International Coordination in Addressing Spillovers: Problems and Solution Strategies

Ila Patnaik
National Institute of Public Finance and Policy, New Delhi

CAFIN Workshop, April 25-26, 2014, UC Santa Cruz
Spillovers

Unconventional monetary policy in AEs said to affect
- net capital flows
- equity prices
- bond yields
- exchange rates
Net capital flows to EMs

2006 2008 2010 2012
200 300 400 500 600 700
Billion USD
Net capital flows
QE1 announcement
QE2 announcement
QE3 announcement
Asset price boom
Monthly stock market closing value, Indexed to 100 in 2006
Exchange rates appreciation, followed by depreciation

Nominal exchange rates, Indexed to 100 in 2006
Central banks intervention

Foreign exchange reserves

USD Billion

Korea
India
Brazil
Mexico
Thailand
South Africa
EM Average
QE1 announcement
QE2 announcement
QE3 announcement

2006 2008 2010 2012
Interest rate response

EM treasury bill rates, 3M to 6M

- China
- India
- Mexico
- Thailand
- South Africa
- EM Average

QE1 announcement
QE2 announcement
QE3 announcement
Some EMs imposed capital controls

Chinn-Ito Score
EM argument for coordination

- AEs monetary policies have negative externalities.
- EMs suffer for no fault of theirs.
- AEs should coordinate because the negative impact on EMs feed back to AEs as well.
Areas of disagreement

▶ Evidence on total impact of UMP on EM GDP not known to be negative. The Fed models do not show negative externatilities.
▶ In the present legal framework and mandate of independent central banks and MPC and FOMC structures, there is limited scope for monetary policy coordination.
▶ Mandate of the US Fed is domestic inflation and unemployment.
▶ Impact on EMs heterogenous. Those with weak fundamentals suffered. EMs must, therefore, put their own house in order.
Some countries were more vulnerable than others

High inflation countries seem more vulnerable

![Graph showing the relationship between CPI inflation and % change in currency value for various countries.]

- Countries listed: CN, CZ, HU, KR, PL, BR, CL, IN, ID, MY, MX, PE, PH, RU, ZA, TH, TR

- The graph compares CPI inflation (% change) with % change in currency value for different countries.
Some countries were more vulnerable than others

Negative current account balance EM’s were more vulnerable
Some countries were more vulnerable than others

Fiscal discipline matters
What is possible today?

Areas for coordination in monetary policy:

- Central banks publish forward guidance
- Technical assistance to EMs to assess risks such as those arising from aggressive versus delayed tapering.
Does currency management protect EMs as a group?

- When currency management is tried or capital controls are imposed by one country, capital flows would get pushed towards another country.
- Beggar thy neighbour: Imposing controls could, in principle, benefit one country at the cost of its neighbour.
- Imposition of controls by one country encourages other countries to impose them. There is the risk of retaliation such as currency wars or trade barriers.
Currency wars?

▶ Individual countries may come under short-term political pressures.
▶ Actions taken by one country, under stressed market conditions, may adversely affect confidence worldwide.
▶ Financial markets would be in the position of guessing the responses of each country.
▶ Currency management is an acceptable tool today. But does it help EMs as a whole?
Proposal

* In order to rule out these possibilities, EMs should require to only move in a coordinated manner on:
  1. Exceptional exchange rate policies
  2. Capital controls
  3. Trade barriers

* Any actions in these three fronts should only be taken in a coordinated manner by all countries.

* Today each EM is on its own. And, protective policies only hurt each other. But if they respond jointly their actions could have more influence and work through the negative feedback loop that includes the reaction of EMs, impact AE behaviour.
Regulatory changes
Financial and regulatory reform

- The G20 played a key role in transforming Financial Stability Forum (FSF) into the expanded Financial Stability Board (FSB)
- The G20 has not actively monitored government’s progress in financial reform process. Bradford and Lim (2013) argue that given the IMF’s mandate, the FSB should take the lead on financial reform
- Callaghan (2013) has proposed the creation of a new “Minister of Finance and Central Bank Governors Committee on Financial Regulation” and that Spring meetings of G20 MoF’s are devoted to reviewing the FSB agenda
- Okubo (2013) has argued that the need for cohesion and harmonisation in regulating financial markets is greater than it was 5 years ago at the time of the GFC, with the G20 having a major role in creating a policy space for coordination
Domestic Financial and regulatory reform

- Initiatives in India: New law and regulatory architecture proposed. But there are serious capacity constraints.
- Proposed area of cooperation: Capacity building in regulatory bodies, legal reforms and support for mechanisms for systemic risk regulation should be supported by agencies like the IMF, AEs, G20 etc.
Measuring and monitoring systemic risk
1. Data and information

Aim: To create and manage a centralised, detailed, high-quality database of financial activity to support regulation data needs in every country.

- Consistent data collection helps regulators and market participants assess / respond to sources of systemic risk
- Data essential to identify indicators/early warnings of crises and design tools for mitigation
- Collection and collation of data should be from regulated and unregulated entities
- Management involves inventory, validation, standardisation and safe storage
- Obtain state-of-the-art analysis of the data
- Dissemination securely to other regulators and public as required
Example: the US OFR

- Office of Financial Research set up by the Dodd-Frank Act within the Treasury
- Statutory mandate for data and research functions within the Act:
  - Data and analysis support to the Council
  - High quality research
  - Promotion of data related standards
  - Publication of data and reports
  - Management of human and financial capital to build the OFR
2. Global information systems for systemic risk monitoring

The problem:

- Systemic risk regulation is rooted in systemic risk measurement
- Systemic risk measurement is increasingly a complex cross-border activity given the internationalisation of finance.
- Authorities in any one country have a limited view of the activities of financial firms and the positions on markets.
- This hinders the ability of the authorities in any one country to understand the situation.
- It also hinders G-20 scale coordinated analysis and actions on systemic risk that are unfolding on the global scale.
A step towards the solution

- Some countries are constructing unified databases which capture a full picture of the financial system, for the purpose of systemic risk measurement.
- How can financial firms with activities in more than one country be monitored?
- Project on unique key number for each financial firm is underway.
The logical next step is ‘International Financial Data Reporting Standard’ (IFDRS) which should be a set of data standards and data exchange protocols through which:

1. Data formats and protocols for electronic filing across countries are harmonised (thus reducing costs of compliance, data management and analysis)
2. Electronic protocols for data exchange between regulators.
3. A structure of MOUs is established between countries governing data exchange
Macroprudential policy coordination: Database and research
Areas for coordination in macro prudential policies

- Capital flow measures have included both capital controls and macro prudential policies.
- No single data base of macro prudential policies.
- Effectiveness of macro prudential policies inconclusive evidence and research.
Macroprudential policies

<table>
<thead>
<tr>
<th>Policy tools</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Changes in reserve requirements</strong></td>
<td>Brazil (2010), China (2010), Peru (2010), Russia (2009), Taiwan (2010), Turkey (2010-11)</td>
</tr>
<tr>
<td><strong>Real estate measures</strong></td>
<td>China (2010-11), India (2010), Hong Kong SAR (2009-10), Korea (2009), Malaysia (2010), Hungary (2010)</td>
</tr>
<tr>
<td>Lowered LTV ceiling, DSR and caps on DTI for mortgage loans</td>
<td></td>
</tr>
<tr>
<td>Ceilings on FX positions, additional capital requirements for FX credit exposure</td>
<td></td>
</tr>
<tr>
<td><strong>Elements of dynamic provisioning</strong></td>
<td>China (2010), India (2009-10), Israel (2010), Mexico (2010), Turkey (2009-10)</td>
</tr>
<tr>
<td>Countercyclical provisioning scheme, capital buffers on loans</td>
<td></td>
</tr>
<tr>
<td><strong>Taxes on capital inflows</strong></td>
<td>Brazil (2009-12), Korea (2011), Peru (2010), Thailand (2010)</td>
</tr>
<tr>
<td>FX loans, FX investment on short-term currency futures, FX investment on fixed income</td>
<td></td>
</tr>
<tr>
<td><strong>Reduced deductibility of interest expenses on foreign debt</strong></td>
<td>Colombia (2010), Russia (2010)</td>
</tr>
<tr>
<td>Interest rate ceiling on external borrowing</td>
<td>India (2009-10)</td>
</tr>
</tbody>
</table>

Source: Pereira (2013)

1 measures reversed in 2011; 2 measures reversed in 2012; 3 measures reversed in 2011

Table: Macro-Prudential measures
Effectiveness of macro prudential policies

- New evidence from Forbes (2013) and Pasricha (2013) confirm that CFM’s very rarely achieve their stated macro-economic objectives even if they might have unintended effects on other financial stability variables.

- Forbes (2013) shows that macro-prudential policies are more effective than CFM’s in fulfilling their macro-economic objectives. Macro-prudential measures can significantly improve specific measures linked to financial fragility, such as bank leverage, inflation expectations, bank credit growth, and exposure to portfolio liabilities.

- Macro prudential policies and CFM’s are hard to differentiate if they are used under the unclear objectives of maintaining financial stability.
Macroprudential CFM’s
Most measures are pure capital controls, not prudential-type measures; Pasricha (2012)
Areas for coordination

- Classification-Databasing-Research-Coordination of macro-prudential measures
- Collecting and making publicly available data on macro prudential policies
- Research on effectiveness of different kinds of macro prudential policies.
Prospects for international coordination

- Monetary policy coordination
- Currency wars and capital controls
- Cooperation on regulatory changes
- Systemic risk: measurement and monitoring
- Macroprudential policies: databases and research
Thank you