

# How emerging markets deal with global spillovers

The developing world cannot rely on a single instrument – the interest rate – to deal with both the domestic business cycle and the global financial cycle

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Traditional development theory took a benign view of capital inflows into developing countries as these filled two critical developmental gaps, namely a savings-investment deficit, and foreign exchange scarcity. While developing countries continue to require large amounts of external savings to supplement their own to accelerate growth and development, a rapidly globalising world with large external imbalances, sophisticated financial markets and growing spillovers of US monetary policy also results in large, volatile capital flows leading to misaligned and volatile exchange rates, sudden stops and external payments crises that threaten macro-economic stability.

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

The second way is to use prudential measures to address financial stability concerns that may arise from failures and leakages from the first line of defence, such as domestic credit booms and asset-price inflation. Higher reserve requirements, countercyclical capital buffers, and capping loan-to-value ratios in the bubble sectors (such as housing) and foreign currency lending are some of the policy instruments that have been used. The G20 initiative to develop domestic currency bond markets and structural reforms that can increase the absorptive capacity of EMEs to direct capital inflows into investment in the real economy is part of the toolkit of this line of defence.

The third way is to impose short-term capital flow management measures (CFMs). This instrument has recently been recognised by the IMF as legitimate in extreme circumstances, and also endorsed by the G20 at their sixth Summit in Cannes. CFMs are putatively leaky, and more effective when imposed on inflows than on outflows. There are two broad types of CFM instruments: market-based controls, which aim to increase the cost of the targeted capital transactions to discourage inflows; and administrative controls, which impose outright restrictions on cross-border capital flows through prohibitions or explicit quantitative limits.

All three lines of defence create distortions of their own, and at best throw sand in the wheels. A point may arise when the three lines together are unable to stop the capital flow Juggernaut, and an external payments crisis and loss of market access follows. There are three tried and trusted options available with developing countries to deal with this, namely bilateral and regional swap agreements, IMF funding and, as was done on a large scale during the recent financial crisis, liquidity and swap facilities with the US Federal Reserve, the issuer of the de facto global reserve currency.

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



**A file photo of heads of government at the sixth summit of the G20 at Cannes, France. It was at this meeting that the group endorsed the use of short-term capital flow management measures to combat external payments crises.**

that are desirable and sustainable over the long-term.

Developing countries have found it impossible to use a single policy instrument – short-term interest rates – to simultaneously target both the domestic economic cycle and global spillovers (the external financial cycle) at the same time. According to the widely accepted ‘Tinbergen Rule’, a policy instrument can be effective only if it has a single objective. They therefore need a new policy instrument that frees up monetary policy to target the domestic economic cycle.

The interest rate is clearly better suited to target domestic imbalances. Targeting a neutral real effective exchange rate, or REER, through market intervention, on the other hand, is clearly better suited to targeting external imbalances. This would, first, ensure that the nominal exchange rate remains closely aligned to fundamentals – i.e., it responds primarily to the current account and is not distorted by volatile capital flows that can be destabilising from time to time, even though they might at times make it easier to finance current account deficits over the short term. Second, by sequestering excessive inflows during episodes of excessive inflows, it enhances the war chest for combating disorderly adjustment which can boost market confidence relative to EME peers. Such a policy/instrument is also entirely consistent with 1(iii) of IMF’s Articles of Agreement that purports “to promote exchange rate stability”.

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

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