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

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It is a pleasure and honor to be at this very important and timely conference and to deliver these closing remarks. As you may imagine, in the past few weeks I have not been able to think too much about the financial cycle, the theme of this conference, as my country undergoes a social crisis of unprecedented dimensions. This crisis offers lessons for the whole emerging world about the risks of inequality for 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 made significant economic and social progress since its return to democracy about three decades ago. However, although inequality has declined, it is still high and inequality in may other social dimensions persist. Beyond inequality of income there is a justified perception of a large gap in many aspects of life between the elite and the rest of population. There has not been a clear sense of urgency to solve central social problems such as low pensions, low wages, and meager health services for the poor and the middle class. Failure to address these problems in a timely way has given rise to tensions that create social discontent and may end may end up in major social and political disruptions.

A critical component of the solution to Chile's urgent social needs is a significant fiscal expansion, where transitory components can be accommodated by current strong fiscal position, but there is also a need to finance permanent components in order to preserve fiscal soundness and avoid a return to the traditional fiscal cycle that has led to malaise in Latin America. I am optimistic, but we need to work hard and persevere because all the problems cannot be solved at once.

Social discontent is of particular concern as growth has declined. Strong growth provides enough benefits to the population that some reforms some reforms to enhance equality and

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social inclusion can be can be postponed. However, as basic growth theory teaches, as income rises, a deceleration of growth should take place. In this context it becomes central to focus on inclusion and inequality in order to ensure progress at more moderate rates of growth. This is an essential lesson for high-growth emerging market economies (EMEs), many of which are in Asia: do not postpone social inclusion and reforms, because high growth will not last forever and a country can fall behind the curve of social progress.

In Chile poverty has declined from levels close to 50 percent 30 years ago to below 10 percent today, and extreme poverty has been almost eradicated. However, new demands surface and failure to address them in a timely manner can have very negative consequences, as the temptation for populist policies or a return to old, failed policies resurfaces with large popular support.

Therefore, social inclusion and reduced inequality should be considered when designing financial and macroeconomic policies, not just in terms of their ethical dimensions but also as a way to maintain stability and foster growth. Good financial policies and a stable economic environment are necessary conditions, but clearly not sufficient, to accomplish the elusive task of development.

Social outbursts have occurred after the introduction of unpopular fiscal measures in France, Ecuador, and more recently Pakistan. In Chile protests started after metro fares increased 3 percent. Chile has fiscal space, but many other countries do not, and they need fiscal adjustment. Authorities in those countries may be more reluctant to adopt unpopular fiscal measures especially during times of low growth. However, countries cannot live beyond their means and fiscal adjustment may be needed to avoid more difficult future adjustments. This is a relevant challenge for the IMF and domestic authorities when designing fiscal consolidation programs.

Now I will offer some remarks on how emerging market economies should manage the global financial cycle.

The Standard Framework and Exchange Rate Flexibility

Most EMEs today follow inflation targeting regimes with flexible exchange rates, and the monetary policy interest rate is adjusted according to an inflation forecast with 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. Countries must be well prepared for this process.

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

But in recent years several developments have indicated that this benchmark framework needs to be reconsidered. In a world of persistent low interest rates, the so-called "low for long" (or even "low forever") and highly liquid global financial markets, search for yield, and volatility of capital flows may pose serious risks to stability and impair the monetary policy transmission mechanism of EMEs. Financial factors may play an increased role in the local business cycle.[2]

Additional measures as well as deviation from the standard framework may be needed. In terms of definitions, I prefer to talk about the standard framework and deviations as well as complements to it rather than distinguish 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 approach allows more clarity about which particular problems to confront. For example, with volatile capital flows, it is important to determine the causes and whether they are local or external in order to have sound policy prescriptions and deviations from the standard benchmark. Another example is the exchange rate: a flexible exchange rate is generally preferable, but under some circumstances some form of exchange rate management may be desirable.

The exchange rate regime is in fact at the core of the discussion of macroeconomic policies. Many years ago, Guillermo Calvo and Carmen Reinhart (2002) pointed to two main reasons why countries would be reluctant to float to allow for depreciations: the inflationary consequences of depreciations and their financial effects. Fear of floating can be overcome with a credible inflation target regime and strong financial regulation. And this has happened in most EMEs.

There have been sharp fluctuations in the last decade, such as those of the global financial crisis and the taper tantrum in 2013. In these cases, inflation remained within reasonable limits while financial markets were able to absorb the depreciation. The low pass-through from exchange rate to prices declined, and most of the inflationary consequences of a depreciation vanish during the policy horizon of the inflation target regime, so there is limited need to tighten when depreciations take place, even when they are significant (De Gregorio 2016).

Moreover, fighting depreciations with monetary tightening could induce a speculative escalation of rate hikes and weakening currencies. An extreme case was what happened in

[1] See Álvarez and De Gregorio (2014) and De Gregorio (2019). For evidence before the global crisis see Gonçalves and Salles (2008).
[2] See Claessens and Gosh (2016) for policy implications. A more skeptical view can be found in Cerutti, Claessens, and Rose (2019, p. 24), who conclude that "most variation in capital flows does not seem to be the result of common shocks nor stem from observables in a central country like the United States."

Argentina in 2018, where monetary policy tightening and a weakening currency led the economy into a severe recession with very high inflation. Of course, this has not been the case with Asian countries and most EMEs, but it is a cautionary tale about unnecessary contractionary 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 may lead to hysteresis and permanent loss of competitiveness. This view has developed with 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] Although inflation may be within target, there is usually a temptation to tighten.[4] This can be considered the leaning against the wind prescription applied to EMEs. However, tightening could exacerbate capital inflows as interest rate differentials widen and carry trade incentives increase. The resulting appreciation of the currency may stimulate asset price bubbles. Whatever the reasons for leaning against the wind in advanced economies, they become less relevant when considered against episodes of capital inflow surges in small open economies because of increased carry trade.

To limit appreciation, foreign exchange intervention may be desirable. 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 is the best time to build up foreign exchange reserves to cushion against fluctuations in global financial markets.[5]

As may be apparent, I am quite asymmetrical in my views on managing the exchange rate. As a general prescription, not absolute of course, I recommend considering intervention only in periods of strength and letting the exchange rate float when the currency weakens, because fear of floating is quite damaging for credibility and sound monetary policy.[6]

Macroprudential Measures and Capital Flow Management

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[3] This also happened during the commodity price boom of the early 2000s, but the difference is that there was a significant current account improvement.
[4] It is paradoxical that inflation obsessive policymakers 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 against global financial shocks but also to protect competitiveness during the commodity price boom (Cabezas and De Gregorio 2019).
[6] Post-scriptum: in the middle of the social crisis in Chile, with large volatility in the foreign exchange market, the Central Bank of Chile announced at the end of November to implement a massive foreign exchange intervention to soften volatility and to allow for a better adjustment. This has been a necessary action in a period of unprecedented uncertainty.

When faced with massive capital inflows, authorities may consider additional measures, in particular since monetary policy and foreign exchange intervention have limited space to contain the effects on activity of the global financial cycle. A fiscal policy contracton is an option, however most of the times it has no sufficient space to tighten. Here is where macroprudential policy and capital flow management (CFM) can be used. I start from the presumption that financial systems are strong and well regulated by microprudential policies, so additional measures should be understood in the context of countercyclical policy.

The main difference between macroprudential policy and CFM is that the former discriminates against cross-border transactions and therefore, in addition to safeguarding financial stability, is used to limit currency appreciation, although its effects have been shown to be small or negligible.

In 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 types of inflows. The rationale for this discrimination is correct, since debt is, for example, more volatile than foreign direct investment. However, this discrimination opens the door to loopholes that undermine CFM effectiveness.

A recent issue of concern is the rise in leverage by nonfinancial corporations in EMEs.[7] As global interest rates have declined, many corporations have issued foreign exchange–denominated debt in international financial markets. As long as this debt finances investment and debt restructuring, it is a positive development. It cannot be ruled out, however, that some of this borrowing could be unhedged and done for the purpose of exploiting carry trade, in particular when financial corporations restrict cross-border operations, and this may 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, which may produce financial turmoil. A careful assessment through, among other things, stress testing is essential for sound policymaking.

A final matter of financial stability that I would like to comment on is the boom in housing prices in many countries, due in part to the secular decline in interest rates. This is not only a financial concern as it has social implications: buying a house is difficult for many young people. This is a challenge for policymakers who need to balance tradeoffs between financial stability—for example, via reductions in loan-to-value ratios—and housing affordability. Policies in this area should go well beyond financial regulation.

Final Remarks

Many of the policies of emerging market economies to deal with the financial cycle are related to the desire to avoid excessive currency appreciation. This fear of appreciation also happens

[7] See, for example, IMF (2017).

with high commodity prices, as the boom of the 2000s shows. But there are inconsistencies in the policy prescriptions for EMEs versus those of large and systemic ones.

The policies of small EMEs do not have spillovers on the global economy. In contrast, in large economies, foreign exchange intervention, CFM, and even nonconventional monetary policy could be considered to be currency wars or currency manipulation. Efforts to clarify the extent of currency management, in particular differences between small open economies and systemic ones, remain a challenge for international financial institutions and polcymakers in major economies. It is not enough to say that, given the negligible income of small EMEs on the global economy, this inconsistency is irrelevant, for two reasons. First, there could be spillovers at a regional level, since being globally small does not rule out being regionally large. And second, if foreign exchange rate intervention is done simultaneously by many small EMEs, their impact may like that of a large economy.

I do not have a clear answer to this conundrum. I do think EMEs should protect themselves from the global financial cycle. Tensions will arise when external spillovers go in a different direction from domestic financial policy goals, for example when advanced economies are loosening while EMEs want to slow down, as happened early in this decade after the strong recovery of EMEs from the global financial crisis. Moreover, EMEs must choose policies that are appropriate to their level of development and the depth and soundness of their domestic financial systems, which may limit exchange rate adjustments. In contrast, the global economy needs adjustments and these adjustments are by nature heterogeneous across countries.

I hope that the current work at the IMF on an integrated policy framework will eventually provide the framework to address these challenges facing policymakers around the globe.

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