BASIC ISSUES

1. Broad view of macroeconomic stability

2. Markets are inherently unstable and not self-correcting

3. The global economy is an asymmetric system.
BROAD VIEW OF MACROECONOMIC STABILITY

- Not only inflation and fiscal balance, but also:
  - Economic activity and employment
  - External sector balance
  - Healthy balance sheets of financial and non-financial agents

- Due to pro-cyclical shocks, counter-cyclical macroeconomic policies are the key.

- So, need to go beyond “inflation targeting”.
MARKETS ARE INHERENTLY UNSTABLE AND NOT SELF-CORRECTING

- This is partly a question of price and wage “rigidities”…
- … and of flexible prices (commodities) …
- … but particularly of financial markets (lack of knowledge about the future and risk/information asymmetries generate inherently incomplete and segmented markets):
  - Alternation of “risk appetite” and “flight to quality”
  - Rationing of credit, particularly during downturns
  - Contagion
THE GLOBAL ECONOMY IS AN ASYMMETRIC SYSTEM

- Financial and macroeconomic: global currencies are those of industrial countries + financial market segmentation
- Technological and productive: technological progress is highly concentrated and diffusion is slow
- Asymmetries in the degree of mobility of factors of production: high mobility of capital vs. limited labor mobility, particularly of unskilled labor
Developing countries are subject to strong cyclical shocks.

Basic lesson from the past: following incentives generated by positive terms of trade and capital account shocks leads to crises.

So, need to develop counter-cyclical macroeconomic policies …

… but limited “policy space” for them.

This dilemma is generally ignored in traditional policy debates.
THE TRADITIONAL VIEW: THE IMPOSSIBLE TRINITY

Capital mobility

A

Autonomy to manage interest rates

B

Autonomy to manage exchange rates

C
FEATURES OF FINANCIAL CYCLES

Variations in:

- Availability (from abundance to rationing)
- Costs (risk premia low during booms, high during crises)
- Maturities (longer-term issues during booms, shorter-term during crises)

- Short-term but, particularly, medium-term fluctuations
UNSTABLE ACCESS TO EXTERNAL FINANCING…

Private capital flows to developing countries

- Private debt
- Portfolio equity
- FDI
... AND VOLATILE SPREADS ...

EMBI Global and US High-Yield Bonds,
October 1994-September 2008
... WITH SHORTER-TERM FLUCTUATIONS

Quarterly issuance of bonds, 2000-2008
(Million dollars)
COUNTER-CYCLICAL POLICIES

- Counter-cyclical macroeconomic policies:
  - Fiscal
  - Monetary
  - Foreign exchange rate and reserves

- Capital management techniques:
  - Promote domestic bond markets
  - Public sector debt management
  - Capital account regulations
  - Macro-prudential regulations
FISCAL POLICY

- Major instruments:
  - Stabilization funds
  - Long-term (structural) rules on spending
  - Automatic stabilizers

- But markets push it in a different direction, as taxes and financing are pro-cyclical

- And there are political-economy pressures that push in the same direction:
  - If there was austerity during the preceding crisis, it is also difficult to justify it during booms
  - Compensating pro-cyclical booms of private spending is politically difficult
FISCAL POLICIES IN THE DEVELOPING WORLD TEND TO BE PRO-CYCLICAL

<table>
<thead>
<tr>
<th>REGION</th>
<th>CYCLICALITY OF FISCAL POLICY (INDEX)</th>
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<tbody>
<tr>
<td>OECD</td>
<td>- 0.11 (countercyclical)</td>
</tr>
<tr>
<td>High-to-Middle Income</td>
<td>0.28 (highly procyclical)</td>
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<td>Developing Countries</td>
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<tr>
<td>Middle-to-Low Income</td>
<td>0.17 (moderately procyclical)</td>
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<td>Developing Countries</td>
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<td>Low-Income Countries</td>
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<td>Africa</td>
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</tr>
<tr>
<td>Latin America</td>
<td>0.25 (highly procyclical)</td>
</tr>
<tr>
<td>Asia</td>
<td>0.16 (moderately procyclical)</td>
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COUNTER-CYCLICAL MONETARY POLICIES

- Pro-cyclical capital flows generate swings in parity interest rates \( (i=i^*+\theta+\hat{e}) \) that have pro-cyclical effects…

- … as well as supply shocks (appreciation pressures during booms, depreciation during crises).

- In sum, a succession of boom-cum price stability (“boombility”) and stagflation pressures.

- So, authorities may have limited room to counter the pro-cyclical swings of markets.

- The attempt to do with through flexible exchange rates simply shifts the problem to the exchange rate, which may lead to crisis.
So, monetary policy must be complemented with active foreign exchange management (and active capital management).

This means that central banks should simultaneously target interest and exchange rates.

This also resolves also the conflicting demands on the exchange rate regime:

- Demand for stability (price stability, stable trade incentives, avoiding pro-cyclical wealth effects)
- Demand for flexibility (room of maneuver to manage shocks)
MASSIVE INTERVENTIONS IN FOREIGN EXCHANGE MARKETS

Acumulación de reservas como % del PIB

Argentina
Brasil
Chile
Colombia
México
Perú

Jul04-Abr06
Jul06-Jun07
En-Jun 08

14.3%
DEVELOPING COUNTRIES HAVE ACCUMULATED PART OF EXPORT REVENUES AND ALL CAPITAL INFLOWS

Reserve accumulation by developing countries (% of GDP at market prices)

- Capital flows
- Current account
CAPITAL MANAGEMENT TECHNIQUES

- The favorite solutions: promote domestic bond markets …
- and improve public sector debt profiles
- Financial liberalization continues, but capital account regulations are still widely used
- A missing instrument: Macro-prudential regulations
DOMESTIC BOND MARKETS HAVE BOOMED SINCE THE ASIAN CRISIS
LESSONS FROM CAPITAL ACCOUNT REGULATIONS

- Both controls on outflows and inflows can work, but quantitative restrictions may be easy to administer.
- Dynamic adjustment is necessary to close loopholes, and in any case regulations are “leaky”.
- Traditional controls work better if the objective is to reduce procyclical flows.
- Quantitative controls have stronger effects, but price-based regulations are also effective.
- Their effect may be temporary.
- Capital account regulations are a complement, not a substitute of adequate macro policy.
THE EFFECT MAY BE TEMPORARY
(SPEED BUMP – Chile 1988-1997)
PRUDENTIAL REGULATION

- Regulations should be comprehensive.
- Increase provisions (reserves) or capital during booms. More generally, avoid build-up of leverage.
- Regulation of collaterals to avoid asset price bubbles from feeding into leverage.
- Discretionary prudential provisioning, based on growth of credit (general, by sector, by agent).
- Regulation of maturity and, particularly, currency mismatches. Avoid dollarization.
INTERNATIONAL COOPERATION

- The room of maneuver for counter-cyclical policies should be at the center
- Surveillance to avoid building up unsustainable dynamics.
- Smoothing financing at the source
- IFIs as “market makers” for counter-cyclical instruments
- Counter-cyclical financing.
CONCLUSIONS

- The essential problem of macroeconomic policy in the mix of pro-cyclical capital flows and the limited room of maneuver for counter-cyclical macroeconomic policies that they generate.

- Dominant frameworks are not always useful to analyze the dilemmas involved.

- Active counter-cyclical policies involve multiple instruments, including active foreign exchange reserve management, elements of exchange rate targeting, counter-cyclical prudential regulations and, possibly, capital account regulations.

- The support for counter-cyclical policies must be at the center of international (IMF) cooperation.
FINANCIAL VOLATILITY AND THE SPACE FOR COUNTER-CYCLICAL MACROECONOMIC POLICIES IN THE DEVELOPING WORLD

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Leontief Lecture, Tufts University
November 17, 2008