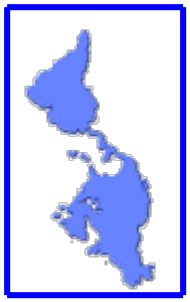

The Global Financial Cycle: What to Do?

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Policy Panel
The Global Financial Cycle and Financial Stability in Small Open Economies

Workshop on Financial Stability
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The 2008 U.S. Crisis and the Global Cycle

- **The 2008 financial crisis in the United States has reignited the interest on international borrowing cycles.**

- **Many have pointed that this crisis was preceded by an excessive bonanza (leading to a global crisis) and have also emphasized the global retrenchment in capital flows in its aftermath.**

- **The crisis has been followed by a protracted collapse in the global economy.**

- **Recent research has pointed to "The Global Cycle," concluding on the impossibility of insulation of economies from this cycle when capital is mobile.**

- **The trilemma now has become a dilemma and independent monetary policies are possible if and only if the capital account is managed, regardless of the exchange rate regime.**

- **Capital account controls have become fashionable again and are now a part of a toolkit of macroprudential regulations.**

What are the Problems? What to Do?

What are the Problems?

- **The belief is that cyclical monetary policy in the financial centers is at the core of these booms and busts: not domestic fundamentals.**
- **Macroeconomic instability:**
  - **capital inflows lead to rapid monetary expansion, inflationary pressures, real exchange rate appreciation, and increasing current account deficits**
- **Asset prices booms and then bust**
- **Fueling crises and dramatic capital flow reversals.**
- **In the aftermath, large nominal and real depreciations**

What to Do?

- **Monetary Policy**
- **Fiscal Policy**
- **Macro-Prudential Toolkit**

Macro-Policies

Monetary Policy

- **It seems that the reports of the monetary trilemma death are greatly exaggerated. See, for example, Cerutti, Claessens, and Rose (2017): Monetary policy can help.**
- **Still, while monetary policy can be autonomous with floating exchange rates, it is impossible for monetary policy to target inflation or unemployment plus deal with financial stability and financial frictions.**
- **The tradeoff between macro-stabilization and financial stability can be daunting: interest rate increases to affect output may worsen financial stability by increasing the fragility of banks and encouraging capital flows.**

Fiscal Policy

- **Fiscal policy cannot react fast enough to financial fragility and stop crises but a well funded government can help in dealing with the crisis when it erupts.**

Macro-Prudential Policy

- **Policies designed to mitigate financial-stability risks associated with capital inflows. These measures are mostly applied to the regulated domestic financial sector (banks):**
  - **Foreign-exchange related prudential measures: For example, limits on banks open FX position (as a proportion of their capital) and limits on banks lending in foreign currencies.**
  - **Domestic prudential regulations: For example, maximum loan to value (of the asset purchase) ratio, limits on domestic credit growth, sectoral limits on loan concentration, dynamic loans-loss provisions.**
- **But**
  - **It may do little good to place restrictions on domestic lenders if foreign lenders can enter the market and operate without restrictions.**
  - **Similarly, restrictions to domestic residents' foreign-currency borrowing are less effective if the same entities can issue foreign-currency debt in offshore markets.**
- **Need to introduce capital controls.**

Cautionary Tale

- **Capital controls and macro-prudential regulations: Financial repression once again?**

- **Capital controls and overall macro prudential regulations may contain booms. But we cannot forget the effects of financial repression on the quality of institutions.**

- **Financial globalization triggers reforms, improving institutions and governance:**
  - **Well-established firms oppose reforms that promote financial development as it promotes better disclosure rules and enforcement, reducing the importance of the firm's collateral and reputation. But opposition is weaker in more open economies with cross-border flows, as incumbent firms can now tap foreign markets for funds at lower costs.**
  - **Financial globalization can reduce the importance of the twin agency problems, that is the incentive of governments and corporate insiders to expropriate outside investors. Open borders can "shackle the government grabbing hand" as they give resident investors an exit.**

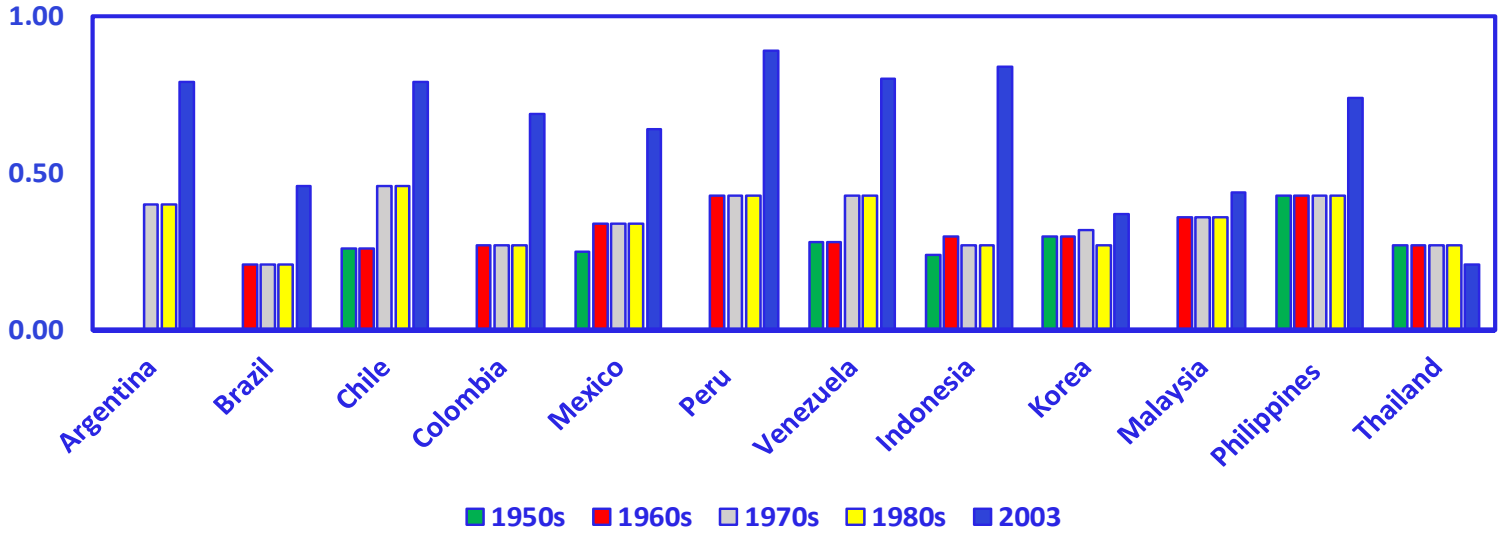
- **Reversals in financial globalization may undo these reforms and cause further distortions in the economy.**

Does Globalization in Fact Trigger Reforms?

Sequencing of Reforms in Emerging Markets

Type of Financial Liberalization	Probabilities of Liberalization Conditional on		
	Insider Trading Laws Existence	Insider Trading Laws Enforcement	Improvement in Law and Order
Partial Liberalization	62 ***	11	18
Full Liberalization	77 ***	44 **	64 ***
Hypothesis Test (P-Value)			
Partial Liberalization = Full Liberalization	0.17	0.08	0.02

Central Bank Independence Index



Has the Cyclicality of Monetary Policy Changed?

- **In the old days, most developing countries were following procyclical monetary policies.**

- **In more recent times, most developing countries follow countercyclical monetary policy.**

- **Vegh and Vuletin (2012) trace this shift in policy to improvements in institutional quality. The authors conclude:**

  - **Procyclical monetary monetary policy is triggered by "Fear of Free Falling." The depreciation of the currency during bad times (typically characterized by large capital outflows) forces policymakers to raise the interest rate to defend the currency to avoid even further capital outflows and systemic bankruptcy of firms indebted in dollars.**
  - **As many emerging markets matured by undertaking market-friendly reforms and having better institutions, this fear of free falling has subsided, allowing policy makers to follow countercyclical policies.**

Globalization and Financial Repression: Inflation and Money Growth 1960-2015

Country	Globalization				Financial Repression			
	Assets Growth	Foreign Exchange Reserves Growth	Growth in Lending to Government, Banks, and Non-Financial Institutions	Inflation	Assets Growth	Foreign Exchange Reserves Growth	Growth in Lending to Government, Banks, and Non-Financial Institutions	Inflation
Asia	**11.9**	**10.1**	**1.8**	**4.0**	**16.3**	**8.8**	**7.5**	**7.8**
Korea	12.6	10.9	1.8	3.5	22.0	5.4	16.6	11.3
Malaysia	10.9	8.0	2.9	3.3	15.3	15.1	0.2	3.0
Philippines	10.3	10.1	0.2	5.3	16.5	7.2	9.3	11.9
Thailand	13.7	11.3	2.5	4.0	11.5	7.6	3.9	5.0
Latin America	**16.0**	**7.9**	**8.0**	**21.7**	**92.6**	**5.5**	**87.1**	**155.1**
Argentina	26.3	4.7	21.6	58.1	182.9	4.3	178.6	238.2
Chile	5.4	5.3	0.1	9.1	121.2	4.1	117.1	83.9
Colombia	9.9	8.8	1.1	11.2	21.0	6.4	14.6	18.4
Mexico	19.6	8.0	11.6	13.6	30.1	2.9	27.2	31.4
Peru	18.6	12.9	5.7	16.7	107.9	9.9	98.0	403.5
All Countries	**14.1**	**8.9**	**5.3**	**13.8**	**58.7**	**7.0**	**51.7**	**89.6**

- **With financial repression, there is a tendency to more inflation and money growth.**

Globalization and Credibility: Central Bank Assets and Inflation

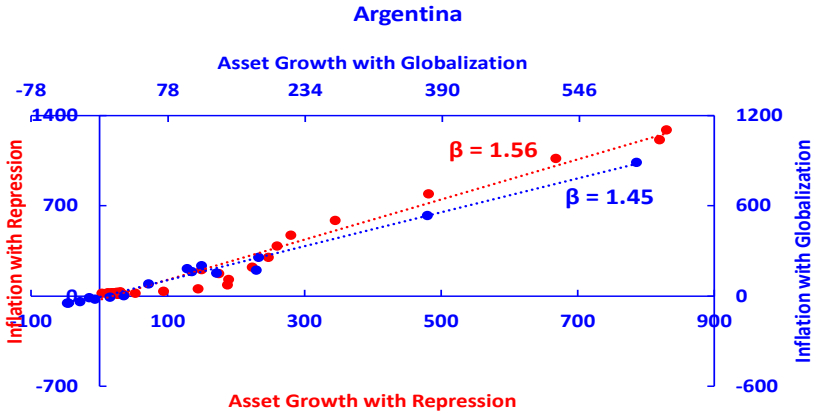
- **To examine central banks' credibility, I follow Sargent & Surico (AER, 2011).**

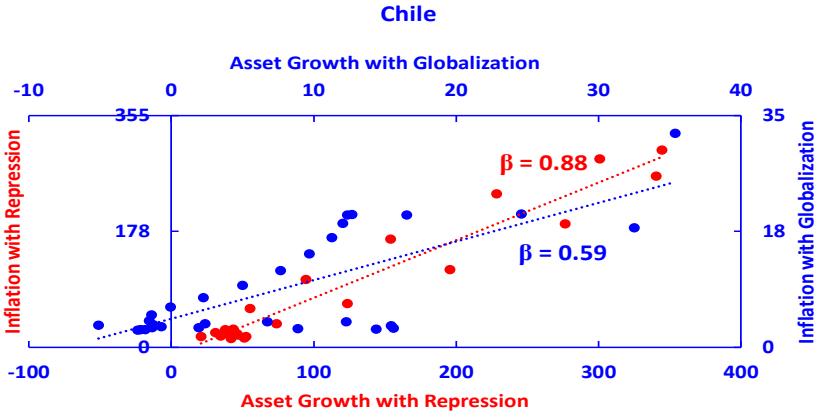
- **In their paper, they examine the low-frequency correlations between money growth and inflation for the United States over selected subperiods in the sample 1900-2005. The question is whether the quantity theory of money holds. That is, whether the correlation between filtered series of money growth and inflation oscillate around one. They find that the inflation on money growth slope is only close to one in the period 1955-75 but is substantially larger than one during 1900-1928, flatter during 1929-1954 and even negative during 1984-2005.**

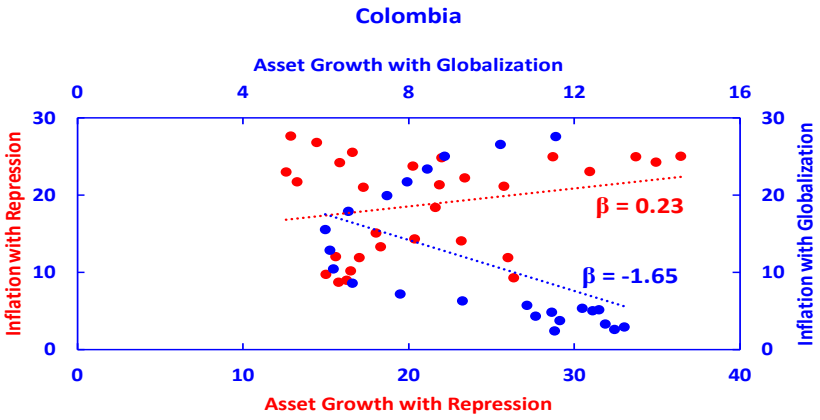
- **What triggers these changes in slopes?**

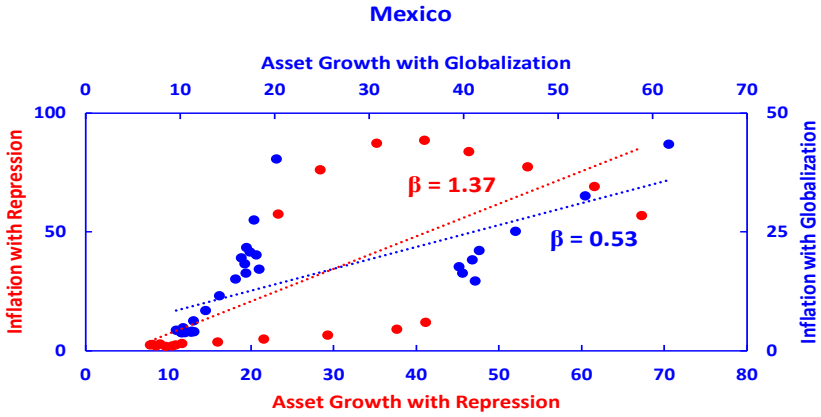
- **To answer this question they estimate a traditional DSGE model with various exogenous shocks and monetary policy rules and examine whether changes in monetary policy parameters can explain the changing slope. These simulations indicate that a credible future move to an anti-inflationary stance can bring these correlations close to zero or even negative. But if the monetary rule implies persistent increases in money growth, the correlation increases to one.**

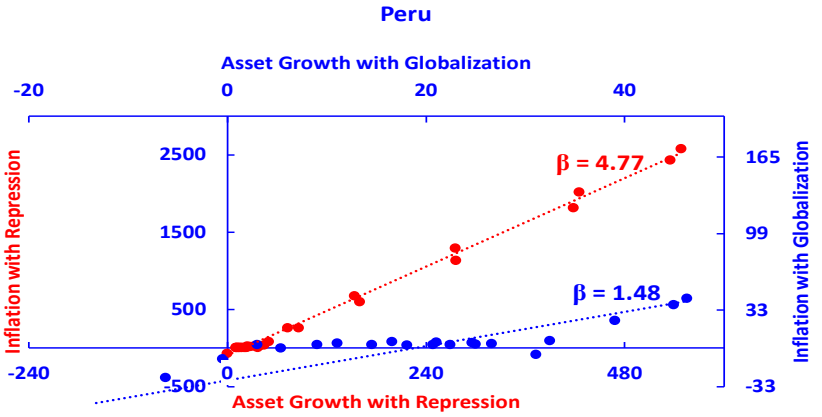
Money Growth and Inflation: Breakdowns or Continuity?











Reflections

- **With globalization, policy makers have to pay more attention to the financial global cycle and monetary policy in the financial center.**

- **Monetary policy cannot do it alone.**

- **Capital controls and "macro-prudential" regulations?**

- **Need to look back to the episode of financial repression and quantify the costs introduced by these distortions.**