

Volatile Capital Flows and Global Financial Safety Net:

A Macro-Finance Perspective

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Introduction

The role of macro-prudential policies in mitigating the deleterious effects of volatile capital inflows and **outflows**

Safeguards

- (1) Foreign exchange reserves
- (2) Price based and quantity based capital controls
- (3) International credit lines (CLs)**

We will focus on funding liquidity.

Policy suggestions

- IMF need not (and indeed it cannot) act as the international lender of last resort.
- However, IMF can *facilitate* international CLs.

Other aspects

- Numeraire – Local or foreign currency. A third alternative - indexation
- Capital controls have their counterparts in standard finance.

International credit lines to take care of sudden outflows: An attempt at classification

C^d - Central bank in developed economy

C^e - Central bank in emerging economy

- Eichengreen, et al (2006)

$$IMF \rightarrow C^e$$

- Aizenman and Pasricha (2010), Aizenman et al. (2010), Obstfeld et al. (2010)

$$C^d \rightarrow C^e$$

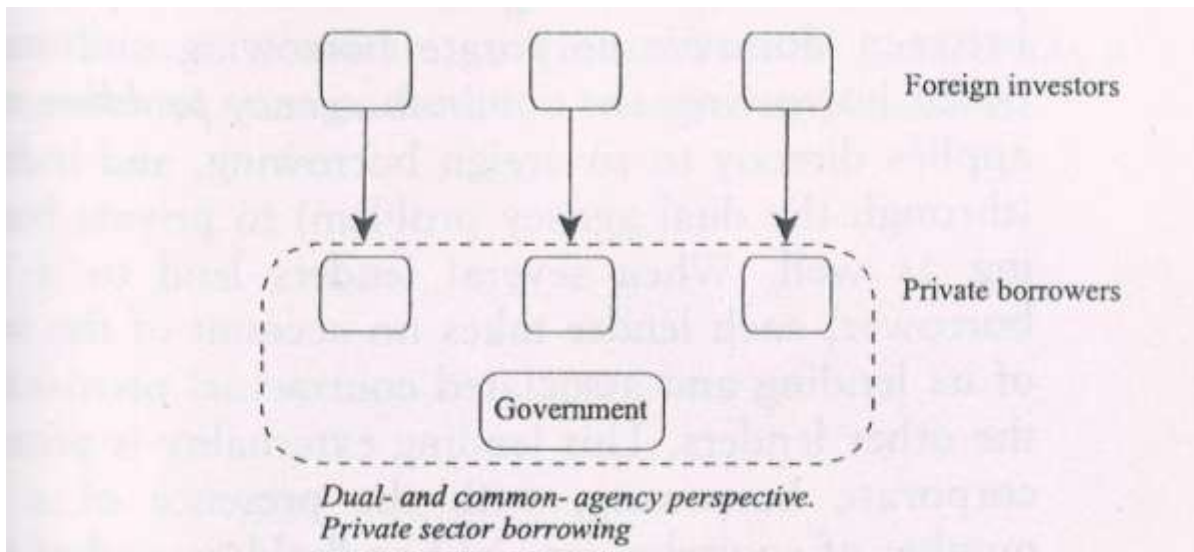
- Obstfeld (2009), Cordella and Yeyati (2010)

$$C^d \rightarrow IMF \rightarrow C^e$$

	Mexico	Poland	Columbia
1. Date of Approval	17 April,2009	6 May,2009	11 May, 2009
2. Maximum amount that can be borrowed (US\$ Billions)	47	20.3	10.4
3. FCL as a percentage of the country's quota with the IMF	1000	1000	900
4. Interest rate under the FCL in %	2.7	2.7	2.7
5. length of the FCL(in months)	12	12	12
6. Upfront Fee (basis points)	24-27	24-27	24-27
7. Real GDP (annual % change, 2008)	1.3	4.8	2.5
8. Gross international reserves (end year 2008, US\$ billions)	95.3	NA	23.7
9. Fiscal deficit as % of GDP	2.0	3.9 (General government balance)	0.1
10. Public Sector Debt as % of GDP	43.3	44.9	32.2
11. Current account Deficit in billions of US\$	16.0	20.10	6.765
12. Current account deficit as a percentage of GDP	0.1	2.3	3.6
13. Consumer Price Index % change	6.5	4.0	7.7
14. Rating (Foreign currency) (STANDARD & POOR) <ul style="list-style-type: none"> • Long term • Outlook/Watch • Date 	BBB Stable 8 Oct, 2007	A- Stable 27 Oct, 2008	BB+ Stable 12 June, 2007

Agency costs

- Standard agency problem in finance (Jensen and Meckling, 1976)
- Dual agency cost perspective in international finance (Tirole, 2002, 2003)
- The investor (principal) has effectively two agents –
(1) borrower in emerging economy, and
(2) government in emerging economy
- Total agency costs involved in international credit lines can be high, given the absence of an international government



Source: Tirole (2002)

Funding Liquidity

- ‘If a substantial subset of IMF members needs to draw on the resources of the Fund simultaneously because they experience shocks simultaneously, then the financial feasibility of an insurance arrangement may be questionable.’(p. 4, Eichengreen, Gupta and Mody, 2006)
- However, volatility in capital flows is quite different from the volatility in, say, the stock markets which face an aggregate uncertainty.
- An outflow from emerging economies is an inflow into developed economies. So there is no aggregate uncertainty or aggregate shortage of liquidity.
- So, funding liquidity is not a serious problem (Singh (2011)).
- CLs can be cheaper than foreign exchange reserves even if pooled.

Two types of Credit Lines

(1) CL for investment or for consumption purpose

(2) CL to take care of systemic outflow from emerging economies

- Over three-quarters of bank lending in the US is under commitment contracts (Loukoianova, et al., 2007).
- In (1), there is effectively a need for reserves or liquid assets as an inventory directly or indirectly.
In (2), there is hardly any such need.
- See also Gatev and Strahan (2006).

Other aspects - Numeraire for debt flows

- Local currency, and *the original sin* (Eichengreen, et al., 2003)
- Foreign currency as the numeraire
- Commodity bundle as numeraire (e.g. *Unidad de Fomento* in Chile)
- Separation of medium of exchange and numeraire
- Need for mutual acceptability for debtors and creditors
- Indexed debt instruments
- Apparent market failure in adopting indexation
- Policy to push indexation

Understanding capital controls

- Emerging economies use ‘quantitative capital controls’, ‘Tobin tax’ or ‘Pigouvian tax’ (Jeanne and Korinek, 2010)
- Hedge funds and mutual funds use ‘entry load’, ‘exit load’, ‘gate’, ‘lock up’, ‘side pocket’ etc. (Stowell, 2010)
- Scottish free banks used ‘option clause’ from 1800 to 1845 (White, 1984)
- These restrictions are contractual, mutually beneficial and market outcomes in finance
- Similar rationale for capital controls

Conclusion

1. Funding liquidity to honour international CLs to take care of sudden outflows is not a serious problem.

The IMF need not act as the international lender of last resort. Instead it can and needs to facilitate international CLs.

International credit lines deserve an important place in the IMS – perhaps as important as foreign exchange reserves.

CL is not a solution for all emerging or developing economies.

2. There is a need to push for indexation of debt instruments.

3. Capital controls are not inherently a non-market idea.