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Policy Coordination:

Implications for Macroprudential Measures in Latin America

Yan Carrière-Swallow

BIS-IDB Workshop of the Financial Stability and Development Network

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Presentation Outline

- The Fund's calls for international coordination of policies
- The case of MPMs and the role of CFMs
- An exploration: Scope for coordination of MPMs in Latin America?

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The Fund's Case for International Coordination of Policies

- Cross-border externalities (spillovers and spillbacks) lead to Pareto-inefficient policy choices: Coordination involves policymakers internalizing the effects of their decisions on others.

- Coordination doesn't always mean reducing: When spillovers are positive, non-cooperation will lead to too little of a policy; when negative, to too much.

- Traditionally, the discussion has centered on the coordination of monetary and fiscal policies between major advanced economies.

The Fund's Latest Call for International Policy Coordination

April-July 2016: "3 Cs" Policy Recommendation to the G20 and IMFC

Comprehensive policy actions exploit synergies by combining structural reforms with a demand-management framework.

Consistent and systematic policy actions guided by policy frameworks provide decisive short to medium-term accommodation without derailing longer-term expectations.

Coordinated policy actions across countries amplify the effects of individual policy actions.

"In the event of a further downward global shock, *international coordination* of monetary, fiscal and structural policies would reinforce their expansionary effects through positive spillovers."

Estimated Gains from International Policy Coordination

Effects on Real GDP Level in Year 1
(Percent deviation from baseline)

Effects on:	When each region stimulates on its own	When stimulus is coordinated in all regions
World	--	**2.4**
United States	1.1	**1.6**
Euro Area	0.9	**1.5**
Japan	1.1	**1.8**
Emerging Asia	2.0	**3.4**
Latin America	1.5	**2.4**
Remaining Countries	1.4	**2.3**

Source: Gaspar, Obstfeld and Sahay, 2016, "Macroeconomic Management When Policy Space in Constrained: A Comprehensive, Consistent, and Coordinated Approach to Economic Policy", Staff Discussion Note SDN/16/09, September.

What coordination of macro policies have we seen?

Relatively few examples of international policy coordination in practice:

- The 1985 Plaza Accord coordinates FX interventions among G-5 to reduce external imbalances;
- The G-7 coordinated interest rate cuts and liquidity provision following 1987 stock market crash;
- Maastricht Treaty and Stability and Growth Pact aim to preserve fiscal sustainability within euro area
- The G-20 coordinated fiscal expansions following the 2008 global financial crisis.

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Most successful instances have followed major global shocks

What coordination of macro policies have we seen?

Why haven't we seen more? Ostry & Ghosh (2013) discuss three most binding impediments to coordination:

1. **Policymakers don't perceive that they face binding trade-offs**: they may think they have more instruments than targets.
2. **Asymmetry** of gains and losses from coordination: global benefits stand to be perceived mainly by small countries.
3. **Uncertainty or disagreement** about the state of the economy or size of spillovers and spillbacks make bargaining and sustained cooperation difficult.

Source: Ostry, J. and A.R. Ghosh, 2013, "Obstacles to International Policy Coordination, and How to Overcome Them", Staff Discussion Note SDN/13/11, December.

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The case for international coordination of MPMs

The Fund has similarly argued for coordinating macroprudential measures when:

i. International linkages transmit the effects of domestic policy across borders, potentially amplifying financial stability risks in other countries through contagion, credit leakage, and diversion.

ii. Managing these spillovers using monetary, macroprudential, exchange rate, or capital flow management measures imposes costs on recipient countries.

Most recently, the case for coordination of macroprudential policies was included as part of the 2016 IMF/BIS/FSB white paper to the G20.

Source: IMF, "Guidance Note on the Liberalization and Management of Capital Flows", March 2013.

Managing volatile capital flows: The role of CFMs

How should a country safeguard financial stability in the face of a capital inflow surge?

- The IMF's institutional view on use of CFMs has evolved over time.
- While CFMs are now included as part of the policy toolbox, guidelines severely limit their use to scenarios where other policy measures have run their course.
  - The Fund seeks to safeguard an open and non-discriminatory international financial architecture

Managing volatile capital flows: The role of CFMs

Pre-Global Financial Crisis

- Generate efficiency costs; aren't needed to ensure financial stability; probably not effective:

Don't use!

- (Since late 1990s: …unless as part of a capital account liberalization process)

- Essentially, coordination at zero.

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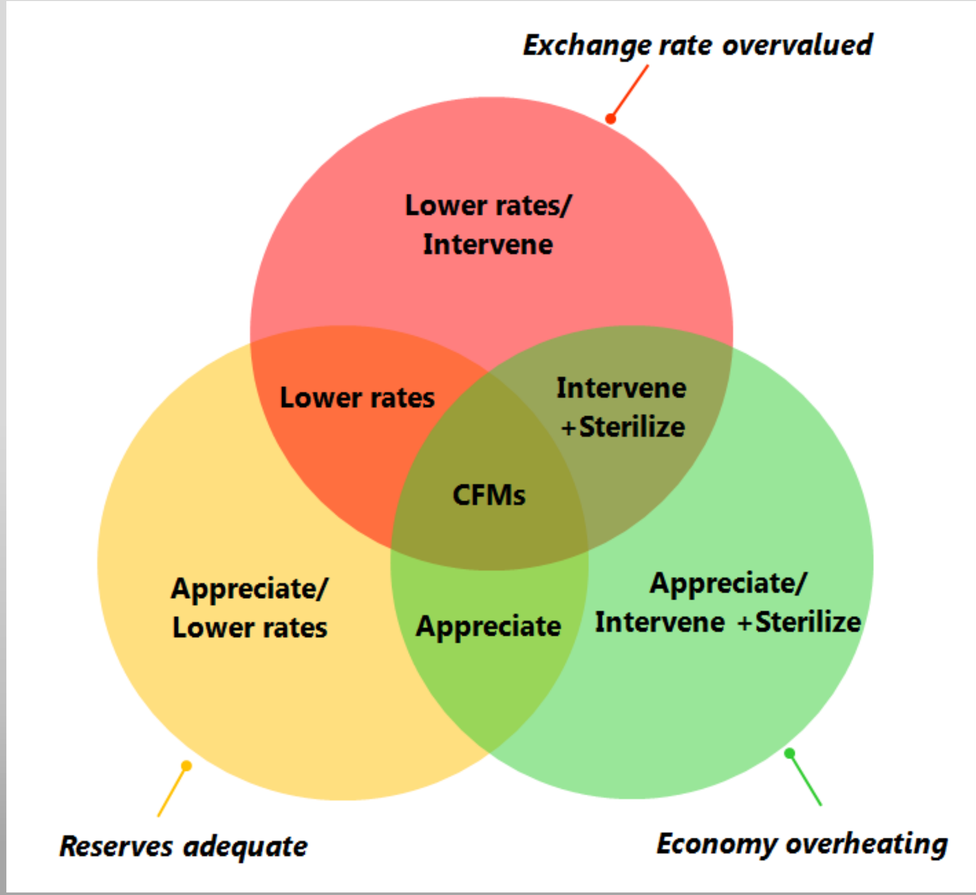
Since 2013



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Managing volatile capital flows: The role of CFMs

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- While CFMs are now included as part of the policy toolbox, guidelines severely limit their use to scenarios where other policy measures have run their course.
  - The Fund seeks to safeguard an open and non-discriminatory international financial architecture
- Above all, the use of CFM policies (and their potential coordination) should not substitute for warranted macroeconomic policy adjustment
- Macroprudential policies are playing an increasingly prominent role in the toolkit

The Fund's framework for use of MPMs and CFMs

MPMs:
Primarily prudential tools to limit systemic risk
(IMF 2013, 2014, IMF-FSB, BIS 2016)

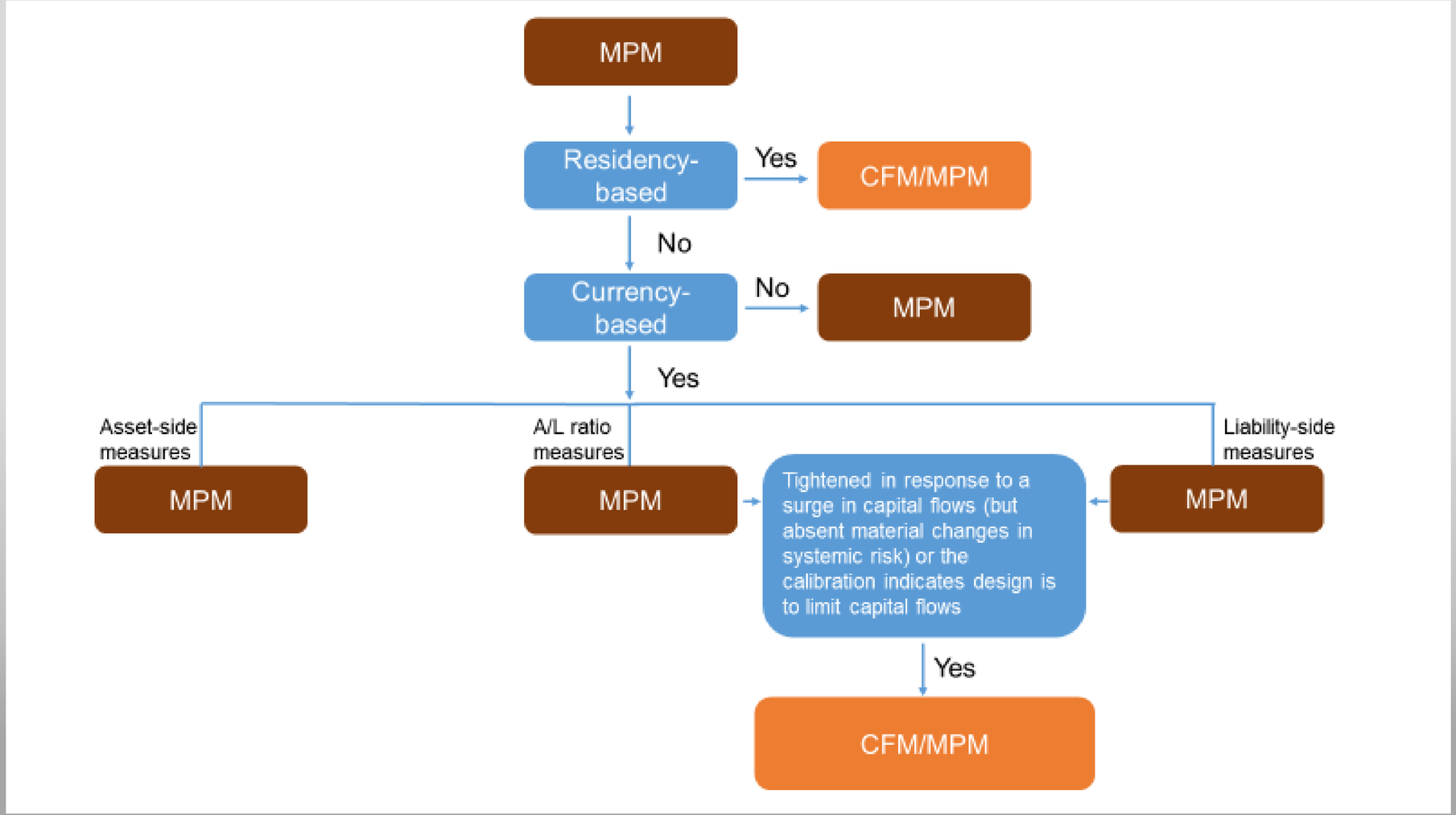
- Aim to (i) build resilience, (ii) contain build-up of systemic risk over time
- Can help limit systemic risk from capital flows even when not designed to limit capital flows
- Policy approach should be well calibrated to contain systemic vulnerabilities based on an assessment of systemic risk
- Prudential tools are precautionary by nature
- A broad range of MPMs may be needed to attain objectives

CFMs:
Tools designed to limit capital flows
(IMF 2012, 2016)

- The institutional view considers a broad macro policy package to handle capital flows
- CFMs should not substitute for warranted macroeconomic policy adjustment
- CFMs can be appropriate in certain circumstances
- CFMs should be transparent, targeted, generally temporary, and non-discriminatory
- CFMs on inflows only in capital flow surges
- CFMs on outflows only in (imminent) crisis situations

Source: IMF Policy Paper, "Increasing Resilience to Large and Volatile Capital Flows: The Role of Macroprudential Policies", September 2017.

The Fund's framework for use of MPMs and CFMs: Is a macroprudential measure also a CFM?



Source: IMF Policy Paper, "Increasing Resilience to Large and Volatile Capital Flows: The Role of Macroprudential Policies", September 2017.

What coordination of MPMs have we seen?

Again, few examples of multilateral efforts to coordinate prudential policies:

- Reciprocity of countercyclical capital buffers under Basel III.
- Nordic-Baltic countries: substantial macroprudential collaboration through informal forum: coordinated use of CCB and reciprocity for macroprudential measures, but not legally binding.
- Vienna Initiative (2009 and 2012) seeks to limit systemic risks caused by deleveraging of Western European banks from subsidiaries in emerging Europe.
- New euro area framework grants ESRB non-binding powers to coordinate macroprudential policies EU-wide, with ECB/SSM authorized to tighten above minimum standards within banking union.

What coordination of MPMs have we seen?

Why haven't we seen more coordination of macroprudential policies?

- **Relatively new:** Prior to global financial crisis, policymakers in AEs rarely recognized the tradeoffs involved with the financial stability objective, leading to underutilization of macroprudential policies.

- **Disagreement and uncertainty** about their transmission, implementation, and cross-border effects remains more salient than with fiscal and monetary policies.

- **Myopia:** Coordination of fiscal/monetary policies has been most successful in responding to crises once they are underway, but macroprudential policies are meant to *prevent* the buildup of systemic risk.

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Scope for coordination of MPMs in Latin America?

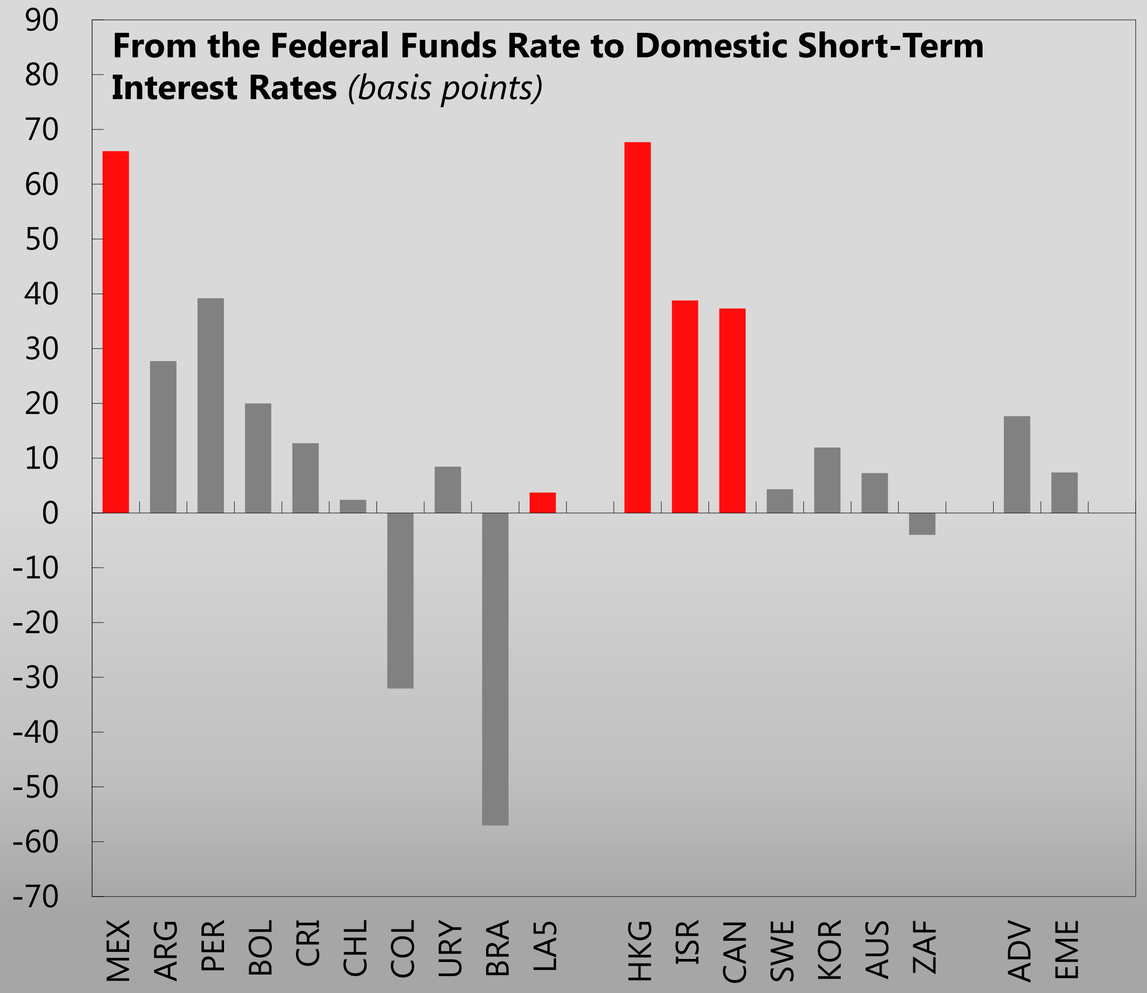
With whom would we want to coordinate macro-prudential policies?

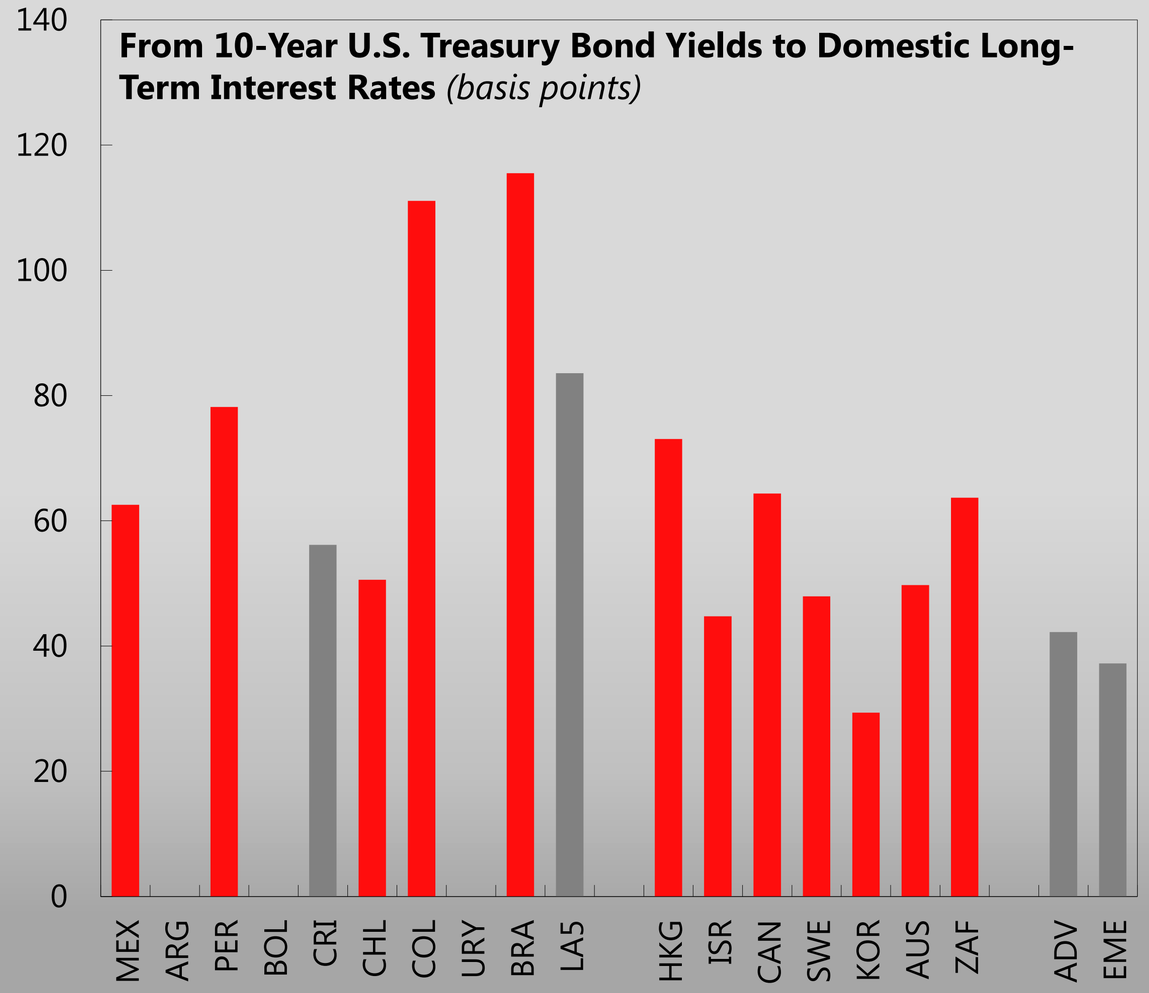
1. Source-recipient coordination: How strong is the case?

- LAC financial systems have strong linkages to financial centers in the U.S. and Europe

- Financial conditions and capital flows in LAC subject to relatively strong spillovers from U.S. and Euro area policies

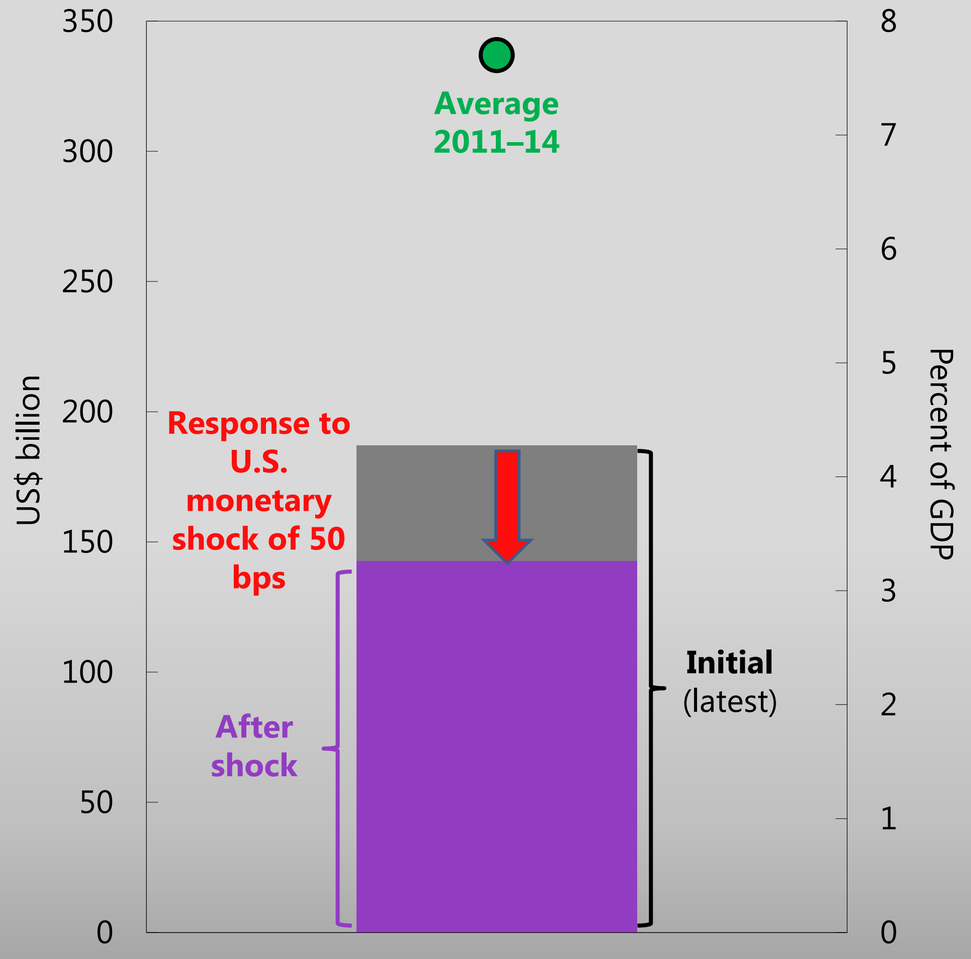
Spillovers to Latin American interest rates



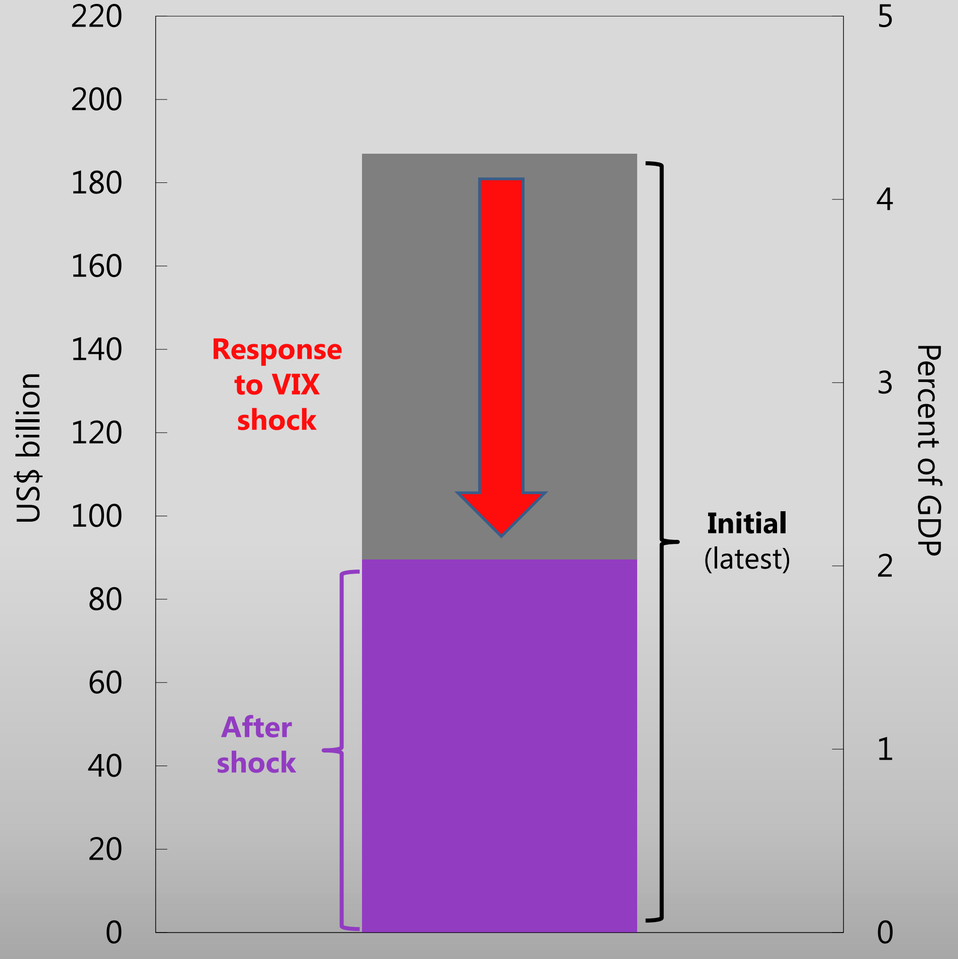


Source: Carrière-Swallow, Y. and B. Gruss, "Implications of Global Financial Integration for Monetary Policy in Latin America", chapter 4 in *Challenges for Central Banking: Perspectives from Latin America*.
Note: Responses in basis points following a 100 basis point increase in the corresponding U.S. rate. Red bars mean statistically significant. ADV = advanced economies; EME = emerging market economies; LA5 = Brazil, Chile, Colombia, Mexico, Peru.

Spillovers to Latin America through gross capital inflows



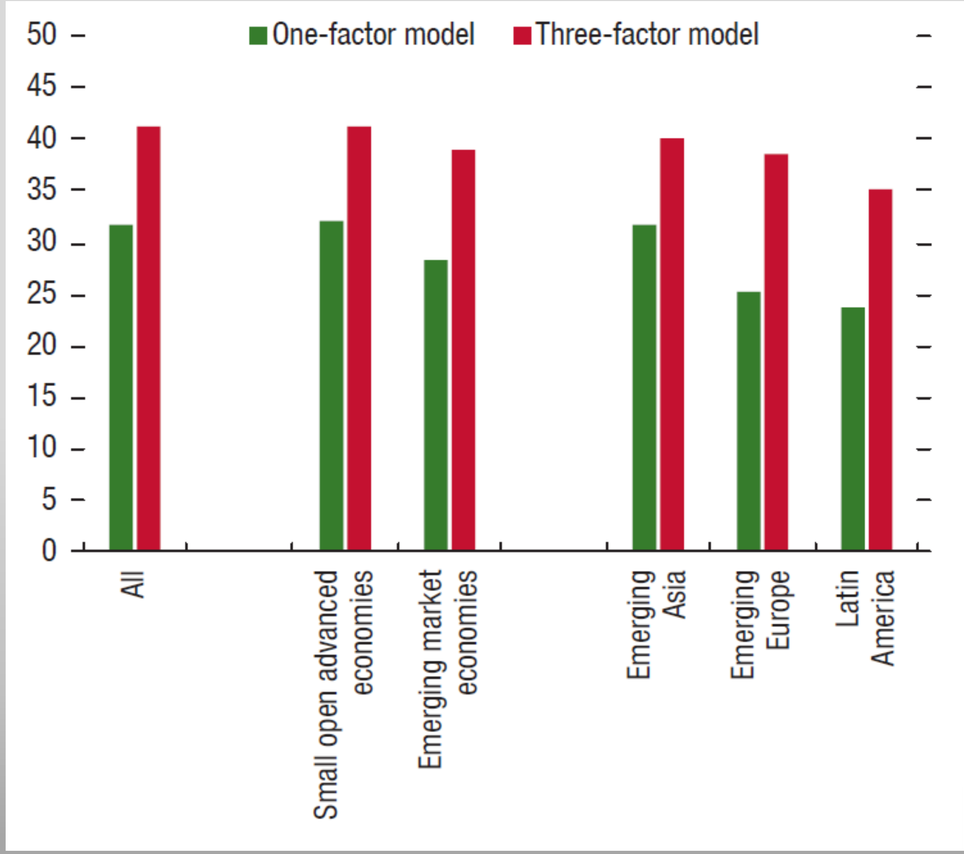
Sources: Haver Analytics; IMF, Balance of Payment Statistics Yearbook database; and IMF staff calculations.
Note: The response to US monetary shock corresponds to the implied change in capital inflows to LA7 countries if US monetary policy tightens unexpectedly by 50 bps. Ratios in percent of GDP refer to trend GDP in U.S. dollars.



Sources: Haver Analytics; IMF, Balance of Payment Statistics Yearbook database; and IMF staff calculations.
Note: The "response to VIX shock" corresponds to the implied change in capital inflows to LA7 countries if VIX increases to close the gap with the U.S. economic policy uncertainty index (this corresponds to a 10-point shock to the VIX, from its current level ([15] to 25 points). Ratios in percent of GDP refer to trend GDP in U.S. dollars.

Overall impact of global factors on LAC financial conditions

Share of variance in countries' overall financial conditions that is accounted for by global factors



Source: "Are Countries Losing Control of Domestic Financial Conditions?" Chapter 3 in *Global Financial Stability Report*, April 2017.

Scope for coordination of MPMs in Latin America?

With whom would we want to coordinate macroprudential policies?

1. Source-recipient coordination: How strong is the case?

- LAC financial systems have strong linkages to financial centers in the U.S. and Europe

- Financial conditions and capital flows in LAC subject to relatively strong spillovers from U.S. and Euro area policies
    - How severe are the costs to recipients? Evidence in favor of the trilemma remains compelling for Latin America, but viewed on a continuum (e.g. REO, 2015 & 2017; Obstfeld et al. 2017)

Scope for coordination of MPMs in Latin America?

With whom would we want to coordinate macroprudential policies?

1. Source-recipient coordination: Impediments

- Even if gains from coordination are substantial for recipients, gains to source countries are likely to be small.

- Asymmetry in size of regional financial systems with respect to the U.S. is large, and spillbacks are unlikely to be quantitively meaningful (though not zero)
  - Not clear if coordination offers a Pareto improvement for U.S. to deviate from inward-looking policies

- The size asymmetry is less pronounced with respect to Spain, but the local deposit funding structure of Spanish subsidiaries in Latin America limits potential spillbacks to parents.

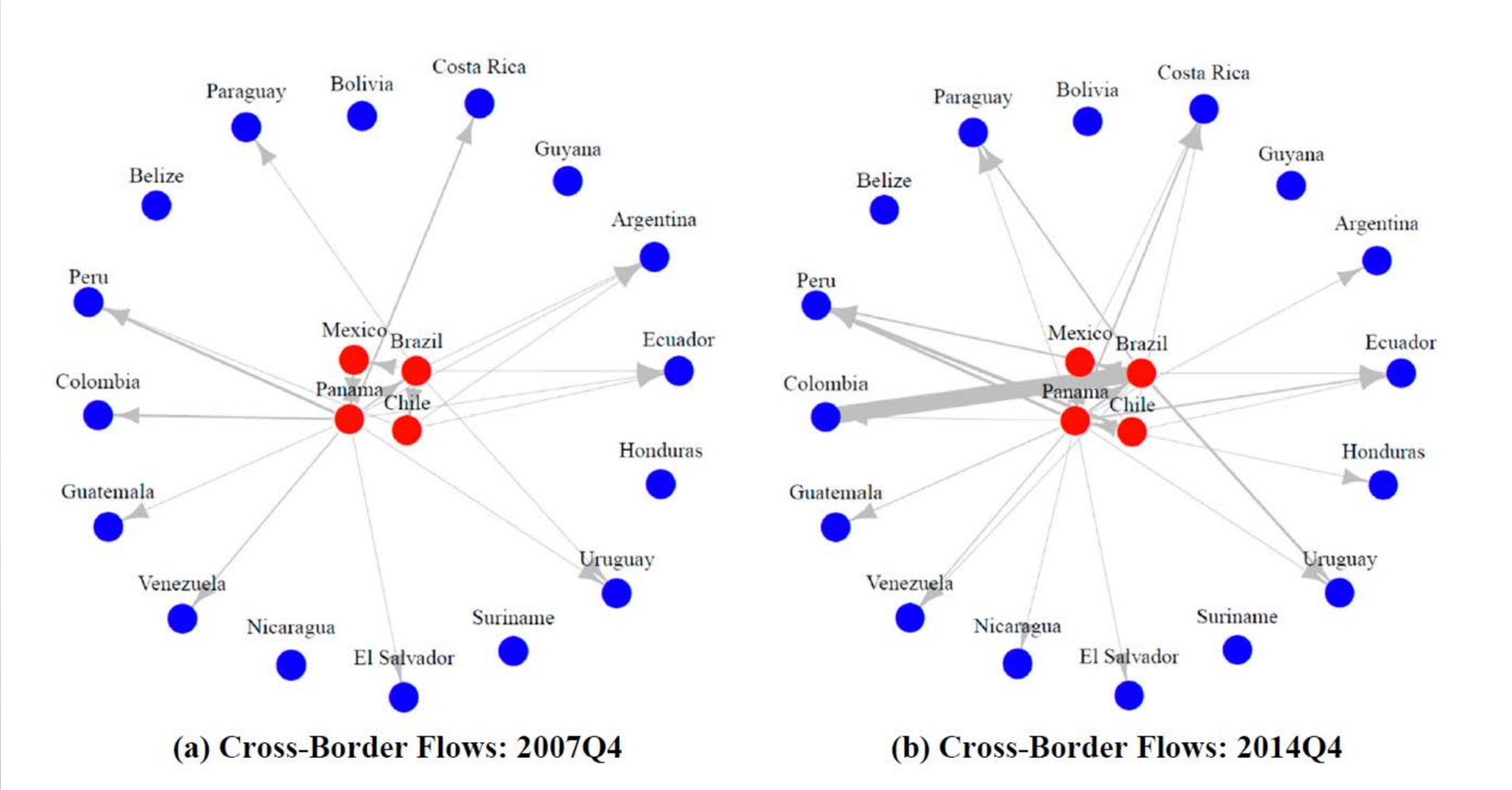
Scope for coordination of MPMs in Latin America?

2. Recipient-recipient coordination: How strong is the case?

- Trade and financial linkages within the region are relatively small with respect to other regions and fundamentals (see 2017 IMF book *Financial Integration in Latin America: A New Strategy for a New Normal*).

- But cross-border banking relationships in Latin America have increased since 2010, in line with a global trend towards financial regionalization (see Cerutti & Zhou, 2017)
    - e.g. Itaú-Corpbanca in Chile and Colombia; Colombia's Davivienda and Bancolombia in Central America.

Expansion of Cross-Border Banking Flows within Latin America



Source: Cerutti & Zhou, 2017. "The Global Banking Network in the Aftermath of the Crisis: Is There Evidence of De-globalization?" Network analysis based on data from BIS Consolidated Banking Statistics. Reporting countries shown in red.

Scope for coordination of MPMs in Latin America?

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- Highly synchronized business cycles limit the cost of spillovers, but also make LAC assets highly substitutable
  - Suggests cross-border *diversion* and *leakage* effects may be important, in line with evidence in Forbes et al. (2016).

Scope for coordination of MPMs in Latin America?

2. Recipient-recipient coordination: Impediments

- Despite potential gains, coordination of macroprudential policies in Latin America will be impeded by disagreements with respect to the appropriate instruments, frameworks, and effectiveness of macroprudential policies.

- Once frameworks for the use of MPM are strengthened within countries, discussions on *reciprocity* across countries may be explored to mitigate undesirable cross-border effects, such as leakage due to regulatory arbitrage.
  - Should not pre-judge the outcome of such discussions: considerable uncertainty about the desirability of these cross-border effects

- A modest but feasible step would be to *collaborate* on data sharing to ensure adequate supervision of cross-border activities. This will make it clearer how financial stability in one country may affects others.

Scope for coordination of MPMs in Latin America?

For Latin America, preserving financial stability in the face of large and volatile capital flows:

- Will continue to call for appropriate macroeconomic adjustment, with exchange rate flexibility playing a key role
- Could appropriately involve the active use of macroprudential instruments within national frameworks to prevent systemic risks
- May call for the use of CFMs, but only in very specific contexts

Is there scope for coordination of macroprudential policies in Latin America?

- Coordination with source countries may provide benefits, but is unlikely to materialize
- Gains from coordination among recipients appear limited at the moment, but could become more substantial as regional linkages strengthen
- Current focus should remain on strengthening national frameworks and data sharing arrangements, and on developing a common understanding of cross-border impacts

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