Emerging Markets in the New Normal: Challenges for Macroeconomic Policies*

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October 2019

It is a pleasure and honor to be in this very important and timely conference and to deliver these closing remarks. As you may guess, in the last few weeks I have had problems to think about the financial cycle, while my country has been through a social crisis of unprecedented dimensions. However, this crisis also offers lessons for the whole emerging world about the perils of inequality on stability and growth, and I want to start with some remarks on these issues.

Social inclusion and macroeconomic stability: lessons from Chile's turmoil

Chile has an economy that have had significant economic and social progress since the return to democracy, about three decades ago. However, despite inequality has declined, it is still high. But beyond inequality of income there is the well-grounded perception of a large gap in many aspects of life between the elite and the rest of population, those, for example, that use a poor public transportation system. There has not been a clear sense of urgency to solve central social problems such us low pensions, low wages and meager health services for the poor and the middle class, among others. Not tackling these problems on time accumulate tensions, which may have pernicious effects on public finances, a cornerstone of social and economic progress. An important component of the solution to Chile's urgent and fully justified social demands is a significant fiscal expansion, where transitory components can be accommodated, but there is a need to finance the permanent components in order to preserve fiscal soundness and to avoid the return to the traditional fiscal cycle that has been the malaise in Latin America. I am optimistic, but we need to work hard since all problems cannot be solved at once.

Social discontent is particularly important as growth has declined. Strong growth provides enough benefits to the population that some inclusive reforms can be postponed. However, as basic growth theory teaches us, as income rises, a deceleration of growth should take place. In this context it becomes particularly important to focus on inclusion and inequality to continue a path of progress at more moderate rates of growth. This is an important lesson for high growth emerging market economies (EMEs), many of which are in Asia: do not postpone social

* Closing remarks ate the conference BOT-IMF High-Level Conference entitled *Emerging Markets in the New Normal: Dealing with Rising Domestic Leverage and the International Financial Cycles* on November 5, 2019 at the Bank of Thailand (BOT).

inclusion and reforms, because high growth will not last forever and we can fall behind of the curve of social progress.

In Chile poverty has declined from levels close to 50% thirty years ago to below 10% currently, and extreme poverty has been almost eradicated. However new demands surface and not facing them on time can have very negative consequences, as the temptation for populist policies or the return to old and failed recipes resurface with large popular support.

Therefore, social inclusion and reducing inequality should be considered when designing financial and macroeconomic policies not just for its ethical dimensions, but also as a need to maintain stability and foster growth. Good financial policies and a stable economic environment are necessary conditions, but clearly not sufficient, to reach the elusive task of development.

Now, let me move to some remarks on how emerging market economies should tackle efficiently the global financial cycle.

The standard framework and exchange rate flexibility

Most EMEs today follow inflation target regimes (IT) with flexible exchange rates, where the monetary policy interest rate is adjusted according to an inflation forecast in a medium-term horizon. The degree of financial integration varies from country to country. However, the evidence shows that as countries develop the degree of financial integration increases as there is a greater need for portfolio diversification, and therefore countries must be well-prepared for this process.

IT regimes were one of the reasons why EMEs performed much better during the global financial crisis than in previous ones, in particular during the Asian crisis. Allowing exchange rates to adjust was perhaps the distinctive difference with previous episodes. Moreover, there is no evidence that using capital flows management during or before the crisis made a significant difference across countries.[1] The strength of EMEs financial markets, caused by strong financial regulation, much stronger than in many advanced economies (AE), made their financial systems resilient during the crisis as global financial conditions, exchange rates and asset prices fluctuated sharply.

However, in recent years several developments have led to think that this benchmark framework needs to be reconsidered. In a world of persistent low interest rates and highly liquid global financial markets, search for yield and volatility of capital flows may pose serious

[1] See Alvarez and De Gregorio (2014) and De Gregorio (2019). For evidence before the global crisis see Gonçalves and Salles (2008).

risk to stability and impair the monetary policy transmission mechanism in EMEs. Financial factors may play an increased role in local business cycle.[2]

Additional measures as well as deviation from the standard framework may be needed. I prefer to talk about the standard framework and deviations as well as complements to it rather than distinguishing between orthodox and heterodox measures. This is not just to remove a sometimes ideological and vacuous differentiation, but also because I think it is better and more rigorous to talk about a benchmark and deviations from it. This allows us to be clear about what are the particular problems we want to confront. For example, it is desirable to have a flexible exchange rate, but under some special circumstances it may be desirable some form of exchange rate management.

Indeed, at the core of the discussion macroeconomic policies is precisely the exchange rate regime. Many years ago, Calvo and Reinhart (2002) pointed to two main reasons why countries would be reluctant to float, in particular, to allow for depreciations. One was the inflationary consequences of depreciations and the other their financial effects. The fear of floating can be overcome with a credible inflation target regime and with strong financial regulation. And this has happened in most EMEs. We have seen sharp fluctuations in the last decade, such as that during the taper antrum episode in 2013, and inflation remained within reasonable limits while financial markets were able to absorb the depreciation. The low pass-through from exchange rate to prices have declined, and most of them vanish during the policy horizon of monetary policy, so there is limited need to tighten when depreciations take place (De Gregorio, 2016).

Moreover, fighting depreciations with monetary tightening could induce a speculative scalation of hiking rates and weakening currencies. An extreme case was what happened in Argentina in 2018, where monetary policy tightening, and a weakening currency led the economy to a severe recession with very high inflation. Of course, this is not the case of Asian countries and most of EMEs, but it is a cautionary tale that reminds us unnecessary contractionay policies during the Asian crisis.

Foreign exchange intervention and competitiveness

Perhaps the most compelling reason to manage exchange rates is that periods of persistent appreciation my lead to hysteresis and permanent loss of competitiveness. This view has developed due to the success of export-led growth strategies in Asia.

This tension becomes particularly important during periods of increased risk appetite and massive capital inflows to EMEs. The consequence is an activity boom, a strong currency, rising asset prices and current account deficits.[3] Despite inflation may be within target, there is

[2] See Claessens and Gosh (2016) for policy implications. A more skeptical view can be found in Cerutti et al. (2019).
[3] This was also what happened during the commodity price boom of the early 2000s, but the difference is that there was a significant current account improvement.

usually a temptation to tighten.[4] We can think this as the leaning against the wind (LAW) prescription applied to EMEs. However, tightening could exacerbate capital inflows as interest rate differentials widen and carry trade incentives increase. Whatever the reasons for LAW in AE, they become less relevant when considered episodes of capital inflow surges in small open economies (SOEs) because of increased carry trade.

In order to limit the appreciation, foreign exchange intervention (FXI) may be desirable.[5] Without subordinating monetary policy to an exchange rate objective, sterilized intervention may help. Effectiveness of exchange rate intervention varies from country to country, but when the currency is strong it is also a profitable moment to build up foreign exchange reserves that are necessary to build a cushion against fluctuations in global financial markets. As you may guess, I am quite asymmetrical in my view on managing the exchange rate. As a general, no absolute of course, prescription, consider intervening only in periods of strength and let it float when weakens, because fear of floating is quite damaging fro credibility and sound monetary policy.

Macroprudential measures and capital flows management

When faced with massive capital inflows authorities may consider additional measures, in particular since monetary policy as well as FXI are not well equipped to tame the financial cycle with its consequences on real activity. Fiscal policy is an option, however most of the times have no sufficient space to tighten. Here is where macroprudencial policies (MPM) and capital flow management (CFM) can be utilized. I start from the presumption that financial systems are strong and well-regulated by microprudential regulation, so additional measures should be understood in the context of countercyclical policy measures.

There is a wide variety of instruments that may be used. Nevertheless, the main difference between MPM and CFM is that the former discriminate against cross-border transactions, and therefore in addition to safeguard financial stability it also is used to limit currency appreciation, although its effects have shown to be elusive. In addition, it is important to realize that these policies should be complement to standard policies, and deviations have to be transparently communicated.

In Latin America, in the cases on Chile in the 1990s and Brazil after the global financial crisis, the surge of capital inflows was exacerbated, if not mostly caused by, very high interest rate differentials. The application of capital controls hid the big distortion of monetary policy. Another problem with CFM measures is that they discriminate among different type of inflows. The rationale for this is correct, since debt is, for example, more volatile than foreign

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[4] It is paradoxical that inflation nutters want to tighten when the currency depreciates to avoid inflation and when the currency strengthens to stem the expansion.

[5] Indeed, the evidence shows that countries accumulated reserves not only to insure themselves from global financial shocks, but also to protect competitiveness during the commodity price boom (Cabezas and De Gregorio, 2019).

investment. However, this discrimination opens the door for different type of loopholes, that may undermine the effectiveness of CFM.

A recent issue that has been a focus of concern is the rise in leverage by non-financial corporations in EMEs.[6] As global interest rates have declined, many corporations have issue foreign exchange denominated debt in international financial markets. As long as it finances investment and debt restructuring it is a positive development. It cannot be ruled out that some of this borrowing could be unhedged and threaten financial stability. Before adopting policy measures, it is crucial to understand the reasons for increased leverage and the consequences of changing global market sentiments. A careful assessment through stress testing is essential for sound policymaking.

A final issue regarding financial stability which I would like to comment is the boom of house prices in many countries. This is in part consequences of the secular decline in interest rates. This is not only a financial concern since it has also social implications as buying a house becomes a serious problem for many young people. This is a challenge for policymakers since there is a need to balance the tradeoffs between financial stability, for example via reductions in loan-to-value ratios, and housing affordability, and polices should move much beyond financial regularion.

Final remark

Many of policies in EMEs to deal with the financial cycle are related to the need to avoid excessive appreciation of the currencies. This can be also the result of high commodity prices as the recent boom shows. This has been at the center of the discussions we have had today, but there are inconsistencies in the policy prescriptions for EMEs and large and systemic ones.

Small EMEs policies do not have spillovers on the global economy, but FXI or CFM done by large economies could be considered currency wars or currency manipulation. Clarifying the extent of currency management is still an unresolved issue among international financial institutions and major economies in the world. It is not enough to say that due to the negligible income that SOEs have on the global economy this inconsistency is irrelevant. First, because there could be spillovers at regional level, and second because if this is done simultaneously by many SOEs, they may add up to a large one.

I do not have a clear answer to this conundrum, since I do think EMEs should protect themselves from the global financial cycle. They can also choose policies that consider to be appropriate given their level of development and deepness and soundness of domestic financial systems. However, the global economy needs adjustments and these adjustments are by nature heterogenous across countries.

[6] See for example IMF (2017).

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