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REGULATION IN THE FACE OF GLOBAL IMBALANCES

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Contents

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I am very grateful for the invitation to participate in this panel on *Lessons from the Crisis on the Role of Central Banks*.[1] The crisis has revealed weaknesses in the functioning of financial markets and the regulatory and supervisory frameworks in several advanced economies, which went through years of credit expansion and leveraging that ultimately proved unsustainable. There are many lessons to be learned in order to reduce the likelihood of another crisis of this magnitude. Indeed, many of the policies implemented during the recent crisis, and which helped to avert a catastrophe, were lessons we learned from the Great Depression.

But the recent episode has also revealed the strengths of policy frameworks and financial systems in emerging market economies (EMEs) that were able to successfully mitigate the effects of the worst global crisis since the Great Depression. Fiscal prudence, more autonomous central banks, low inflation, flexible exchange rates, and financial regulation and supervision, consistent with their lower degree of financial sophistication, were central to this unprecedented performance. Many of these lessons have been learned the hard way, through decades of macroeconomic mismanagement, and several costly experiences of currency and financial crises.

Today, however, I would like to focus on the challenges to macroeconomic management faced by EMEs in the current global environment. Indeed, the two-speed recovery of the global economy is creating tensions in EMEs, putting pressure on macroeconomic management, in particular, in the context of inflationary pressures, capital inflows and currency appreciation. I will refer to these challenges, starting from monetary policy and exchange rate appreciation, to then move to financial stability issues.

1 | Inflation and currency appreciation

The conduct of monetary policy by independent central banks with a clear mandate for price stability was central to allow for the implementation of countercyclical monetary policies in EMEs during the Great Recession. Today the appropriate stance of monetary policy must avoid the buildup of inflationary pressures in a world of rising commodity prices and economic activity close to full capacity in many EMEs. Failing to act decisively against inflation pressures will undermine credibility, with negative consequences on the ability to achieve stable inflation with low output costs in the future.

Perhaps the main apprehension of policymakers in tightening monetary policy is the fear of further appreciation of their currencies. As monetary policy in advanced economies is expected to remain very expansionary for a prolonged period of time, many EMEs that have been tightening monetary policy have also experienced appreciation of their currencies. Not dealing with inflationary pressures in a timely manner, however, could result in economic overheating and rising inflation.

Most emerging markets have enjoyed great success from trade openness and export-led growth, and hence their worries arising from exchange rate appreciation are well justified. However, it is important to distinguish between real appreciation –the relevant variable from the competitiveness standpoint– and nominal appreciation. Exchange rate actions that attempt to mitigate a real exchange rate appreciation will have only transitory effects, which could provide valuable time for the economy to adjust to a new global environment and might hence be relevant from the point of view of welfare, but cannot be thought of as a permanent tool to foster competitiveness. In order to sustain the real exchange rate, real actions need to be taken, such as increasing domestic savings. It is time to rebuild fiscal buffers in emerging market economies and accelerate the pace of reforms to achieve productivity gains that can sustain competitiveness.

It is important to note that the economic strength of EMEs relative to advanced economies is the main reason why their real exchange rates are appreciating. In addition, the correction of global imbalances

1 The author is very grateful for comments and discussions with Rodrigo Cifuentes, Kevin Cowan, Luis Oscar Herrera, and Enrique Orellana.

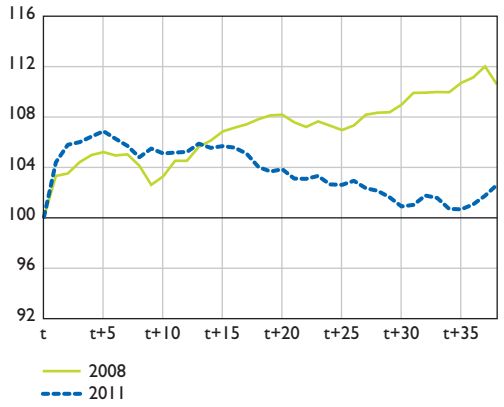
requires both an increase in consumption in surplus economies and a shift of this greater demand towards goods produced by advanced economies, especially since in the latter growth of domestic demand will be sluggish because of the post-crisis deleveraging process. Relative price adjustments around the world should help this process. Many EMEs have been trying to mitigate the appreciation through exchange rate intervention, with partial success. Chile is one of the latest to join this group. Others have sought the use of capital controls or macroprudential regulations, not only for exchange rate reasons, but also to avoid the buildup of excessive market or liquidity risk associated to the foreign exchange position.

In January this year we announced a program of reserves accumulation of 12 billion dollars, about 5 percent of GDP. This measure had a dual purpose. On the one hand, it would relieve some pressures on the exchange rate, facilitating the adjustment of the economy to the current international environment. On the other hand, it would increase Chile's international liquidity position to levels around 17 percent of GDP. Indeed, evidence shows that having a high level of reserves makes economies more resilient to financial turbulences, even though they are generally not massively used. Reserves act as a deterrent against sharp capital flow reversals.[2] In addition, reserves allow central banks to credibly establish foreign currency liquidity facilities. These played an important role in normalising both domestic currency and foreign currency short term debt markets in many EMEs during the recent global crisis.

After an initial sizable depreciation, the peso has strengthened, for some days even reaching levels similar to those prevailing before the intervention announcement. This contrasts sharply with the experience of the previous period of reserve accumulation initiated in April 2008 (Chart 1). In that episode and with the global financial crisis intensifying it was deemed appropriate to accumulate about 4 percent of GDP over a period of 8 months. This process was suspended after the collapse of Lehman Brothers that triggered a sharp depreciation of most currencies in EMEs. During that episode, the currency depreciated almost continuously by about 18 percent between early April and late August. Two very important issues help explain to a large extent the difference between the two episodes.

Chart 1 Nominal exchange rate

(chilean pesos per US dollar; day of intervention annoucement = 100)



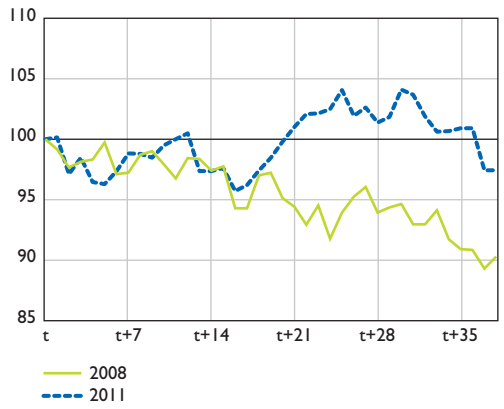
Source: Central Bank of Chile

In 2008, the dollar strengthened and the price of copper fell. Today, the dollar has remained weak and the copper price has reached all-time highs (Chart 2). This example shows how the effects of the intervention are confounded by other macroeconomic developments. Overall, available estimations indicate that, without the intervention, the peso would be between 3 and 5 percent stronger than it is today.

A key uncertainty for policymakers in EMEs is how long the period of decoupling and "exchange rate tensions" will last. Part of the tensions will be persistent, as many EMEs have proven very resilient in the current crisis –validating their policy frameworks.

Chart 2 Cooper price

(day of intervention annoucement = 100)



Source: Bloomberg

2 *For further discussion, see "International reserve holdings in emerging markets" by Jose De Gregorio, Central Bank of Chile Economic Policy Paper No. 40, January 2011.*

This resilience should be factored into a lower risk premia for the assets issued by these economies. However, some of the tensions will prove transitory and will subside once activity in advanced economies recovers more strongly. Therefore, over time some tensions should alleviate, and this depends crucially on a healthy recovery of advanced economies.

The cyclical difference between EMEs and advanced economies, with the consequences on expected relative returns and risk, is inducing large gross capital inflows to EMEs. Net capital inflows, however, are well below the levels seen in the early 1990s. Indeed, at this time EMEs are running current account surpluses on average, while in the early 1990s deficit predominated. In the case of Chile, we have not seen net capital inflows yet. But, as the adjustment progresses we should observe rising net capital inflows to EMEs. In addition, large gross capital inflows raise concerns from a financial stability perspective, an issue to which I will turn next.

2| Financial stability and capital inflows

We can think of three ways through which unsteady gross inflows may affect financial stability in a country. The first one is that in small and often illiquid markets capital inflows may *increase asset prices beyond fundamentals*. The problem arises if asset prices respond significantly to inflows, and these inflows stop or revert suddenly. A sharp decline in asset prices affects the balance sheets of local and foreign agents. If, in addition, the financing of asset purchases is highly leveraged, the fall in asset prices may trigger solvency problems, just as those of the subprime crisis. In addition, drastic reductions of positions in domestic markets by non residents may also introduce excess volatility in the exchange rate markets as investors leave the country. Through these chains of effects, a reversal or even a slowdown in capital inflows may significantly weaken financial stability in the local economy and also potentially in the economies from which the inflows are being financed.

A second source of vulnerabilities may arise from *cross border flows that provide debt funding* to local agents. These can be financial intermediaries or non-financial companies, and the funding can be via deposits or lending. If lending is short term, then this may result in maturity mismatches. If lending is in a foreign currency, then the risk of currency mismatches must also be factored in. The problem arises if local agents do not correctly internalise these risks or if regulation limiting these risks in the financial sector is inadequate.

A third source of problems is that capital flows may *increase the scale and the complexity* of the local financial system, and this expansion may expose weaknesses in the regulatory and supervisory structure. For example, if external funding has not been readily available in the past for certain intermediaries, awareness of currency mismatches can be weak for these institutions or for their customers, and may not be properly addressed in the regulatory framework. Similarly, the availability of new funding may cause credit to rise at a faster pace than that of the supervisory capacity required to monitor its quality.

These three sources of risk call for different policy actions.

The first approach for *dealing with asset price misalignments* is for authorities to communicate their views on the extent of potential asset price distortions and their consequences for financial stability. These "verbal interventions" are relatively common regarding the exchange rate. I see no reason why we should not use them also for other assets such as bonds and equity, since they are relevant variables from the point of view of macroeconomic and financial stability. Indeed, recent experience has shown that central banks need to be more assertive and communicative about the conduct of financial systems. In our last *Financial Stability Report* we indicated that evidence pointed to some overvaluation of stock prices in Chile, but we also indicated that financial stability was not threatened by potential corrections, even sharp corrections, in these prices. Of course, making this assessment is not a trivial task –as modeling asset prices is complex– and it is not the role of central banks to communicate continuous assessments of asset prices. For this reason, this kind of communication must be done exceptionally, and in the context of discussing the potential implications of these price developments on current and future financial stability. In addition, communication must be done in a timely manner, before vulnerabilities build up.

In addition, central banks may choose to participate in distorted financial markets where there may be threats

to financial stability, as is sometimes done with reserve accumulation and exchange rate intervention in EMEs, or as has been the case of some interventions in debt and other asset markets in advanced economies. However, interventions beyond currency markets must be truly exceptional and only on the grounds of preserving financial stability or complementing monetary policy.

Another way to control the vulnerability of the system to the reversals of asset prices is to limit the amount of debt that finances the purchase of those assets with higher prices or increase capital buffers for such debt. In terms of macroprudential policies there are a series of options for this. Higher capital requirements for intermediaries participating in the business of making leveraged purchases of financial assets are one option. In the same vein, reducing loan to value (LTV) ratios in mortgage loans, increasing provisions for housing loans or increasing capital requirements on mortgage lending are all viable options if the distortion is in the housing market. Several countries in Asia have been actively using LTV caps over the last couple of years to reduce the risks from housing price booms. Which of these tools should be used will depend, however, on the institutional setting of each country, the functioning of the financial system and the asset price that is distorted. For example, in Chile, if it were determined that housing prices are distorted and lenders are not correctly internalising this distortion, then the Superintendent of Banks and Financial Institutions (SBIF) has the authority to increase provisions and capital requirements on housing loans.

Addressing the risks that arise from *expanding cross border debt* requires, at the very least, that existing prudential regulation ensure that funding liquidity risk is dealt with adequately by financial intermediaries. Often, however, this may simply lead to a transfer of this risk to the non-financial sector. Hence, there remains a role for a foreign currency liquidity buffer made up of international reserves.

Vulnerabilities regarding currency risk that often come hand in hand with increased foreign debt, merit special attention. In the past we have seen many crises originating from the accumulation of unhedged foreign currency debt in banks and non-financial corporations. This was one of the main amplifiers of the Chilean banking crisis of the early 1980s– where firms in the domestic sector built up substantial amounts of dollar-denominated debt during a period of fixed exchange rates and capital account opening. It was also an important factor in the Mexican crisis of 1995, in the Asian crisis, and more recently in financial problems in some Eastern European countries. On the other hand, low currency mismatches allowed the central banks of many EMEs to lower interest rates aggressively as a response to falling demand during the crisis. In the past there was fear of exchange rate depreciation because of currency mismatches.

Exchange rate flexibility is a key component in any policy mix to reduce currency mismatches. Indeed, this is an example of a macroeconomic policy that also contributes to financial stability. In the case of Chile, and elsewhere in Latin America, we saw currency mismatches drop after currencies were allowed to float following the Asian crisis, as agents and regulators adjusted to increased exchange rate volatility (Chart 3). Indeed, bank regulation should not only incorporate currency risks explicitly, but also indirectly by dealing with the credit risks that arise from currency mismatches in the corporate sector.

Finally, *the growth in size and complexity of the financial system that often accompanies capital flows* calls for a continuous process of revision in microprudential regulation. One of the key elements to consider here is the scope of financial regulation and supervision. For a start, in periods of abundant foreign capital, intermediaries that have not accessed cross-border financing may begin doing so, lacking both the adequate regulation and internal risk management. Furthermore, if prudential regulation on traditional intermediaries tightens in these episodes, incentives are increased for by-passing these intermediaries. An additional element to consider is the speed at which financial innovations are incorporated into middle income economies. For sure, large global financial institutions have incentives to expand the scope of their financial services. However, if possible, the speed at which this is done should be kept in line with the capacity of domestic regulators and supervisors to monitor and respond to the potential risks generated by these changes.

Chart 3 Dollarisation of liabilities of the corporate sector in Latin America: 1992-2009

(in percent, annual average across firms)

Source: IMF.

Regarding monetary policy, the main challenge of EMEs today is to avoid persistent deviations of inflation from its target, especially in an environment where the price of agricultural commodities and oil have been rising sharply. Changes in relative prices have to take place, but the risk of propagation to other prices has to be mitigated, in particular in economies, like Chile, that are operating close to full capacity. Monetary policy cannot be subordinated to exchange rate objectives, even in cases where measures to alleviate exchange rate appreciation have been adopted. This is the reason why in Chile we implement sterilised intervention in a fully transparent way, with pre-announced magnitudes for foreign exchange purchases. This allows preserving independence of monetary policy to stabilise inflation.

Regarding financial stability, I have outlined some issues relevant to EMEs, but there is a need for global cooperation. My opinion is that too much of the recent discussion on capital inflows has been framed from the perspective of recipient countries. Although this view is certainly relevant, it is incomplete. The risks of excessive currency mismatches, overvalued assets, complex products and so on, are also relevant for the institutions making these investments —be they large internationally active banks, defined benefit pension funds or insurance companies. Hence, addressing the global risks to financial stability requires that source countries also properly monitor and control these risks with adequate supervision and regulation.

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