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Managing Abundance to Avoid a Bust in Latin America

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EXECUTIVE SUMMARY

Exceptional global circumstances have produced a double bonanza of easy foreign financing and high terms of trade for Latin America (LA), particularly for commodity exporters—favorable conditions that will not last forever. Managing this abundance will be critical to avoiding a boom-bust cycle. This note explores the sources of these double tailwinds, the problems and vulnerabilities they can engender in LA, and how to build an appropriate policy response.

Persistent double tailwinds, with risks of an abrupt end. *A Global Liquidity Flood:* Building on capital flow “pull” factors associated with improved fundamentals in emerging markets (EMs) and a likely sustained shift in investors’ portfolios, the combination of low interest rates in advanced economies (AEs) and investors’ higher risk tolerance is a strong “push” factor that will continue for some time, but could revert hastily once AEs’ recovery gains footing. Economic and political constraints in AEs have led them to lean strongly on easy monetary policy. At the same time, some key EMs are limiting the adjustment of their current account balances—by maintaining broad capital account restrictions and heavy exchange rate intervention—leaving others to receive higher capital inflows and contribute more to the restoration and rebalancing of global demand. *A Terms of Trade Bonanza:* As demand by systemic EMs has pushed up commodity prices, LA is enjoying strong terms of trade, raising issues in many ways similar to easy foreign financing. A key risk for the region is a sharp reversal of these two favorable external conditions following, e.g., a large oil price shock, rapid monetary tightening in AEs, or a global slowdown coupled with heightened risk aversion.

Concerns for Latin America. The unusual intensity of these favorable external conditions is conducive to a buildup of vulnerabilities and heightened risks of reversals. These conditions can mask underlying fragilities in external, financial, and fiscal accounts, and bring complacency and exuberance. Risks of demand booms, large current account deficits, and excess financial intermediation are concerns of first order, compared to Dutch disease concerns. Current accounts in LA, already in deficit, can rapidly move to vulnerable positions as domestic demand tends to react exuberantly to easy external financing conditions and strong terms of trade. The financial sector is susceptible to playing an amplifying role in credit and asset bubbles and excess absorption, and can seriously exacerbate problems when capital inflows reverse or terms of trade decline. The risks from financial vulnerabilities and excess current account deficits interact and reinforce each other, compounding the difficulties countries may face when tailwinds turn to headwinds.

Building the policy response. A set of policies is needed to contain the risk of boom-bust cycles. The region’s flexible exchange rates should play a key role in dampening incentives for capital inflows and currency mismatches while also facilitating warranted equilibrium appreciations; foreign exchange intervention should avoid playing an early role and resisting fundamental shifts. Fiscal policy needs at least to be acyclical, undoing recent stimuli and saving temporary revenue gains. Always-desirable macroprudential policies should continue being developed and intensified, with the focus on segments prone to bubbles, to contain financial vulnerabilities and reduce credit procyclicality. But even with sound macroprudential policies, private sector exuberance and excess current account deficits can happen as corporates bypass domestic financial institutions. In the current exceptional global setting, to avoid excessive risk from large current account deficits, the temporary use of capital account restrictions on macroeconomic stability grounds could be considered, but adjustments in macroeconomic policies are a key first priority. As long as such restrictions are not used to substitute for such adjustments, their temporary use in financially-open LA can be viewed as a prudent move to prevent boom-busts, thereby contributing to global financial stability.

I. INTRODUCTION

Latin American economies today are at a challenging juncture as key global conditions have aligned in very exceptional ways, representing a double tailwind for many countries of the region. These countries must figure out how to best respond to a sustained period of unusually easy foreign financing conditions and large capital inflows. At the same time, they face high world prices for their commodity exports—another source of abundance that is likely to be persistent but not permanent. Such conditions are, of course, in many ways favorable, creating opportunities with important upsides. But such conditions can also lead to an accumulation of important vulnerabilities for the future. There are challenges both while these conditions persist and during the transition after they end because severe dislocations and crises may arise if the good times are improperly managed. Indeed, some of Latin America’s own past experiences with the “problems of plenty” have illustrated that good times can be followed by bad endings.

Indeed, one key concern in Latin America (LA) should be that the double tailwinds of easy money and high commodity prices may lead to financial exuberance and external vulnerabilities, heightening the risks of costly sudden reversals. Past experience has showcased how both market and regulatory failures can lead to excess absorption and accumulation of risks in private balance sheets. Moreover, the external current accounts in Latin America have shown in the past a significant propensity to overshoot under similar conditions.

Relative to the past, many LA countries today have better policy frameworks, a development that reduces the chances of excesses and risks and thereby makes them more attractive to foreign capital. Improved fundamentals in the region likely have brought a permanent shift in investors’ portfolio allocations. At the same time, they reduce the vulnerabilities associated with larger capital inflows. Especially relevant is the greater degree of exchange rate flexibility accompanied by relatively successful inflation targeting frameworks as an alternative nominal anchor. Bank supervision has progressed greatly in controlling currency mismatches, at least on banks’ balance sheets. In some cases, the degree of fiscal policy procyclicality has been reduced. Moreover, the level of public debt has been brought down considerably, reducing vulnerabilities in general.

The problem that Latin America now faces from external factors is on a scale of uncharted dimensions. First, the global setting implies that the region has unusually ample access to cheap foreign financing—a combination of persistently very low interest rates in advanced countries and higher risk tolerance from international investors—while at the same time some countries outside the region have policies in place that represent strong barriers to capital inflows and wider current account deficits. Second, strong growth in Asia, coupled with supply constraints, has sustained high commodity prices, bringing terms of trade for LA commodity exporters that are unusually favorable but unlikely to be fully sustained. (These global conditions are discussed more fully in the following section.)

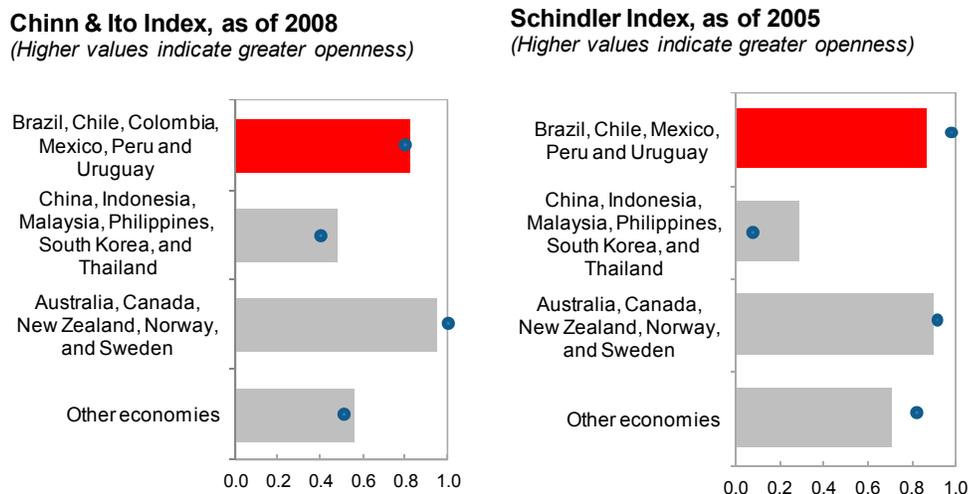
It is essential to recognize that key characteristics of LA countries today make the challenges and policy discussions different from many EM countries of other regions.

This note emphasizes especially the larger economies of LA, those which in general are characterized by a high degree of financial integration with the global market and by having important commodity exporting sectors. These LA countries have open capital accounts (see Figure 1 for a comparison with other regions) and most have highly flexible exchange rate regimes. Many of them have fiscal policy rules to ensure debt sustainability. Crucially, these countries normally have external current accounts that are in deficit (and in fact already have deteriorated, notwithstanding the boost from commodity revenues). Much of this stands in sharp contrast with the situation of a number of Asian economies today, with their current account surpluses, less flexible exchange rates and more aggressive foreign exchange market intervention policies, and less open capital accounts.

While there is increasing agreement about the broad contours of policy responses to episodes of surging capital inflows to emerging economies (see IMF, 2011, Ostry et al, 2010, and Ostry et al, 2011), this note differs in being focused on the particular situation of LA today, incorporating also the commodity boom challenge and LA’s structural characteristics. It seeks to address for LA in particular the rationale, nature, and sequencing of the policy response. What is known as the “capital inflows problem” in fact encompasses a variety of problems and issues, including drivers, distortions, and associated vulnerabilities, which have important tradeoffs. To help with the policy judgments that are required, this note seeks to organize the main issues and challenges that LA faces at this juncture and to discuss the effects of alternative responses.

Figure 1. Capital Account Openness of Latin America and Other Regions

Capital accounts tend to be relatively open in Latin America.



Note: Bars correspond to means and dots to medians of each country group.
Source: Chinn & Ito, 2009; and Schindler, 2009. Indices have been rescaled to facilitate comparison.

The rest of this note discusses the unusual aspects of the current external environment that are particularly conducive to strong capital inflows to Latin America (Section II); why today's easy foreign financing conditions are a concern for the region (Section III); and how Latin American should build its policy response (Section IV).

II. A GLOBAL LIQUIDITY FLOOD AND TERMS OF TRADE BONANZA FOR LATIN AMERICA

In a multi-speed global recovery such as the current one, real exchange rates and current accounts would be expected to respond differently across countries, with an appreciation and a larger deficit (narrower surplus) in economies with stronger cyclical positions. The dual of this is that net exports should play a greater role in the recovery of countries with weaker cyclical positions, with the rest playing the counterpart role in global rebalancing. Capital flows would be expected to be redirected from cyclically lagging to leading countries.

However, the current global circumstances are conducive to dynamics in Latin America beyond the usual cyclical reaction, with overly strong capital inflows, large current account deficits, and currency overvaluation. The constrained policy mix in advanced economies (AE) is expected to produce unusually strong, deep, and long-lasting monetary stimuli, while the behavior of a systemic group of EMs outside the region has limited the adjustment in their external positions, increasing the required global rebalancing efforts of more flexible countries. Moreover, a group of important EMs has been successful in maintaining growth, underpinned by substantial policy stimuli in some cases, which in turn has sustained commodity prices at a high level.²

Low interest rates in AE are a strong push factor for capital flows, one linked to a sluggish recovery that is held back by lingering private debt-overhang problems and limited space, both political and economic, for fiscal stimulus. In the run up to the global financial crisis, conditions in advanced economies were on an unsustainable path, and the corrections that ensued were exacerbated by the dislocations produced by the crisis and the prolonged process of balance sheet repair. The global financial crisis opened large output gaps in advanced economies and required, *inter alia*, a substantial loosening of monetary conditions. However, political constraints have created a situation where efforts needed for a fiscal consolidation over the medium term seem trapped in gridlock, while the scope for greater fiscal stimulus in the short term has either been limited (in some cases by lack of fiscal space) or tilted to a less effective design. The lack of progress in medium-term fiscal consolidation may add to contractionary headwinds through upward pressures in long-term interest rates, and could exacerbate future upward movements in rates once private sector

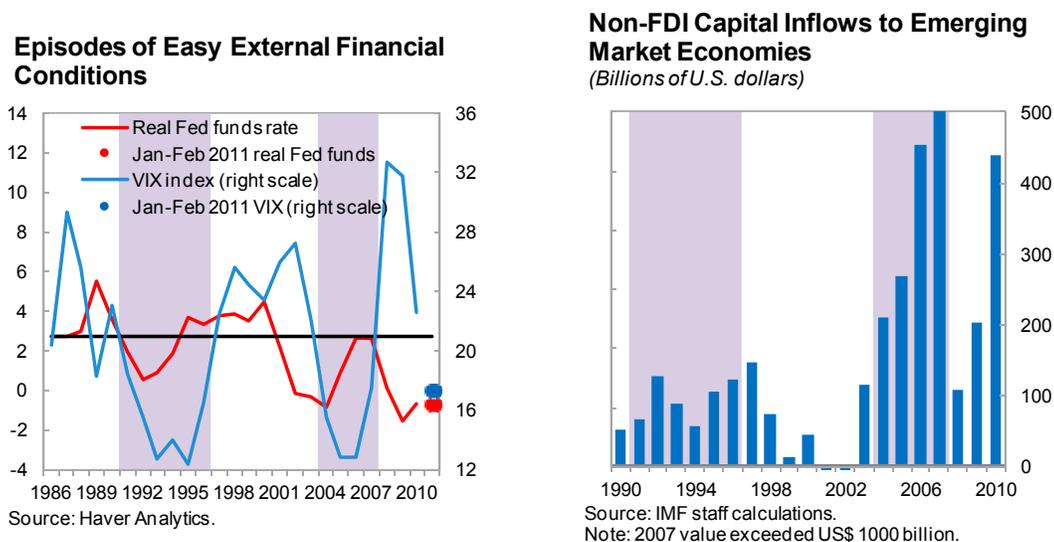
² The contribution of Asian economies, and in particular China, to global demand for commodities far exceeds their share in world GDP. In China the intensity of use of some commodities—especially metals—per unit of GDP is exceptionally high, so that China accounts for as much as 40 percent of global demand.

demand takes hold—an important risk for Latin America. Moreover, the slow progress in resolving the debt overhang in the household sector and balance sheet repair of financial institutions also has held back private spending and led to an unusually heavy reliance on easy monetary policy. This combination of economic, political and legal constraints has translated into a dependence by AEs on monetary policy beyond what would be expected under a policy mix that provided further fiscal stimulus until the output gap has significantly narrowed (anchoring fiscal policy where needed on a medium-term consolidation framework) and faster repair of balance sheets.³ This, in turn, has generated unusually lax foreign financing conditions for emerging markets, which are expected to be protracted, but could reverse quickly once the recovery in AEs gains footing.

In addition to low policy interest rates in advanced economies, financing conditions for EMs today are easy because global risk appetite has recovered strongly. This is reflected in very low risk premia for many EM countries, including in LA, with sovereign spreads near their record low levels of early 2007. This, on top of low interest rates in AEs, means very low borrowing costs for LA. In past episodes in which there were both low interest rates and high risk appetite, capital flows to EMs increased considerably (Figure 2).

Figure 2. Global Financial Conditions and Capital Inflows

During episodes of low global interest rates and low risk aversion, capital flows to emerging market economies have been significantly higher.

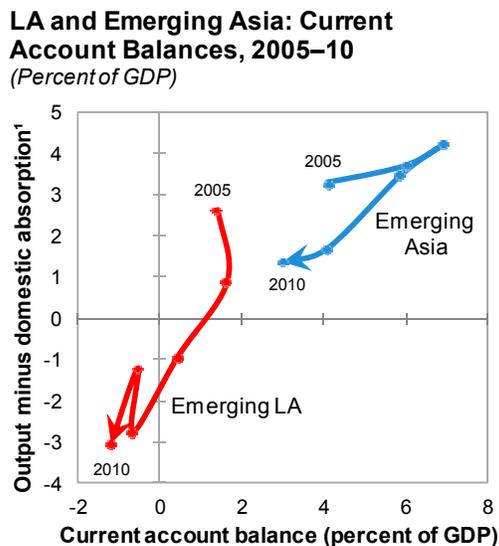


³ Enduring financial sector impairments in AEs have also entailed persistent expansionary monetary policies. A faster balance sheet repair in AEs would attenuate the drag from protracted deleveraging, lowering the need for macro stimuli. Furthermore, a protracted debt overhang situation introduces uncertainty over property rights and induces underinvestment and asset degradation, exacerbating the cycle and the required policy response.

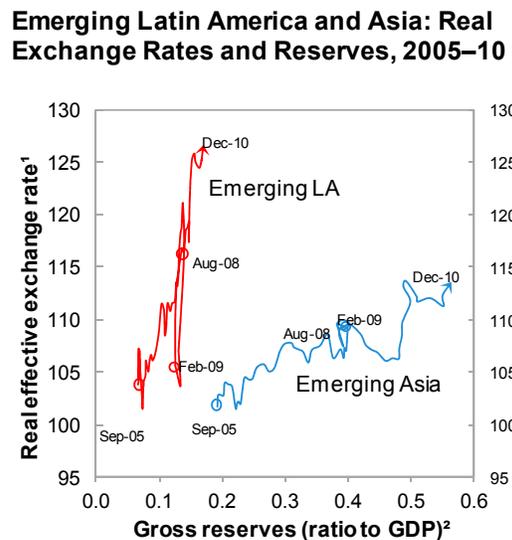
Lack of rebalancing in some surplus economies has implied further inflow pressures for LA. The response to the high liquidity environment has varied substantially across countries with respect to exchange rate flexibility and changes in the current account (Figure 3). Latin America has allowed relatively greater exchange rate appreciation and absorption and therefore contributed significantly to global rebalancing. Other EMs, some of them systemic, have let currencies appreciate less, sustaining large current account surpluses and maintaining major restrictions over the capital and financial accounts. One effect has been to deflect AE's easy financing conditions toward those EMs with more open capital accounts. As the global forces for rebalancing continue, the pressure for appreciation and current account widening will be amplified for the flexible EMs. Put differently, once it became clear after the global crisis that the U.S. could no longer be the consumer of last resort, the rest of the world, and particularly EMs, were called on to take its place in sustaining global demand. But Latin America would be too small to become a consumer powerhouse and sustain global growth. For example, suppose that the U.S. current account deficit were to narrow by 2 percentage points of U.S. GDP. If the counterpart of this shift were to come entirely from Latin America, then the region's current account deficit would have to widen by the equivalent of more than 6 percentage points of Latin America's GDP.

Figure 3. Current Accounts and Exchange Rates in Latin America and Asia

In contrast to Asian EMs, Latin American EMs show current account deficits, real exchange rates that move widely in both directions, and less reserve accumulation.



Note: Weighted averages of 15 Latin American and 10 Asian economies.
¹Output minus domestic absorption in percent of output, at constant (2005) prices.



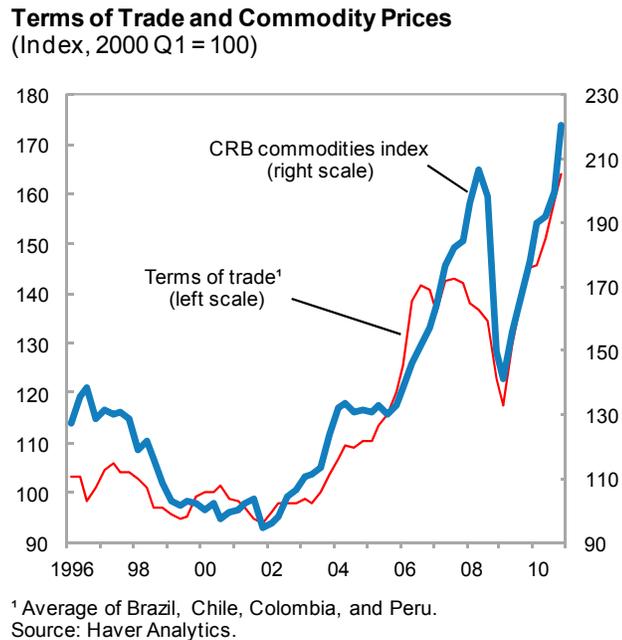
Note: Weighted averages of 15 Latin American and 10 Asian economies.
¹Index 2005=100.
²Gross international reserves as a share of 2006–08 average GDP.

The current juncture is also characterized by high terms of trade for LA, which creates challenges in some ways similar to easy foreign money, and a double tailwind for the region. Despite the sub-par and uneven global recovery, prices of commodities, especially

metals, are high in relation to past levels; the supply response will take considerable time to fully develop and thus to moderate prices.⁴ High commodity prices have a direct positive impact on the terms of trade of many LA countries (Figure 4). While undoubtedly good news, they also represent a challenge as they feed domestic absorption booms, enlarge government revenues, and appreciate the exchange rate. The difficulty of disentangling temporary and permanent price changes complicates matters more. Today's high commodity prices and terms of trade in LA occur in a context where global growth has shifted from AEs to dynamic EMs, particularly in Asia, where the intensity of use of some commodities (per unit of GDP) has risen dramatically, and is believed to represent in part a secular move in global resource scarcity. On the other hand, it is believed that eventual supply responses will bring down prices of many commodities, although it is impossible to know with precision the degree and timing of that response. The broader point is that another key risk to Latin America is that commodity prices can change rapidly and significantly when underlying conditions change. One such risk is that of a sustained oil supply disruption resulting in a global recession that would pull down the prices of other commodities.

Figure 4. Commodity Prices and Terms of Trade in Latin America

High world prices of commodities mean a bonanza for LA's commodity exporters.



⁴ For an analysis of long cycles in commodity prices, in particular of metals, see Box 1.5 of the October 2010 *World Economic Outlook* (IMF 2010e).

III. WHY IS TODAY'S EASY FOREIGN MONEY A CONCERN FOR LATIN AMERICA?

Easy external financing conditions and high terms of trade provide a good opportunity to finance investment and consumption and to improve balance sheet resilience through debt management. Moreover, the larger capital inflows into the region are partly associated with improvements in fundamentals and therefore represent a permanent shift in investors' portfolio allocations. As such, some equilibrium appreciation of real exchange rates would be expected to ensue. The traditional macro configuration of this process, involving both a permanent and transitory component, includes some widening of the current account deficit (often reflecting higher investment and perhaps lower saving), some exchange rate appreciation (providing greater incentives for importing tradable goods and producing non-tradable goods that help limit excess pressures on domestic resources), along with greater net capital inflows to finance the larger current account deficit. High commodity terms of trade open opportunities that are similar in certain macro effects: they provide higher income to spur consumption (possibly also by the public sector) while also raising incentives for real investment to expand production of commodities, also adding to domestic demand. Moreover, high commodity export prices tend to lead to appreciation of the real exchange rate.

However, the intensity of current global circumstances, with an important transitory component, could be conducive to the buildup of substantial vulnerabilities and heightened risks of setbacks, as the double tailwinds can provide a false sense of strength. Two distinct albeit related risks are critical: an eventual high external current account deficit and the possibility of excess domestic intermediation of the financial system. (Box 1 reviews the several key channels through which low foreign interest rates and capital inflows can influence domestic demand and the current account balance, in addition to output and employment.)

In contrast to the situation of some other EMs, external current account deficits in LA pose a constraint to the region's role in global rebalancing without overstressing into vulnerable external positions. Structural features in LA are a distinct differentiating factor from other EMs. These include tendencies in national rates of saving and investment that place the region in a more vulnerable position because of current account deficits, open capital accounts that leave countries widely exposed to the current exceptional easy money circumstances, and low levels of sovereign debt that make the region an attractive destination for inflows (amid a potential perception of greater room for implicit government guarantees, as discussed below). In this context, the current juncture of prolonged easy money has the potential to substantially widen external deficits in LA, bringing the region closer to a risky external position. As noted above, the size of the required global rebalancing is clearly too large to be absorbed only by Latin America. In this context, policies that tend to limit excess absorption and current account deficits for a systemic group of EMs with existing current account deficits, including in some circumstances temporary capital account restrictions, can help enhance global stability. This is particularly relevant in a world of substantial capital account restrictions among systemic EMs and second-best policy responses in many AEs.

Box 1. How Do Low Foreign Interest Rates and Capital Flows Affect the Macroeconomy?

In a basic view, low foreign interest rates lead to capital inflows and currency appreciation—to the degree that policymakers allow such appreciation—and a decline in the current account balance and GDP. In this story:

- Foreign investors, eyeing the higher returns in an EM economy, decide to transfer more of their portfolio to that economy. In turn, the increased *flow* of foreign exchange that foreign investors bring to the FX market causes the EM currency to appreciate.
- In turn, this currency appreciation means *a loss of competitiveness and expenditure-switching occurs*: the EM is able to sell a smaller quantity of exports than before, while its own residents switch their purchases toward now-cheaper imports. With export volumes down, and domestic demand shifting to foreign goods, the EM experiences a decline in its net exports, meaning a drop in aggregate demand and GDP.
- Yet EM policymakers have *a readily-available option to resist all these developments*: by buying foreign exchange, they can reduce or even prevent currency appreciation, in turn reducing the drop in net exports and GDP. Although this policy will not stop capital inflows (and may increase them), the hope is that it will divert their balance of payments counterpart from being a larger current account deficit to being the accumulation of reserves. Finally, to avoid letting the purchases of foreign exchange have an inflationary impact, their counterpart issuance of domestic currency can be sterilized.

While the above story contains many elements of truth, it misses some very essential elements—and so risks distorting the picture of policy options and adjustment paths that are available to EMs. Among the key omissions:

- *Low foreign interest rates will stimulate domestic demand*; this additional spending induces a weaker current account balance, financed by available capital inflows. The higher spending may also bring more GDP and inflation—thus capital inflows are not inherently contractionary. (If expenditure-switching effects were strong enough to produce a net contraction, then the EM could simply cut its policy interest rate to maintain full employment by stimulating both domestic and external demand.)
- *FX intervention will sustain the incentives for capital inflows and thus cause more capital inflows to occur than otherwise*, strengthening the stimulus on domestic demand—and weakening the current account balance, as noted above. So even if intervention is able to slow real appreciation, its overall effect on the current account balance is unclear.
- *Sterilized FX intervention may need to occur at an accelerating pace* if its purpose is to hold the nominal exchange to a given objective.
- *Sterilization of FX intervention is unlikely to succeed in preventing a drop in effective borrowing costs* and a resulting boost to domestic demand. Sterilized intervention will not be able to offset the effect on domestic demand of lower foreign interest rates, since for most domestic agents the reduced external financing cost is unaffected by sterilization because of non-trivial corporate risk premia.

Together, these further considerations mean that an EM with an open capital account cannot fully insulate itself from capital inflows, and that the relevant risks are likely to be overheating and demand-driven deterioration of the current account, rather than recession. They also make clear that exchange rate flexibility and fiscal policy are highly relevant tools for containing the impact of capital inflows on the macroeconomy—in contrast to the basic view’s emphasis on avoidance of currency appreciation as the key to insulating the economy.

Large external current account deficits have been and may continue to be a critical vulnerability for LA—the size of the current account deficit merits attention separate from assessments of real exchange rates. In theory one might think of a simple mapping between current account deficits and real exchange rates -- or some concept of real exchange rate misalignment (deviation from equilibrium). But in practice, the latter is a much more difficult metric to operationalize in terms of risk, in part because of the challenges in assessing equilibrium real exchange rates.⁵ In fact, if there is one statistic that has shown to be robust in determining the likelihood of current account reversal episodes—a rapid and large retrenchment of a current account—it is the initial size of the current account deficit in EMs. And fast adjustments of the current account are almost always painful in terms of the real economy. Moreover, once the drag from the debt overhang is worked out and the recovery takes hold in advanced economies, EMs may have to cope with a swift increase in foreign interest rates (as policy rates are returned to more normal levels, and as the private sectors of advanced economies begin again to invest and require more funding). This process could be rapid and substantial when markets reassess prospects of long-term interest rates. Moreover, difficulties in a handful of countries with large imbalances could be enough to generate cross-country contagion to others with more moderate imbalances.

In the past, LA’s external current account deficits became excessive under easy external financing conditions as a result of traditional distortions and externalities, as well as policy slippages. Distortions can affect the financial sector, foreign investors, and domestic borrowers. Financial intermediation can be procyclical and exacerbate the expansionary effect of capital inflows (for example, due to implicit or explicit government guarantees). Corporate financing can become excessive if individual borrowers undertake similar actions that increase aggregate risk but are not internalized at the individual level, and foreign investors are willing to lend under those circumstances. Fiscal policy may become dangerously procyclical as revenues boom, and underlying current account balances may weaken substantially – even though headline fiscal and current account balances may not appear overly vulnerable at current commodity export prices. Moreover, even if financial sector vulnerabilities could be contained, corporates can have direct access to foreign financing to undertake investments that, even if FDI, could pose excessive external risks. The region has shown in the past that it can be prone to excess domestic demand (absorption) when foreign financing conditions are lax, linked in part to relatively open capital accounts and to access to credit by otherwise liquidity constrained agents (Figure 5).

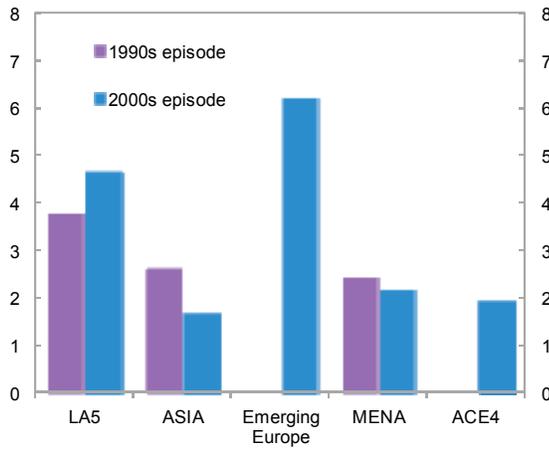
⁵ In addition to econometric and measurement issues, conceptual issues are also relevant, regarding the definition of the real exchange rate itself as well as the meaning of long-run equilibrium of current accounts. As a practical matter, there is usually no tight relationship between short-run movements in current accounts and real exchange rates; it appears that many of the short-run changes in current accounts are driven by shifts in demand. This again points to the value of monitoring and assessing demand conditions. (Some methods of exchange rate assessment are in essence current account assessments, the final results of which are translated into exchange rate terms using assumed elasticities of exports and imports.)

Figure 5. Domestic Demand and External Financing Conditions

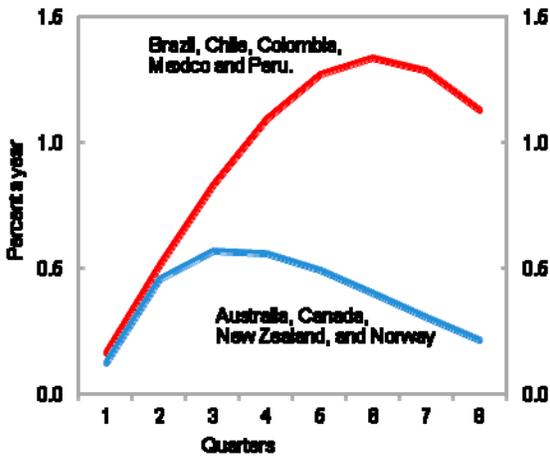
Easy external financing conditions produce accelerations of domestic demand—more so in Latin America than in advanced commodity exporting countries.

Domestic Demand Growth in Episodes of Easy External Financing

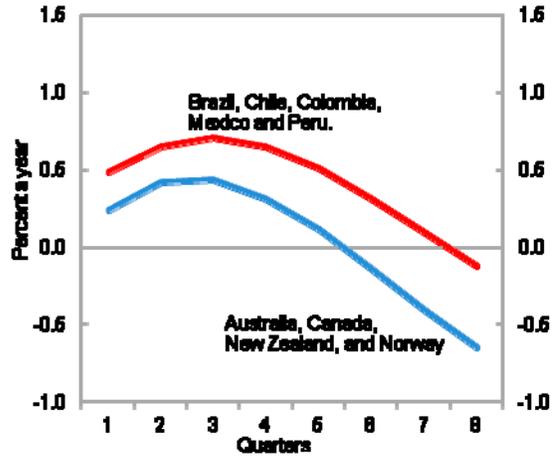
(Difference of growth rates relative to non-episode years)



Domestic Demand Response to Negative VIX Shock



Domestic Demand Response to Negative International Real Interest Rate (U.S. Treasury Bill) Shock



Source: IMF (2010a), *Regional Economic Outlook: Western Hemisphere*, Chapter 3.

The second critical concern is excessive risk taking in the financial sector leading to potential vulnerabilities. The financial sector is particularly susceptible to playing an amplifying role in the development of credit and asset bubbles and excess absorption, potentially exacerbating the impact during the later reversal of capital flows. But even if prudential measures could dampen the amplifying effect of the financial sector, corporates would still face easy foreign financing conditions and could be able to borrow directly from abroad, thus bypassing the domestic financial system. Such corporates could be prone to over-leveraging and excessive currency and maturity mismatches which, in turn, would pose risks to the domestic banks that are exposed to those companies.

The risks from financial vulnerabilities and excessive current account deficits interact and reinforce each other. Favorable external financial conditions, likely to be sustained in time, can lead to excess intermediation and credit booms during the inflow phase, which would exacerbate the forces leading to excessive current account deficits. When easy foreign financing conditions reverse, a sudden compression of absorption would undoubtedly be enough to reduce output and employment, even if the financial system were otherwise healthy; under such conditions, the subsequent recovery might be relatively quick. But a “double whammy” combining financial distress along with a current account reversal would compound the difficulty and time required for adjustment and recovery. Experience shows that the challenges associated with the resolution of financial system distress and debt overhang problems can create major dislocations and prolong the process of balance sheet repair, putting a great drag on the recovery to full employment for a protracted period (as indeed advanced economies are experiencing today). Macroprudential financial policies are essential to contain the financial sector exuberance that is ultimately the greater threat to activity and employment. Such policies may also indirectly reduce the chances of excessive current account deficits by dampening the amplifying impact of financial intermediation on domestic demand. However, even with sound macroprudential policies shielding the financial sector, excessive private sector exuberance and current account deficits can still happen if corporates can by-pass the domestic financial sector, which can increase in time if lax financing conditions are protracted.⁶

There are also concerns among a number of country authorities with the possible negative impact on growth of excessive real exchange rate appreciation. This concern relates to the potential impact on the tradable sector from currency overvaluation and its deleterious effects on overall growth, both in the short and long run. In the short term, the concern is that the positive impact of capital inflows on demand may be overwhelmed by the negative impact of appreciation on some tradable sectors, impinging on activity. In the long term, the concern stems from the negative effects of “de-industrialization” on productivity and potential growth. However, there is no clear evidence that capital inflows and

⁶ For further discussion, see Ostry et al. (2011), and De Gregorio (2010a, 2010b).

overvaluation reduce growth in LA during episodes of cheap financing, although there is some evidence that growth later suffers in those cases where the reversal leads to a crisis. In some countries, particularly in Asia, concerns about growth tend to stem from the presumed highly elastic response of exports to prices (and the inability⁷ or unwillingness of exporting firms to lower their prices in domestic currency terms in response to appreciation), leading to lower export volumes and therefore slower GDP growth in the short run. In principle, if such economic slack threatens to be large enough to be of macroeconomic significance, then monetary policy should be able to respond with interest rate cuts to help maintain full employment (unless the economy is already overheating and inflation rising, in which case the moderation of external demand might be welcomed). Nevertheless, the fear in many of these EMs seems to be that slack will develop, that domestic sources of demand may not take up the slack quickly enough, and that employment will suffer, at least in parts of their large export sectors.

In most LA countries this potential problem would be less likely, especially for commodity exports. The prices of these homogeneous goods are set in world markets, in foreign currency terms, so that exporters in a single country tend to be price takers. This means that there is no question of losing their share of the global commodity market—commodity exporting firms have no choice but to accept lower profit margins (to the extent that their costs, such as labor, are priced domestically). The bottom line is that the volume of commodity exports is likely to be maintained in the face of currency appreciation.⁸ Regarding other types of exports, another consideration is that a large share of the region’s non-commodity trade is intraregional, and there is a high correlation of currency movements among the regional trade partners that have very flexible exchange rates. Nonetheless, in the presence of a lengthy but temporary shock and sectoral adjustment costs, there is a possibility that some economic dislocations may occur, and that the flow of labor from the export sector to the non-traded goods sector cannot be perfectly smooth (see IMF 2010a). In contrast with the concern in Asian EMs that appreciations can be contractionary, the risk from easy foreign financing conditions and currency appreciation for the LA region generally stems from excess absorption and the external vulnerabilities associated with sudden reversals.

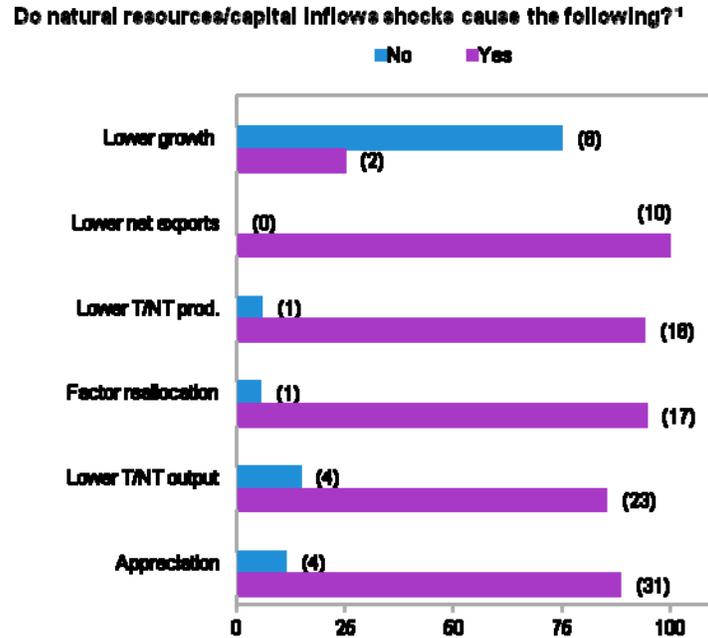
As for the possible negative effects of capital flows and currency appreciation on output in the longer run, this concern appears to be widely held but rests on structural assumptions for which there is little evidence. For a review of the literature on this subject, see Magud and Sosa (2010). Their findings are summarized in Figure 6.

⁷ Such inability might be the case in industries characterized by a high degree of competition and low profit margins, sectors that do not earn economic rents, perhaps with labor being the main element of their costs. Note that none of these conditions apply to the production of commodities.

⁸ Commodity export volumes could suffer as a result of decisions on the supply side if currency appreciation were large enough to drive prices below marginal costs of production. This is unlikely in the current environment, given the currently very high level of global commodity prices.

Figure 6. A Snapshot of the Literature on Effects of “Dutch Disease”

The literature finds that inflows of foreign capital and natural resource booms induce real appreciation, shift resources, and reduce exports—but not that this means lower growth.



Source: Megud & Sosa (2010).

¹ Percent of total observations. Number of observations in parenthesis

IV. HOW SHOULD LATIN AMERICA BUILD ITS POLICY RESPONSE?

The unusual magnitude and expected duration of today’s easy foreign financing conditions and high terms of trade for LA may require the use of many or even all policy margins, albeit in different degrees and sequencings. The appropriate set of policy responses for a Latin American economy over the next few years, while exceptional conditions persist, will depend on the nature of concerns and vulnerabilities, which in turn depend on structural and other initial conditions, including, critically, the stage in the economic cycle. In all cases, a priority is to set macroeconomic policies right. Indeed, one key message of this section is that fiscal policy needs to shift gears, leaving behind its expansionary bias during the global recession. Saving temporary fiscal revenues is paramount at the current juncture. That said, capital account restrictions could be needed in some cases, but they cannot substitute for the necessary adjustments in macroeconomic policies. They should be seen with a macroeconomic stability motivation in mind—to avoid excessive risk from large current account deficits—rather than an aim of targeting the exchange rate. Indeed the success of policies to confront today’s environment cannot be

defined in simple terms of the level of the exchange rate.⁹ In practice, the policy response is likely to need to advance on many fronts, in overlapping timeframes and at varying speeds, because of implementation lags and constraints, including in the fiscal and macroprudential policy fronts. This means that a range of policy sequencings, depending on country circumstances, can help reduce the risk of boom-busts and thereby contribute to global stability.

The most essential and high priority lines of action are to align the macro policy stance and monetary/fiscal policy mix, allow the exchange rate to move in line with the country’s cyclical position, and strengthen macroprudential financial regulation and supervision. As discussed below, the policy stance needs to reflect that in times of private sector exuberance, the public sector should not itself add more fuel to the fire. The policy mix needs to avoid placing too much of a burden on monetary policy since higher policy interest rates would attract carry trade inflows. In this context, fiscal policy should avoid being procyclical, that is, at least aim to be *acyclical*, and should be countercyclical if public debt is at vulnerable levels. Currency appreciation is generally desirable on cyclical and “defensive” grounds (to avoid one-sided bets), although FX market intervention also has some role in the response, particularly after a substantial degree of appreciation has been allowed and one-sided bets have subsided. Macroprudential policies will be an essential pillar of the policy response in all configurations.

Restrictions to the capital account could also be needed in some cases, as a complement to other policies in limiting the buildup of excessive external risks, but need to be considered cautiously. For overall consistency of policies to reduce external vulnerabilities, temporary capital account restrictions should not substitute for necessary adjustments in macroeconomic policies. Moreover, to avoid undermining global cooperation and contributing to possibly escalating rounds of new capital account restrictions by many emerging market economies, a country should consider temporary use of such restrictions, on macroeconomic stability grounds, only when commensurate to the external vulnerabilities it is facing (that is, starting from a current account deficit position and aiming to prevent excessive further growth of absorption and widening of that deficit).¹⁰ Also, a careful appraisal of costs and benefits would be needed because introducing capital account restrictions would represent a regime change for some countries and the effectiveness of

⁹A number of appropriate policies—from fiscal tightening to macroprudential measures to taxes on capital inflows— could indeed also affect the exchange rate, among other effects. Yet the exchange rate should not be seen as the center of the picture. A policy package that focuses on the level of the exchange rate is likely to miss important elements and even risks inducing perverse effects (and perhaps is unlikely to succeed even on its own terms, even when a great effort is applied and a heavy cost is paid).

¹⁰ There is a risk of EM s putting up walls against capital inflows, each motivated in part by others’ actions. Indeed, to the extent that capital account restrictions in one country divert capital flows to all other economies, countries might fear that they would face magnified inflows if they did not follow others in applying controls. See IMF (2011).

restrictions may vary. The need for a proactive policy response to contain domestic demand booms and financial vulnerabilities is related to the depth of capital markets in the country. This is because countries with shallow markets would likely have higher domestic spreads to start with (linked to their limited integration with global capital markets), and more credit-constrained agents, and therefore a higher sensitivity to an easing of foreign financing conditions. In that light, financial development in itself can help absorb external shocks.

A. Macroeconomic Policies

In a context where monetary policy may have undesirable side effects by increasing interest rate differentials, fiscal policy is an effective instrument to help address the challenges of high terms of trade, easy foreign financing, and capital inflows. Foremost, it can directly reduce domestic demand growth, limit the widening of the current account deficit, and contain real exchange rate appreciation pressures. Indeed, fiscal policy during capital inflows episodes (in the form of real spending growth) is found to be useful for achieving a soft landing after capital inflows reverse (in the form of a lower growth decline) and for limiting the real exchange rate appreciation during the boom episode.¹¹ Of course, adjusting fiscal policy is not without political challenges, and it can also introduce efficiency costs (distorting the desirable provision of public goods) if the structural fiscal position is already on a sound footing. This highlights the tradeoffs and second-best choices that are innate to the policy response for LA in the current conditions, including the feasibility of using instruments that address proximally the perceived distortions, *inter alia*, in the financial sector and the excess foreign financing push factors.

In practical terms, fiscal policy should at least avoid being procyclical; that is, it should avoid spending cyclical revenues that are the temporary result of today's environment. This advice may appear obvious, but in practice requires care in identifying which part of revenue growth is truly structural rather than merely cyclical.¹² In the current context, the likelihood is that revenues will be growing strongly for several cyclical reasons. One is that GDP will likely rise above potential output. Moreover, revenues from taxes that have domestic demand (or imports) as their base, and revenues from taxes linked to asset price gains, are likely to be boosted—for an extended period, but not forever. The danger is that such cyclical good fortune with revenues will not be recognized as such, and that all revenue growth will be permitted to trigger new expenditure. Unfortunately, such a procyclical response could happen in many countries because of the absence of established fiscal frameworks distinguishing temporary from permanent factors. Indeed, a number of fiscal policy targets in the region do not refer to cyclically-adjusted balances, nor are simpler fiscal

¹¹ See “Managing Large Capital Inflows,” Chapter 3 of October 2007 *World Economic Outlook*.

¹² The experience of some emerging European economies, in which boom conditions led to large but temporary revenue growth, illustrates fiscal procyclicality amid strong capital inflows. See Bakker and Gulde (2010) and IMF (2010c).

balance targets often tightened enough in good times. A much safer approach would be to assume that all revenue growth that is in excess of growth of potential output (prudently estimated) is temporary and cyclical in nature—unless it can be clearly attributed to changes in tax policies—and to avoid letting it trigger new spending.

In the current global setting, fiscal policy should also be careful about spending revenue gains driven by today’s high commodity export prices.¹³ The case for not spending temporary revenue gains is well known. Even where commodity price gains are perceived to be permanent—and such permanence is of course never certain—it could be advisable to avoid the immediate spending of all of such gains, particularly in the current context of overheating pressures.¹⁴ The revenue gain may allow some additional spending, but of second order effect, linked to the reduction in the government’s net debt and interest bill. Moreover, a symmetrical approach to commodity revenue fluctuations would at times mean maintaining spending when commodity prices fall sharply (spending the resources that were previously saved during a commodity boom).

Where cyclical factors give rise to temporary revenue gains that are not spent, the government will face the question of whether to accumulate financial assets or reduce its debt—and in what currencies and markets. This decision will depend, *inter alia*, on the level and structure of public sector debt and the need for liquidity buffers. Investing the temporary fiscal surpluses abroad could help to better insulate the economy from the effects of cyclical gains in fiscal revenue. Reducing domestic public debt would, under some degree of financial friction, tend to lower domestic interest rates and crowd in the private sector, thereby limiting the desirable dampening effect of fiscal tightening and resulting fiscal surpluses on domestic demand. Choosing instead to invest abroad (or to repay external debt) could be construed as a type of FX intervention by the fiscal policy authority. However, placing public savings abroad would be guided by the need to reduce the procyclicality of domestic demand, and would not limit the flexibility of the exchange rate.

In some situations, it may be desirable to actively consolidate the structural fiscal position, particularly if that position is already in need of consolidation for other reasons. These reasons would include a level of public debt not yet in a comfortable zone, factors that are expected to reduce structural revenue or raise structural expenditure in the years ahead, or that a recent active countercyclical fiscal expansion has yet to be reversed. This last consideration is especially relevant in Latin America now because the fiscal stimulus implemented in 2009—appropriate at the time of the global recession— was only partly reversed in 2010 (in some cases, further stimulus was added in 2010). Today’s setting

¹³ Such gains may come either directly from state-owned exporting companies, or from taxes on private companies whose profitability is boosted by higher commodity prices. In some cases, such revenues arise from special taxes on the exports of certain sectors (agriculture).

¹⁴ The case for such restraint is even stronger if the export commodity in question is a non-renewable resource, the national production of which is already declining or is expected to decline in the medium term.

is a perfect opportunity from a macro conditions point of view to step up the pace of such needed consolidation efforts. On the other hand, if the structural fiscal position is already at an appropriate stance, it is not clear that a temporary fiscal tightening would be desirable as the social costs of temporarily reducing the provision of public goods (or raising taxes) might outweigh the benefits in terms of containing domestic demand growth.

Although it is sometimes suggested that fiscal consolidation could attract more capital inflows, this concern seems less relevant today for Latin America. The suggestion is that fiscal consolidation might dramatically improve investor confidence and make the country's assets more attractive. However, the scope for such an effect is limited by the already high degree of investor confidence in the solvency of public sectors in Latin America, as indicated by already low bond spreads and the historically high number of investment grade ratings.

B. Exchange Rate Policies and Exchange Market Intervention

In the current global context, it is almost inevitable that real exchange rates in Latin America will appreciate, either nominally or through inflation, relative to those of advanced economies for cyclical reasons. Indeed, this process is already well under way. To the extent that the drivers of this appreciation are cyclical, the near term equilibrium exchange rates will be stronger than the future equilibrium values. In that sense, currencies will be for some time at levels that could be seen as "overvalued" if only medium-term norms were considered. Moreover, to the extent that some of the capital inflows are permanent associated with improved fundamentals, a more persistent equilibrium real appreciation is also expected to ensue.

While there may be legitimate concerns about such temporary cycles of the real exchange rate, it is important to recognize the inevitability of their occurrence and the cyclical usefulness and benefits of real appreciations. Precisely because it occurs at a time of high domestic demand and incipient overheating pressures in many countries of Latin America, the danger that the expenditure-switching effects of appreciation could cause a shortfall in aggregate demand and a recession is dispelled. On the contrary, such expenditure-switching will be a safety valve, providing incentives to channel spending to foreign sources, thereby helping to avoid domestic demand feeding into inflation.

With some degree of real appreciation being inevitable, key questions are whether it will occur primarily through the nominal exchange rate, potentially very quickly, or through higher inflation, perhaps more gradually, and what would be the effect on the magnitude of inflows. Yet this is not to say that real exchange rates, capital inflows, and other macroeconomic outcomes will turn out the same with either approach. As discussed below, this question of exchange rate policy choices can be decisive in the response to capital inflows. For example, it is possible that a policy of resisting nominal appreciation would bring in much more capital inflows than otherwise, resulting in greater absorption and a larger current account deficit.

Today, a number of Latin American economies have the advantage of policy frameworks with floating—or very flexible—exchange rates. Allowing substantial flexibility of the nominal exchange rate, including appreciation in response to waves of capital inflows, is a near-automatic way to help limit the size of capital inflows. Currency appreciation acts to reduce the incentives for new inflows as it facilitates expectations of depreciation; equivalently, it raises the price of acquiring assets that would otherwise appear cheap. Critically, exchange rate flexibility deters currency mismatches by making exchange rate risks apparent. This is not to claim that currency appreciation alone will immediately choke off all (net) capital inflows or carry trade incentives, as a simple “overshooting” argument might suggest.¹⁵ The point is that exchange rate flexibility will help reduce incentives for capital inflows,¹⁶ whereas an alternative policy of active FX market intervention would help sustain such incentives.

Moreover, cross-country experience shows that nominal exchange rate flexibility is associated with smaller booms in domestic demand—indeed, less sensitivity of domestic demand to fluctuations in global financing conditions. During past episodes of easy international financial conditions (e.g., 1991–96 and 2004–07), countries with more inflexible exchange rate regimes exhibited a larger domestic demand boom (with respect to their own trend) vis-à-vis countries with more flexible regimes. This finding is influenced by, but is not exclusively due to, the performance of fixed exchange rate regimes. Furthermore, the contractionary adjustment of domestic demand that occurs when easy money conditions end is considerably larger (again, with respect to countries’ own trend) if a country has had a more inflexible exchange rate regime during the boom (Figure 7).¹⁷

The alternative policy of trying hard to resist nominal appreciation via very active FX sterilized intervention may have limited effectiveness, and can have perverse effects—particularly if deployed “too early” in the policy response process. The effectiveness of sterilized FX intervention—in terms of its goal of influencing the nominal exchange rate—is rather unclear, or at best difficult to gauge, and such uncertainty needs to be considered against the costs of intervention, particularly of its sterilization.¹⁸ In fact, in contrast with

¹⁵ See Brunnermeier, Nagel, and Pederson (2009) on why carry trade flows are instead sustained over time.

¹⁶ See IMF (2010b) for evidence on how exchange rate flexibility moderates capital inflows (*Global Financial Stability Report*, chapter 4, April 2010).

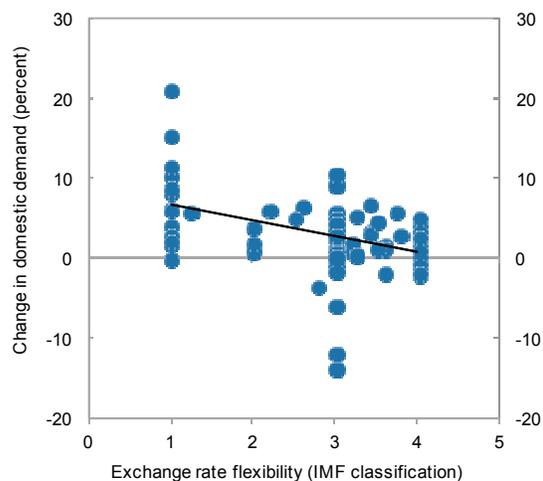
¹⁷ See IMF (2010a) and Canales-Krilijenko (2010).

¹⁸ Sterilization costs arise from the differential between the interest rate that central banks earn on international reserves and the (typically higher) interest rate they pay on the domestic debt used to sterilize intervention. The cost of intervention depends also on valuation gains/losses resulting from subsequent exchange rate movements. The interest rate differential can be thought of as representing two elements: the *expected* rate of depreciation of the currency and a risk premium. In principle, a central bank’s losses on the interest differential will be partially offset—on average—by valuation gains on the reserves that it acquires through sterilized intervention, as its own currency tends to depreciate. In practice, however, such depreciation is uncertain to occur. If the currency subsequently appreciates, then valuation changes will add to, rather than reduce, the cost of intervention.

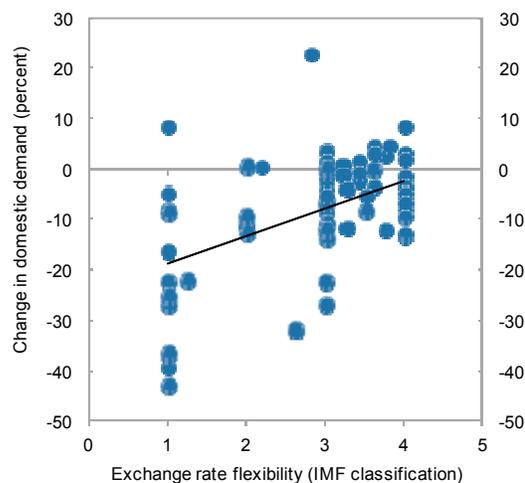
Figure 7. Domestic Demand Booms and Exchange Rate Flexibility

Economies with less exchange rate flexibility experience greater expansions of domestic demand growth during episodes of easy external financing—and also experience greater contractions of domestic demand when global financing conditions tighten.

Expansions in Episodes of Easy Money¹



Contractions in Periods of Tight Money¹



Sources: Canales-Kriljenko, 2010; based on IMF, *International Financial Statistics*

¹ In a sample of 42 advanced and emerging market countries. Periods of "easy money" include 1991–96 and 2004–07; periods of tight money include 1997–98 and 2009.

the evidence about fiscal policy, IMF research suggests that resisting a nominal appreciation does *not* limit the REER appreciation during capital inflows episodes, but does have a negative effect on GDP, with a larger drop in activity after the boom.¹⁹ Intervening too soon (when appreciation expectations are strong and the domestic currency is relatively cheap) is likely to be self-defeating, triggering more capital inflows to fuel domestic demand and widen the current account deficit. It would therefore be important to wait until the currency is clearly on the strong side so that intervention may get better traction. In judging this, it is essential to recognize that the equilibrium REER may have appreciated from past levels, both on cyclical and secular grounds. This includes terms of trade well above historical levels, and which may remain that way for a protracted period.

It is sometimes asserted that sufficiently large FX intervention, provided that it is fully sterilized, would be able to insulate an economy from the effects of cheap foreign money, but in practice domestic financing conditions will be loosened. Domestic credit conditions are bound to be relaxed, invigorating domestic demand (as will be discussed further below). This is because some agents, particularly larger corporations and financial institutions, will be able to obtain cheap credit directly from abroad (perhaps even import financing that will not even flow in as cash). In principle, a central bank could continue hiking its policy interest rate to limit overall domestic demand but, since capital inflows are

¹⁹ See IMF (2007), chapter 3 of *World Economic Outlook*, "Managing Large Capital Inflows."

partly endogenous, this would likely trigger even more rapid inflows and stimulate an ever-greater switch by domestic agents toward foreign funding sources.

That said, foreign exchange intervention could be part of the toolkit, particularly if deployed once the appreciation has run its course to increase effectiveness and when designed to limit potential counterproductive effects. Intervention, after the exchange rate is perceived to be clearly on the strong side, is more likely to be effective—and not simply in influencing the exchange rate, but also in trying to dampen or break a cycle in which rising animal spirits, capital and credit flows, domestic demand and asset prices reinforce each other—including by signaling the authorities’ special assessment of a concerning situation. Intervention that begins too soon or is routine loses these advantages. In any intervention strategy it would be essential to protect exchange rate flexibility so that one-sided bets do not become entrenched. Some basic parameters can help in the design of such intervention, including avoiding fixed target prices that can invite markets to test the commitments, and keeping intervention focused on the amount of foreign exchange to be bought, particularly when designed with an announced end date to give a natural way back to full floating.

Given that problems of reserve adequacy generally are not a major issue in Latin America at this point, intervention needs to be guided by other metrics. If a country has limited international reserves, intervention could be beneficial for building a safe buffer. However, because the region generally has relatively comfortable buffers according to traditional metrics, intervention decisions would be more judgmental depending on the scale of the problem, which should be measured by the size of net inflows and the current account deficit. Countries with higher deposit dollarization may want to consider some more “leaning-against-the-wind” to limit the possibility of a large depreciation when conditions reverse. However, one should be mindful that exchange rate volatility and appreciation tend to lower dollarization and heavy intervention may hold back this process.

C. Macroprudential Policies

Because intense and prolonged easy foreign financing conditions are conducive to credit and asset bubbles, a solid microprudential (MiP) framework and strengthening macroprudential (MaP) policies would be essential to ensure financial resilience and to reduce financial procyclicality. The resilience exhibited by the financial sector in LA during the recent global financial crisis should not be reason for MiP complacency in the present context (and amid continued financial development in the region). Moreover, MaP should be used to tackle systemic risk and dampen financial procyclicality, reducing vulnerabilities from maturity and currency mismatches and containing risk taking and the softening of lending standards. As the recent financial crisis made evident, liquidity risks need to be addressed in good times (when market functioning is not impaired and perception of liquidity is prevalent) to avoid morphing into solvency problems under duress. Macroprudential policies, by limiting financial procyclicality, would contribute to reducing the impact on credit and absorption. Countries that have chosen to allow lesser degrees of currency

flexibility, in light of substantial dollarization, may need to resort to greater use of macroprudential policies. But MaP is not a silver bullet and it cannot substitute for the essential monetary, fiscal, and exchange rate policies discussed above. For cases where inflows are primarily channeled through the financial sector, MaP may in effect be enough of an effective barrier to counter the adverse macroeconomic vulnerabilities arising from excess capital inflows.²⁰

MaP design should consider at the same time both broad oversight and targeted interventions, and these should be embedded in an institutional set up. To avoid distorting markets or segments not affected by over-exuberant conditions, prudential measures should aim to “lean against the wind” in the specific sectors concerned at a particular juncture. For example, higher reserve requirements and dynamic provisioning could help if overall credit is expanding rapidly, but higher loan-to-value ratios are useful if real estate credit is the segment expanding too fast. If the problem is risk taking by intermediaries, regulations could address funding risks. If exchange rate mismatches at the final borrower level are a source of concern, prudential regulations could incorporate the credit risk born by the currency mismatch at the borrower level. Given the new nature of using prudential instruments for macroeconomic risk management purposes, constrained experimentation may be needed to explore effectiveness while taking into account potential negative side effects on financial sector development.²¹ A broad-range oversight is needed because conditions of excess leverage can occur in any segment of the financial system (regulated or shadow) with material externalities to the rest of the system and the overall economy. Macroprudential oversight therefore should encompass the entire financial spectrum and may also require monitoring the balance sheet of the corporate sector. Given that there is an overlap of responsibilities and instruments in the conduct of macroprudential policies, it would be important to adopt an institutional mechanism with clear mandates, transparency, and principles for coordination. Because a macroprudential framework cannot only be rules based—it would be impossible to calibrate the appropriate tools for all circumstances—the approach would require some degree of judgment.

D. Capital Account Restrictions

Macroeconomic and MaP policies can be insufficient to contain risks in a context where the shadow banking sector can intermediate capital flows and where corporations have direct access to foreign financing, thereby feeding excess private sector absorption. As

²⁰ IMF (2011) and Ostry et al. (2011) discuss conditions in which MaP may be insufficient and need to be complemented by capital account restrictions. IMF (2010d) discusses MaP in the Latin American context.

²¹ Latin America has been at the forefront of macroprudential policies, even before the global financial crisis, with many countries in the region having already in place dynamic provisioning and prudential liquidity buffers in the form of reserve requirements. Financial stability committees are being studied or set up, while work is underway in many countries to implement Basle III, including countercyclical and systemic capital surcharges. (See IMF (2010d), *Regional Economic Outlook: Western Hemisphere*, October 2010.)

discussed above, even under fully sterilized intervention, lower international interest rates would effectively loosen domestic financing conditions, since corporates and financial institutions with direct access to foreign financing would face lower interest rates while sterilized intervention would maintain the domestic interest rate unchanged. Moreover, excessive credit expansion may be exacerbated by banks loosening their lending standards. Easy external financing conditions would in the end spillover into domestic demand and excessive external current account deficits, which raises the issue of how then to counter the buildup of vulnerabilities.

In the present context of extraordinary external circumstances, a temporary recourse to capital account restrictions could be needed if the external current account deficit threatens to reach clearly unsustainable levels. A first principle for the use of capital account restrictions is that it should be temporary, limited to extraordinary circumstances only. A second principle is that they should not be used as a barrier to the healthy and necessary part of the external adjustment that was discussed above, but only when justified by serious concerns about stability. A third principle is that capital account restrictions should not substitute for basic adjustments to macroeconomic policies and the strengthening of MaP in bubble-prone sectors. However, those essential policy responses may not suffice, and they are likely to face implementation lags and constraints. Given Latin America's existing external deficits and recent trends, there are limits to how much more current account deterioration can be safely tolerated. If macroeconomic and financial policy adjustments are not enough to contain the expansion of domestic demand, countries may need to resort to capital account restrictions. In practice, to determine when deteriorating external positions are becoming a concern, it would be important to focus on estimates of underlying current accounts, stripping the cyclical components and temporary terms of trade fluctuations. The objective of capital account restrictions would be to effectively increase domestic interest rates to contain excessive private demand growth.

Given the above considerations, capital account restrictions would need to be designed to take into account country conditions and be applied on a broad basis. This comprises, *inter alia*, taking into account the degree of integration into capital markets (including development and credibility barriers); the extent to which introducing capital account restrictions would represent a regime change for the country, with damaging collateral effects; the institutional capacity to implement and administer such restrictions; and willingness to apply them broadly across sectors and instruments (including FDI) to avoid leaving entryways open that can lead to a high degree of circumvention (and potential bubble conditions in particular segments and markets). In short, feasibility and effectiveness of capital account restrictions cannot be presumed, but will vary in practice. The evidence in the literature about the effectiveness of capital controls tends to support this view: controls are likely to have some effect, particularly on the composition of capital inflows (even if some of this may reflect a shift in recording). The evidence on the effect on the total volume of inflows is less conclusive, possibly reflecting the narrow or selective coverage of controls typically applied in practice. Many studies have also concluded that the effectiveness of

controls tends to diminish over time as methods of circumvention develop, so that an ongoing effort to tighten the policy and its administration may be needed to maintain effectiveness. In this connection, it seems likely that willingness to implement a wide coverage of restrictions on capital account flows may be essential.

V. CONCLUDING REMARKS

The Latin American region is facing exceptional global circumstances that are causing large and prolonged capital inflows into the region and high terms of trade. The appropriate policy response for Latin America to this exceptional alignment of global circumstances is an array of policies: allowing flexible exchange rate regimes to play their cyclical role and defensive part against easy foreign financing; pursuing fiscal policies that are at least acyclical; proactively strengthening microprudential frameworks and introducing macroprudential policies that shield the financial sector and reduce procyclicality; and, in some circumstances, to avoid excessive risk from large current account deficits, using capital account restrictions to preserve macroeconomic stability. Such potential temporary recourse to capital account restrictions in Latin America should be seen as a defensive move to prevent future crises, thereby contributing to global stability in a world of second-best policies. In practice, the policy response is likely to need to advance on many fronts at varying speeds because of implementation constraints and lags, including on the fiscal and macroprudential policy fronts. Capital account restrictions, however, should not substitute for essential adjustments to macroeconomic policies and the strengthening of macroprudential policies.

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