EMEs' Response to Global Spill Overs

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Traditional development theory took a benign view of capital inflows into developing countries as these filled two critical developmental gaps, namely a savings-investment deficit, and foreign exchange scarcity. While developing countries continue to require large amounts of external savings to supplement their own to accelerate growth and development, **a rapidly globalizing world with large external imbalances, sophisticated financial markets and growing monetary policy spill overs also result in large, volatile capital flows leading to misaligned and volatile exchange rates, sudden stops and external payments crises** that threaten macro-economic stability. Capital flows to emerging markets are now back to their pre-crisis highs, despite declining growth, lower current account surpluses and rising public debt.

There are three key ways in which EMEs have dealt with global spill overs, although their sequencing and deployment have varied enormously across space and time. **By and large, the monetary policy is the first line of defence** in EMEs that have floated their currencies to varying degrees. This response includes greater exchange rate flexibility, coupled with adequate reserves that enable market intervention where required to deal with exchange rate misalignment and extreme volatility.

The second way is to use prudential measures to address financial stability concerns that may arise from failures and leakages from the first line of defence, such as domestic credit booms and asset price inflation. Higher reserve requirements, countercyclical capital buffers, and capping loan to value ratios in the bubble sectors (such as housing) and foreign currency lending are some of the policy instruments that have been used. The G 20 initiative to develop domestic

currency bond markets and structural reforms that can increase the absorptive capacity of EMEs to direct capital inflows into investment in the real economy is part of the tool kit of this line of defence. Prudential measures however can be effective only so long as the inflows pass through a well regulated formal financial system and do not bypass it.

The third way is to impose short-term capital control measures (CCMs). This instrument has recently been recognized by the IMF as legitimate in extreme circumstances, and also endorsed by the G 20 at their sixth Summit in Cannes. CCMs are putatively leaky, and more effective when imposed on inflows than on outflows. There are two broad types of capital controls, namely those that rely on market instruments to raise or reduce the cost of certain transactions, as appropriate, and administrative controls, that try and restrict or prohibit cross border capital transactions.

All three lines of defence create distortions of their own, and at best throw sand in the wheels. **A point may arise when the three lines together are unable to stop the capital flow Juggernaut, and an external payments crisis and loss of market access follows**. The latter is on account of a **basic asymmetry in their ability to act against currency appreciation and currency depreciation.** Since local currency is used in the latter, their capacity is potentially unlimited. In the latter case, however, they are constrained by the size of their hard currency reserves. **There are three tried and trusted options available with developing countries to deal with this, namely bilateral and regional swap agreements, IMF funding and, as was done on a large scale during the recent financial crisis, liquidity and swap facilities with the US Federal Reserve**, the issuer of the de facto global reserve currency. **There is considerable scope for streamlining all the three backstops**: Regional arrangements need a suitable surveillance system and mutually acceptable governance structure to be effective,

IMF instruments need to become more nimble and shed their 'stigma' image. One cannot, as a matter of course, expect bilateral arrangements, including US Fed swap facilities, to ever become transparent, rule-bound and a-political.

What more needs to be done? There is perhaps a need for streamlining the first line of defence, so as to limit the distortion of monetary policy by volatile capital flows on the one hand, and minimise recourse to short-term prudential and capital flow measures on the other. Ideally, only those prudential and capital control measures should be in places that are desirable and sustainable over the long-term.

Developing countries have found it impossible to use a single policy instrument – short term interest rates – to simultaneously target both the domestic economic cycle and global spill overs – the external financial cycle -- at the same time. According to the widely accepted 'Tinbergen rule' a policy instrument can be effective only if it has a single objective. Despite this, EME central banks have been using a single policy instrument, namely the interest rate, to sometimes target domestic imbalances (the inflation-growth matrix) and sometimes external imbalances (the exchange rate-current account balance matrix), supplemented occasionally by market intervention, depending on which balance appears more pressing at the moment. This risks making the instrument ineffective, the policy inconsistent and magnifying rather than attenuating both domestic and external imbalances. Since there are two targets, a second policy instrument is required to achieve both objectives. **They therefore need a new policy instrument that frees up monetary policy to target the domestic economic cycle. The interest rate is clearly better suited to target domestic imbalances. Targeting a neutral Real Effective Exchange Rate (REER) through market intervention, on the other hand, is clearly better suited to targeting external imbalances.** Unlike the nominal exchange rate, the REER is without doubt an

invisible target which is difficult to compute. However such targeting would, first, ensure that the nominal exchange rate remains closely aligned to fundamentals, i.e it responds primarily to the current account and is not distorted by destabilizing volatile capital flows from time to time, even though they might at times make it easier to finance current account deficits over the short term. Second, by sequestering excessive inflows during episodes of excessive inflows, it enhances the war chest for combating disorderly adjustment which can boost market confidence relative to EME peers. **Such a policy/instrument is also entirely consistent with 1(iii) of IMF's Articles of Agreement that purports "to promote exchange rate stability".**

A number of EMEs, such as India, have, as a matter of course, relied more on interventions in the foreign exchange market to manage volatile capital flows. However, they neither target it consistently, nor are they consistent in the use of instruments to achieve their target. A consistent, well-articulated and effectively communicated exchange rate and/or reserve management policy which protects monetary independence has still to be worked out by EME central banks. The use of separate instruments to target domestic and external balances by the central bank must be done within an overall framework of policy consistency that attenuates conflicting outcomes. There would, for instance, be no conflicting outcomes when there is a need to tighten monetary policy and sell foreign exchange reserves, or inversely when there is a need to loosen monetary policy and buy foreign exchange reserves. There could, however, be some conflict when there is a need to loosen monetary policy and sell reserves, and inversely when there is a need to tighten monetary policy and buy reserves. In the case of such conflict the central bank would need to conduct sterilization/liquidity provision operations alongside market intervention so that the monetary policy stance is not compromised.

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Use of Prudential Measures

Preference	PMs	Specifics
1.	Cap on LTV ratio	• On housing loans **(CHN, INA, IND, MYS, TWN, THA, TUR)**
2.	Increase in Reserve Requirements	• Applied generally on most, if not all, types of domestic and foreign deposits **(ARG, BRA, INA, IND, MYS, PER, TUR)**
3.	Increasing or Implementing Countercyclical capital requirements	• Increase in capital requirements on new consumer credit operations (esp. personal credit, payroll-deducted loans and vehicles) **(BRA)** • Introduced a capital conservation buffer, a countercyclical buffer, and a systemic capital. Raised the minimum capital adequacy ratio to 11.5% from 8% for large banks (small banks: 10.5%) **(CHN)** • Introduction of capital surcharges for systemically important institutions, on top of Basel requirements **(SAF)**
4.	Caps on foreign or domestic currency lending	• 30% limit on short-term offshore borrowing of domestic banks **(INA)** • Ceiling on FX mortgage lending set at 50% of total mortgage lending **(POL)** • Limited credit to highly vulnerable sectors (mainly property credit, consumption credit, stock-related credit) **(VNM)**

Use of Capital Control Measures (CMM)

Preference	Non-discriminatory CFMs	Specifics
1.	Reserve Requirement (RR) on FCY or NR deposits	• Unremunerated RR of 30% on short-term capital inflows for a year **(ARG)** • Unremunerated RR on domestic and FC deposits, FC liabilities with maturity less than 2 years **(PER)** • RRR on short-term FX deposits and other liabilities gradually increased **(TUR)**
	Limits on exposure to FX derivatives	• Ceiling on forward exchange position that can be held by resident and non-resident banks (ceiling set as a % of bank's equity capital) **(KOR)** • Holdings of onshore TWD derivatives (NDF & options) by domestic and foreign banks limited to 20% of total forex positions **(TWN)**
2.	Capital flows control through price or volume	• Limit on short-term offshore borrowing of the banks at 30% of capital **(INA)** •
	Levy on FCY Liabilities	• Macroprudential Stability Levy – Levy of up to 0.5% on financial institutions' non-deposit FCY liability balances **(KOR)**
	Restricted holding periods of investments	• Minimum holding period on Bank Indonesia bills **(INA)**
	Capital requirements for FX credit risk	• Higher capital requirement for banks to position foreign exchange forwards **(PHP)**

Preference	Discriminatory CFMs	Specifics
1.	Capital flows control through price or volume on non-residents only	• Tax on financial operations (IOF) for non-resident portfolio investment in equity and fixed income **(BRA)** • Fee on NR purchases of central bank paper, capital gains tax on NR investments in the stock market **(PER)** • Withholding tax on foreign purchases of treasury and money stabilization bonds **(KOR)** • Banned non-residents from placing funds in time deposits **(TWN)** • Withholding tax on capital gains and interest payments for government and state-owned company bonds earned by non-residents **(THA)**

Country abbreviations: Argentina (ARG), Brazil (BRA), Chile (CHL), China (CHN), India (IND), Indonesia (INA), Malaysia (MYS), Mexico (MEX), Peru (PER), Philippines (PHP), Poland (POL), South Africa (SAF), South Korea (KOR), Taiwan (TWN), Thailand (THL), Turkey (TUR), Vietnam (VNM)

Global Monetary Easing: Spillovers and Lines of Defence, by Wang Chua, Norhana Endut, Nozlan Khadri & Wee Haw Sim (*Bank Negara Malaysia Working Paper Series WP3/2013, December 2013*)