that it lacks a mechanism, market based or otherwise, to induce surplus countries to adjust. This can lead to the persistence of large external imbalances that are potentially destabilizing. Recent history however indicates that this is not entirely correct, as there is also little pressure on countries with reserve currencies, and especially THE global reserve currency, to adjust even when they run large current account deficits, on account of the large external demand for their currencies. The latter is also consistent with the 'Triffin Paradox', by which the reserve currency issuer is expected to run larger and larger current account deficits to meet the growing needs of global liquidity. This is manifestly not true in the cases of currencies like the Japanese yen and the Swiss franc. Both countries have run current account surpluses over the last decade and a half. Similarly, even while its currency was becoming important in the composition of the global portfolio of reserve currencies, the euro was running a roughly balanced current account position with the rest of the world. This is because it is really the dollar that is accepted as the de facto global reserve currency by markets, even though the IMF may have classified other currencies also as reserves.

In effect, the US Federal Reserve acts as the global central bank. Policy easing by the US Federal reserve, both prior to and following the global financial crisis, led to a surge in capital inflows into emerging markets, appreciating their currencies. There were intervening periods of sudden stops, as US monetary policy changed course, resulting in sharp currency depreciation, sudden stops and external payments crises. This happened in the eighties in Latin America, in the nineties in

East Asia, and is now affecting EMDEs globally. International financial markets in EMEs appear to respond more to US Fed actions than to economic fundamentals in EMEs.

According to the impossible trinity, a country can have only two of the following three: Fixed exchange rate, monetary independence and free capital flows. A free monetary policy means that it is free to respond to the domestic business cycle. The Taylor Rule is a rule bound – as opposed to discretionary – monetary policy by which the central bank adjusts its short term policy rate based on a mathematical formula using differentials between a country's potential GDP and actual GDP, and inflation target and actual inflation. The Taylor Rule and its variants are now used by almost all advanced country central banks. The author of the rule, John B Taylor of Stanford University, is of the view that it is relevant for developing country central banks also. Many developing countries have indeed started using the Taylor Rule.

In advanced economies the Taylor Rule responds to the domestic business cycle. Monetary policy in developing countries, on the other hand, is in addition constrained to respond to the external financial cycle, which distorts the application of the Taylor Rule. Thus, if domestic growth concerns warrant low interest rates, a sudden stop in capital inflows may induce them to keep interest rates unduly high to attract foreign capital, thereby magnifying the downturn in the business cycle. In other words, they end up trying to negotiate the impossible trinity. Raising interest rates at such times rarely works because the stops are frequently not country specific, and in any case foreign investors are more concerned about capital losses than higher interest income.

Domestic debt in EMEs is backstopped by their central banks. External deficits denominated in international reserve currencies are not. The dependence on market support makes them susceptible to external payments crises in the event of market revolt if deficits are perceived to be excessive and unsustainable. This happened on a large scale in Latin America in the early eighties, in East Asia in the late nineties, and across a broad swathe of EMEs currently. This threat of external payments crisis compels developing countries to frequently use monetary policy for managing external imbalances, in addition to managing the domestic business cycle.

They need separate instruments, as part of a consistent policy framework, to target the external financial cycle so that their central banks to retain monetary independence.

Regulatory Spill overs

Compared to monetary spillovers, the direct impact of the ongoing financial regulatory reforms on EMEs has been relatively benign so far. Surprisingly, despite the general decline in cross border claims on financial assets amongst advanced economies, especially in Europe, capital flows to EMEs are back to pre-crisis highs. In the case of Asia, for example, aggregate inflows to 10 large Asian economies fell to 1.7% of GDP during the global financial crisis of 2008–2009, from an average of 8.4% in the previous three years. But inflows rebounded sharply in 2010–2012 to 7.4% of GDP. These flows were in excess of what they could absorb, and had to be consequently cycled back to advanced economies through reserve accumulation. The recent sudden stops were also associated with monetary actions in advanced economies – the US Fed taper – rather than with any regulatory actions. It would therefore appear that capital flows to EMEs appear to be far more impacted by monetary policies in advanced economies than their regulatory reforms.

Looking ahead, the indirect spillover of regulatory reform on Emerging Markets over the longer term could, however, be more substantial. While the rationale for tightening capital adequacy norms for the banking sector in AMEs where the recent financial crisis originated is self-evident, the case for immediately migrating from Basel II to Basel III in EMEs is not. Their financial systems were and remain quite different. The primary drivers of leverage in advanced market economies (AMEs) and EMEs are strikingly different. Galloping leverage in AMEs through shadow banking in the run up to the recent global financial crisis was an attempt to increase returns on capital through increased trading of claims on real economy assets in an environment of low returns. This led to a rapid expansion of financial assets as a proportion of their GDP. High credit growth in the more tightly regulated EMEs, like the PRC and India, on the other hand, was primarily through deposit based banking to finance high rates of investment and growth.

While the concern in advanced economies relates to regulatory laxity that puts their financial system at risk from bubbles, the concerns in EMEs before the crisis were developmental rather than regulatory, as they strove to move away from a repressed to a less regulated financial system. This position has not changed, especially since their financial systems withstood the global financial crisis reasonably well.

The moot point, therefore, is, whether EMEs should immediately move to a regulatory framework calibrated to risks in AME financial systems that could pull scarce savings away from investment necessary to sustain current levels of high growth to cover non-existent risks. The argument in favor of common regulatory norms is to avoid arbitrage. This alone is not very convincing because any capital migrating to a more regulated environment would incur additional costs, as regulation is a proxy tax. The cost of capital is already high in EMEs. Enhanced capital requirements of Basel III are almost guaranteed to keep it high in the foreseeable future.

EMEs have so far been largely bystanders in the global debate in Basel and in the G 20 on financial regulatory reform, possibly because their deposit-and-ending based financial systems are structurally very different from the more market based systems in advanced economies. They however need to be better engaged at the rule-making stage and at least negotiate a regulatory carve-out for the phase-in of Basel III, especially since advanced economies are lagging behind them in implementation. According to a recent assessment by the BCBS, G20 EMEs are actually ahead of advanced countries in implementing Basel III. This not only puts them in the vanguard of Basel III related financial instruments that are still little understood by markets, thereby introducing new risks in their financial systems, but could also extract a high developmental cost through foregone growth.

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