Financial Integration, instability and the (absence of) a LRR: the emerging market perspective

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January 2019
The challenge

• At the IMF WB meeting in Bali last year, Singapore and South Korea topped the new WB Human Capital Index
• They were justly lauded for it
• At the same time, pundits and bankers warned against the dangers of large current account deficits.
• Countries with such a deficit were justly condemned for it.
• Justly?
Singapore’s current account during takeoff
Korea’s current account during takeoff
The task

• To make the world safe for countries to act like Korea and Singapore

• We are very far from that ideal today

• Why?
The problem

• For EMs (and also perhaps for non EMs), capital flows are only partially a function of country characteristics and policies

• The world financial cycle (prompted largely by US monetary policy)

• Predisposition toward sudden stops and the inevitable current account reversals
The sudden stop epidemic

Source: Calvo (2014)
Capital flow volatility

Non-resident Net Capital Flows to Major EMs

Source: Institute of International Finance
Analytics

• Capital flows depend on asset prices: when asset prices are high, collateral is strong (key: no perfect capital mobility)
• Asset prices depend on capital flows: land is more productive when planted or when it has buildings on it
• Conclusion: 2-way causality
• Conclusion: multiple equilibria and self-fulfilling expectations all over the place!
• In EMs, problem made worse by original sin: difficulty to borrow in own currency.
One example (Neut-Velasco 2008)
Policy implications (1)

• Surveillance and anticipation is of limited use: by definition you cannot anticipate things that happen because of exogenous changes in expectations

• Floating exchange rates are not a panacea:
  • Balance sheet effects can exacerbate problems
  • As a result, many countries display “fear of floating”

• Macro-prudential is not a panacea either:
  • All the reasons Helene mentioned
  • Plus: even if you are “prudent” you can be subject to a self-fulfilling run
  • Plus: macro-prudential does not extend to shadow banking or informal credit
Policy implications (2)

• One thing can make a big difference: an international lender of last resort (LRR)
• Problem: the IMF is neither sufficiently large or sufficiently swift to do the job.
• Bilateral swap arrangements are available only to a few EMs
• Regional financing arrangements (RFAs) exist only in a few regions
The global financial safety net that isn’t
The G20 EPG proposals

• Build a real global financial safety net

• “Establish a standing IMF liquidity facility to give countries timely access to temporary support during global liquidity shocks”. (How do you pay for it?)

• “Enable the IMF to rapidly mobilize additional resources in large and severe global crises”.

• Stitch together bits of the GFSN: for instance, make eligibility requirements more uniform across lenders

• Encourage exchanges of information and coordination among lenders
Thank you!