



Peterson
Institute for
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Economics

POLICY IMPLICATIONS FOR SMALL OPEN ECONOMIES

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I. The issues

- The papers in this session deal with two very important, and related issues, on policymaking in SOEs:
 - Monetary policy independence (Gagnon, Klein and Kang) with financial integration with flexible exchange rate. Trilemma or dilemma?
 - The role of capital controls and macroprudential tools for exchange rate goals and financial stability? (Kang, Kim-Lee, and Klein).

II. On Monetary Policy Independence

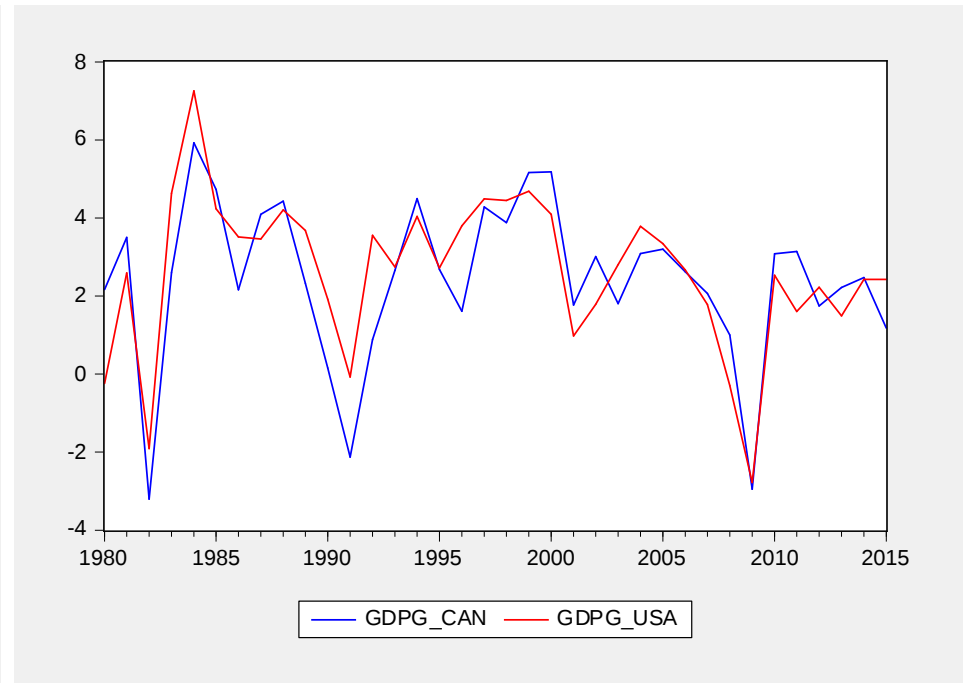
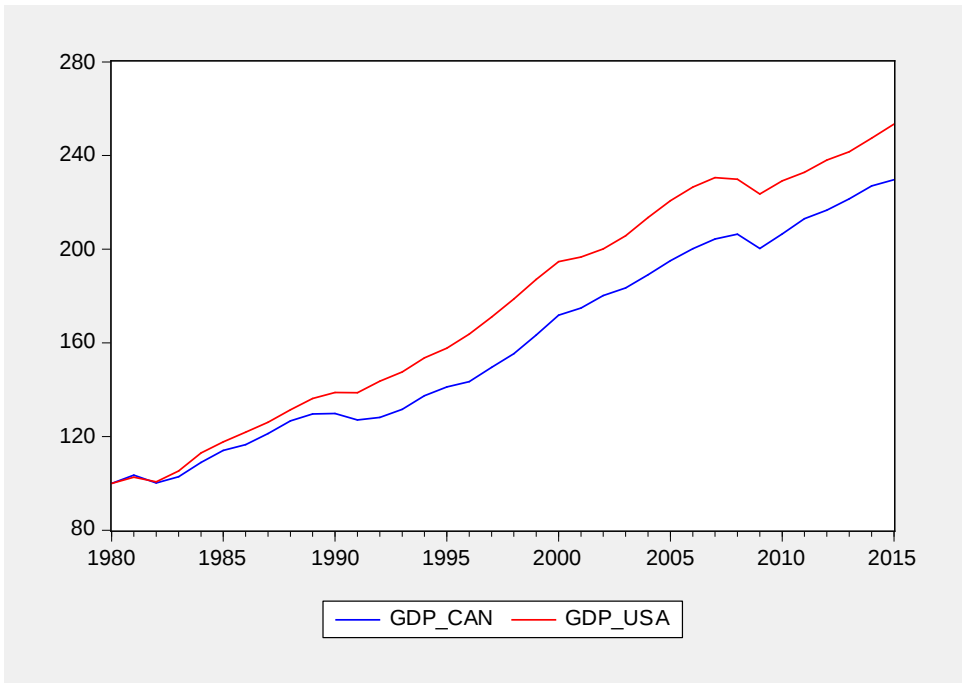
Cross-country evidence:

- Gagnon's results: Inflation targeting economies did better while hard pegs did worse than other economies in a large sample of countries from 2007-2012. *Comment* No controls for capital account openness or other financial variables.
- Alvarez and De Gregorio (2014) sample of EMEs and DEs. **Countries that were able to cut MP rates did better.** Higher private credit, more financial openness (foreign assets-wealth effect), less trade openness, and greater exchange rate intervention worsened economic performance. No clear evidence on **fiscal policy**.

Canada-USA:

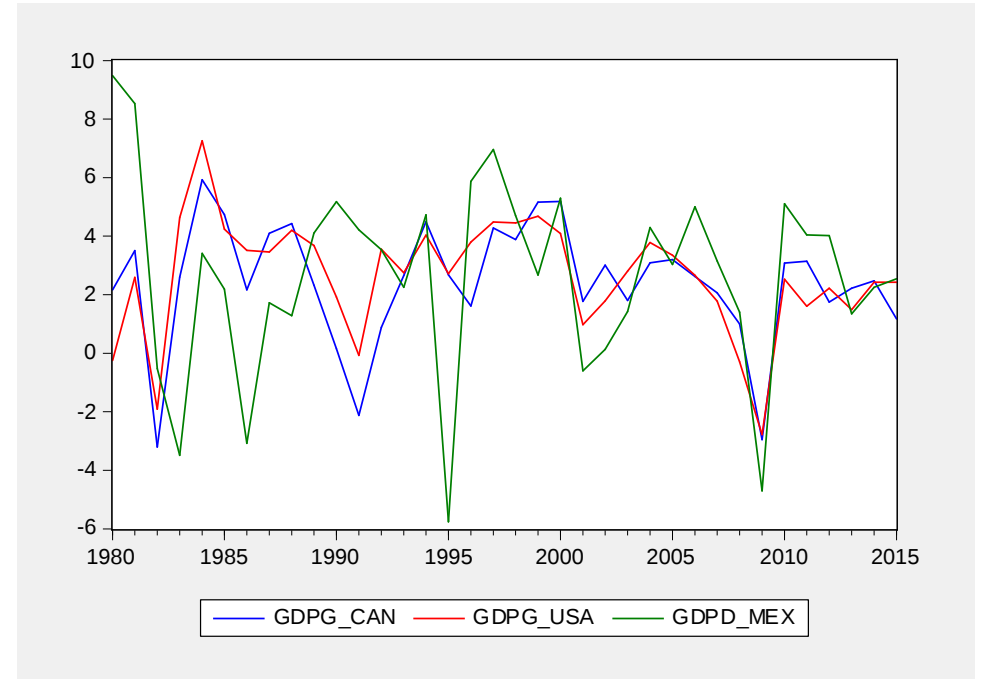
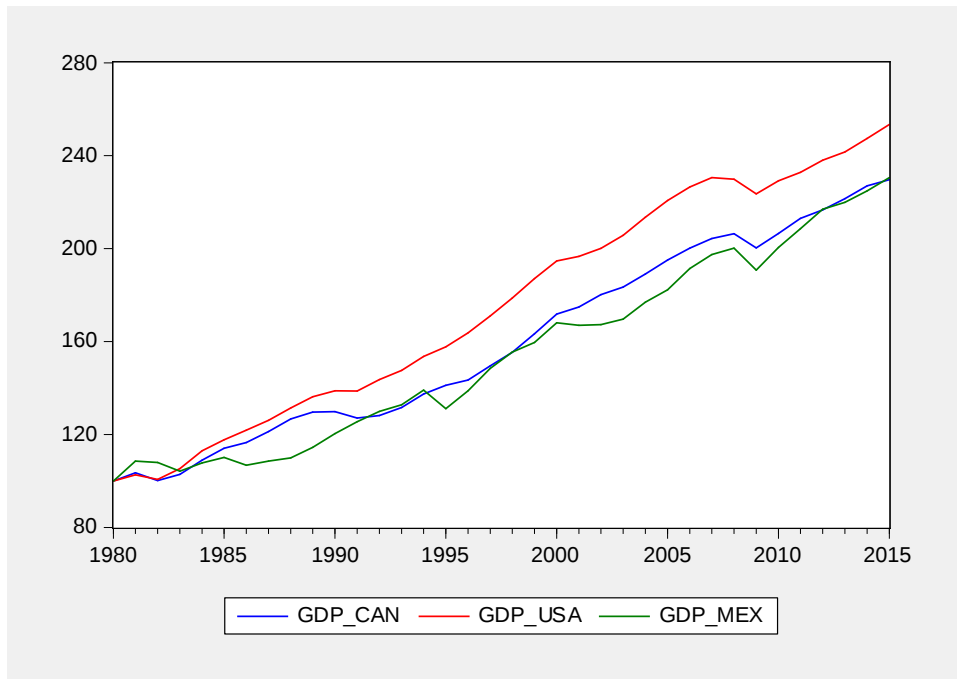
- Interest rates are highly correlated, but also they experience large exchange rate fluctuations. This is exactly what we would expect from Mundell-Fleming when there is free capital mobility and rapid exchange rate adjustment. Therefore the **monetary mechanism** is at work through the **exchange rate channel**.
- Being (strongly) sympathetic with this view, the concern is what is the right metric to evaluate policy frameworks.

Canada-USA GDP and GDP growth

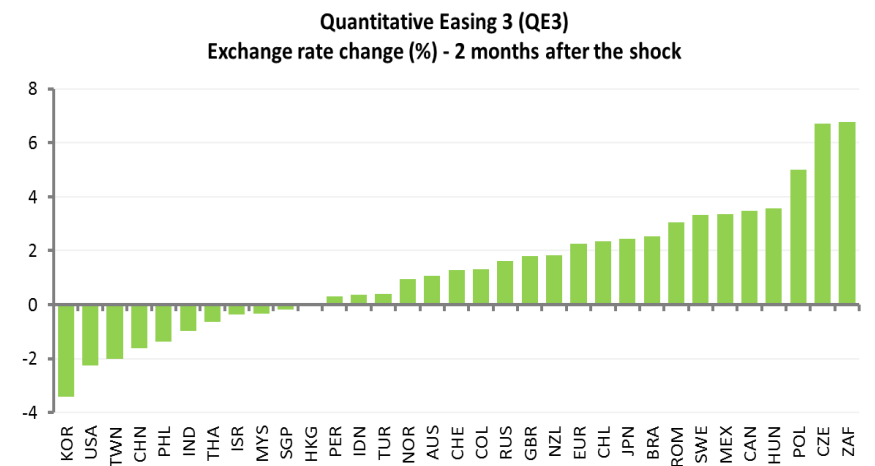
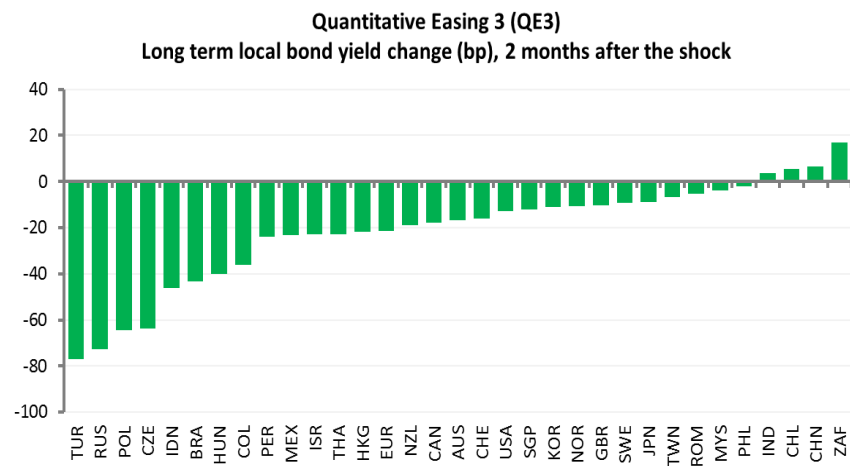
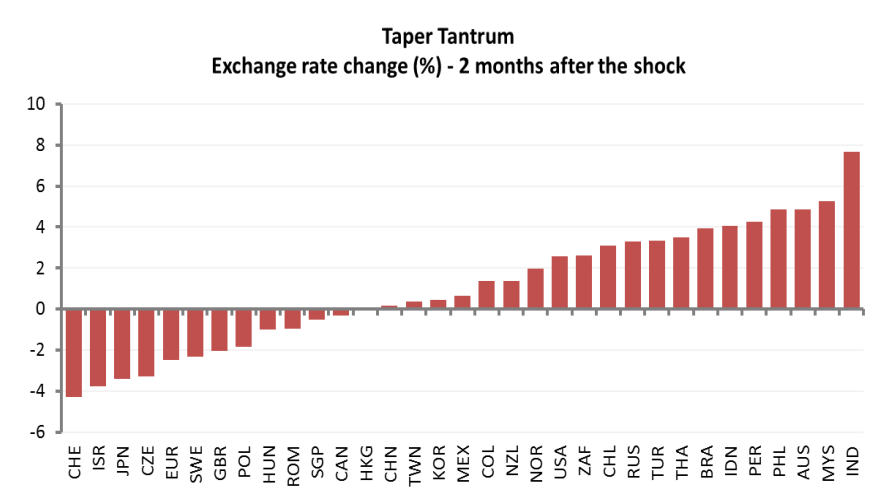
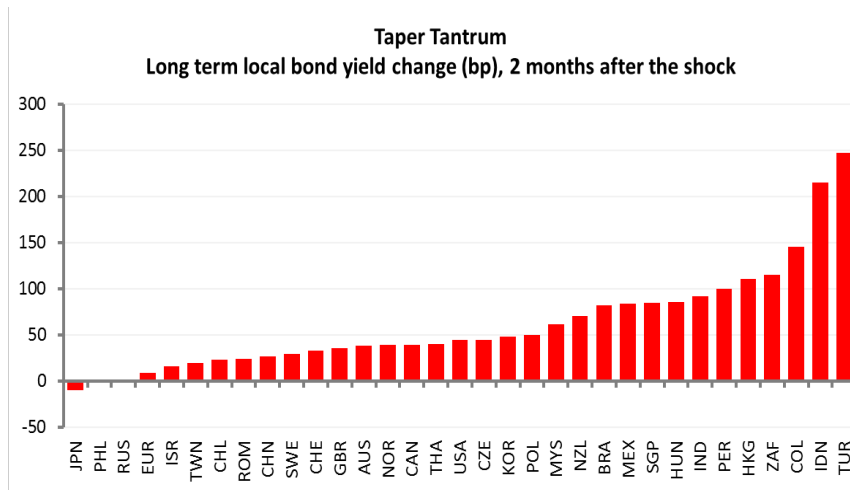


From 1980 to 2015 the USA accumulated 10% more output than Canada.
Very high correlation, for the rate of growth is 0.83.
What is the metric to measure Canada's policy framework.

Perhaps adding Mexico could help

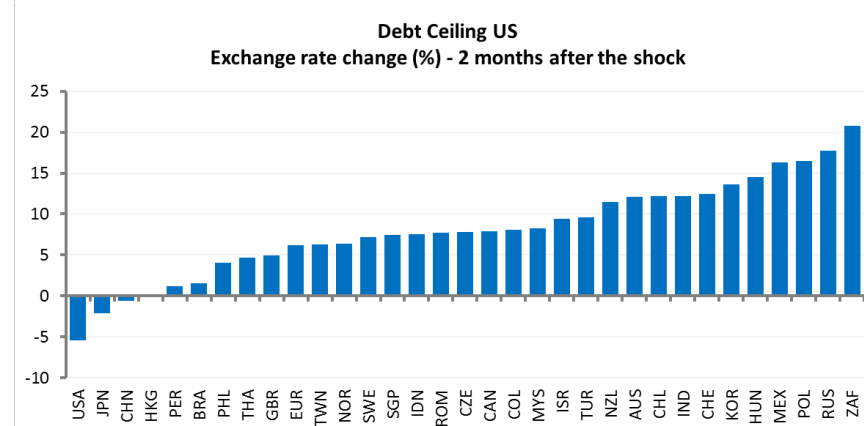
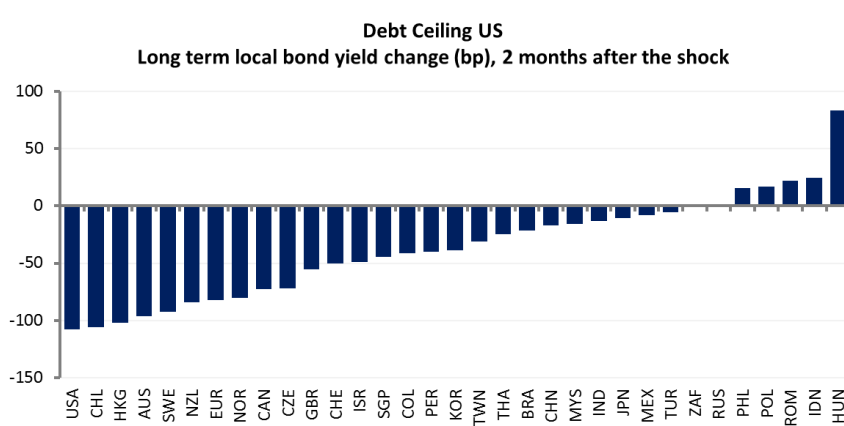
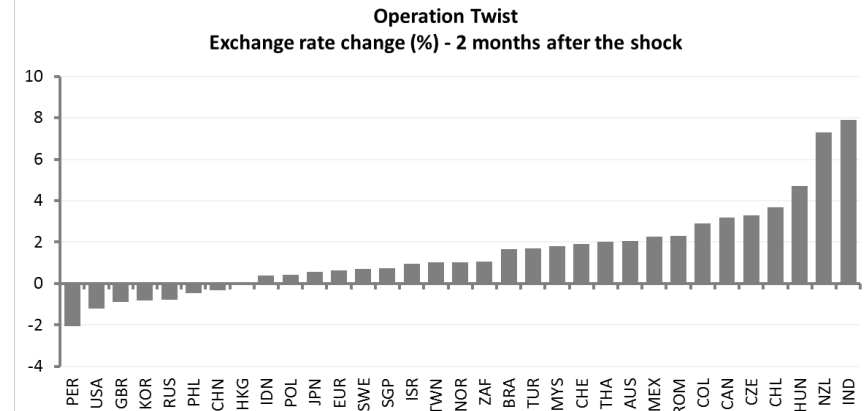
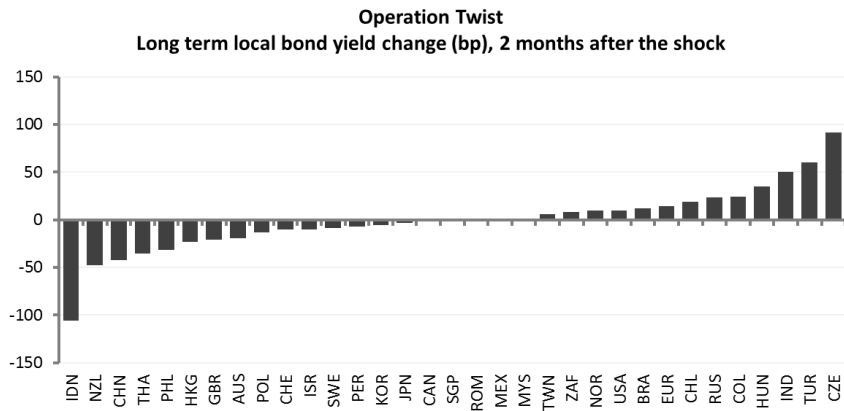


Local bond yields and Exchange rate responses 2- months after selected episodes

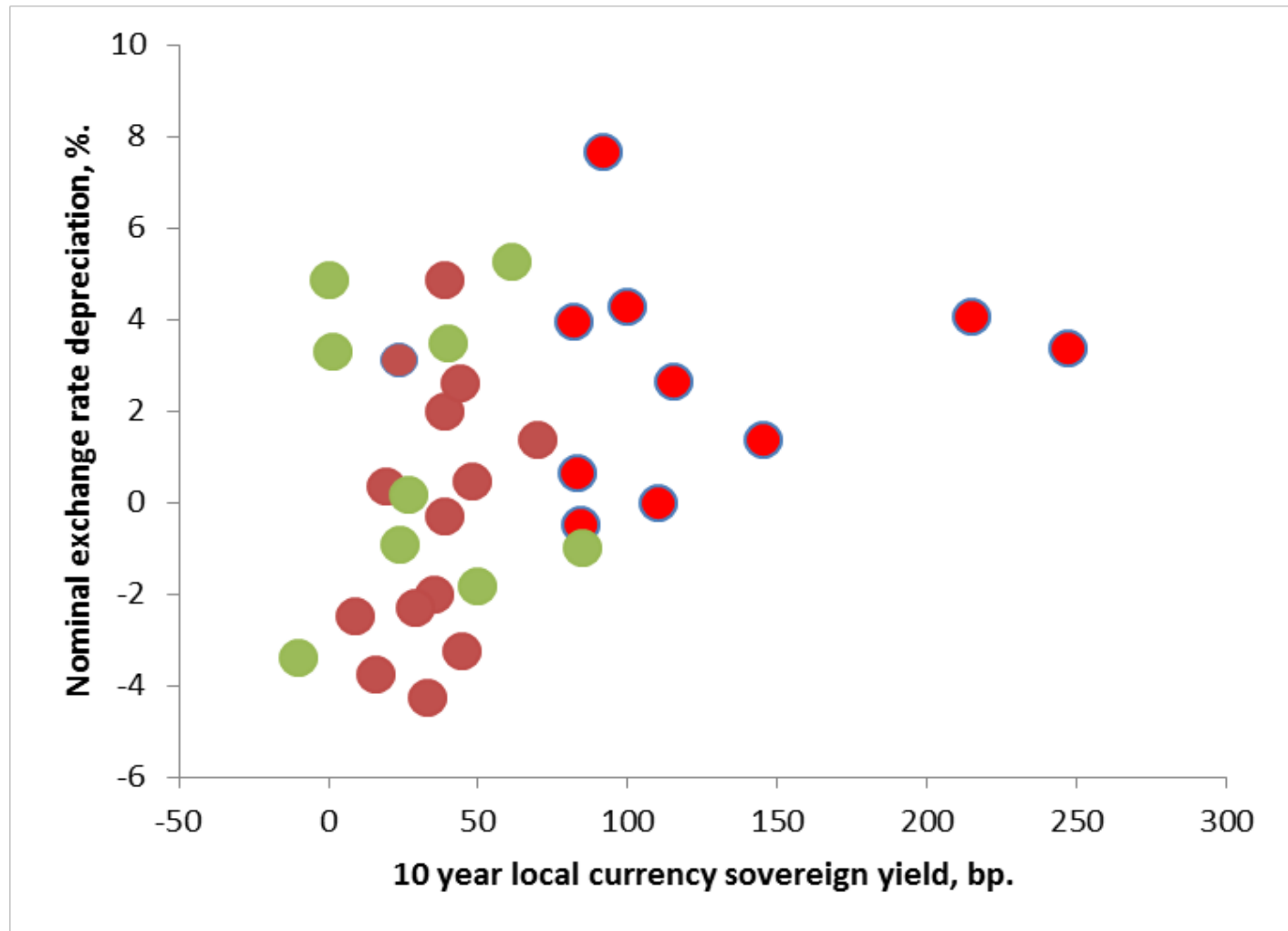


Source: De Gregorio and Garcia (2016), "Financial Integration and the Transmission of Shocks", forthcoming, and Bloomberg.

Local bond yields and Exchange rate responses 2 months after selected episodes



Response of exchange rate and local yields during Taper tantrum (2-months)



Clustering according to responses to four episode

Three clusters						
Cluster 1		Cluster 2			Cluster 3	
Brazil	Mexico	Australia	Israel	Sweden	China	Poland
Colombia	Peru	Canada	New Zealand	Switzerland	Hungary	Romania
Hong Kong	Singapore	Chile	Norway	Taiwan	Japan	Russia
India	Turkey	Czech Republic	Rep. Of Korea	United Kingdom	Malaysia	Thailand
Indonesia		Germany	South Africa	United Stated	Philippines	



III. On Capital Controls and Financial Integration

- Klein: Gates (transitory and specific controls) versus Walls (permanent and broad-based controls).
- Question: Are Wall countries those that have not liberalized yet and Gate-countries those relatively open that want to introduce some sand in the wheels?
- The results can be interpreted as countries pre- vs. post-liberalization.
- Policy issues: when, how and whether to liberalize? Once open what to do?

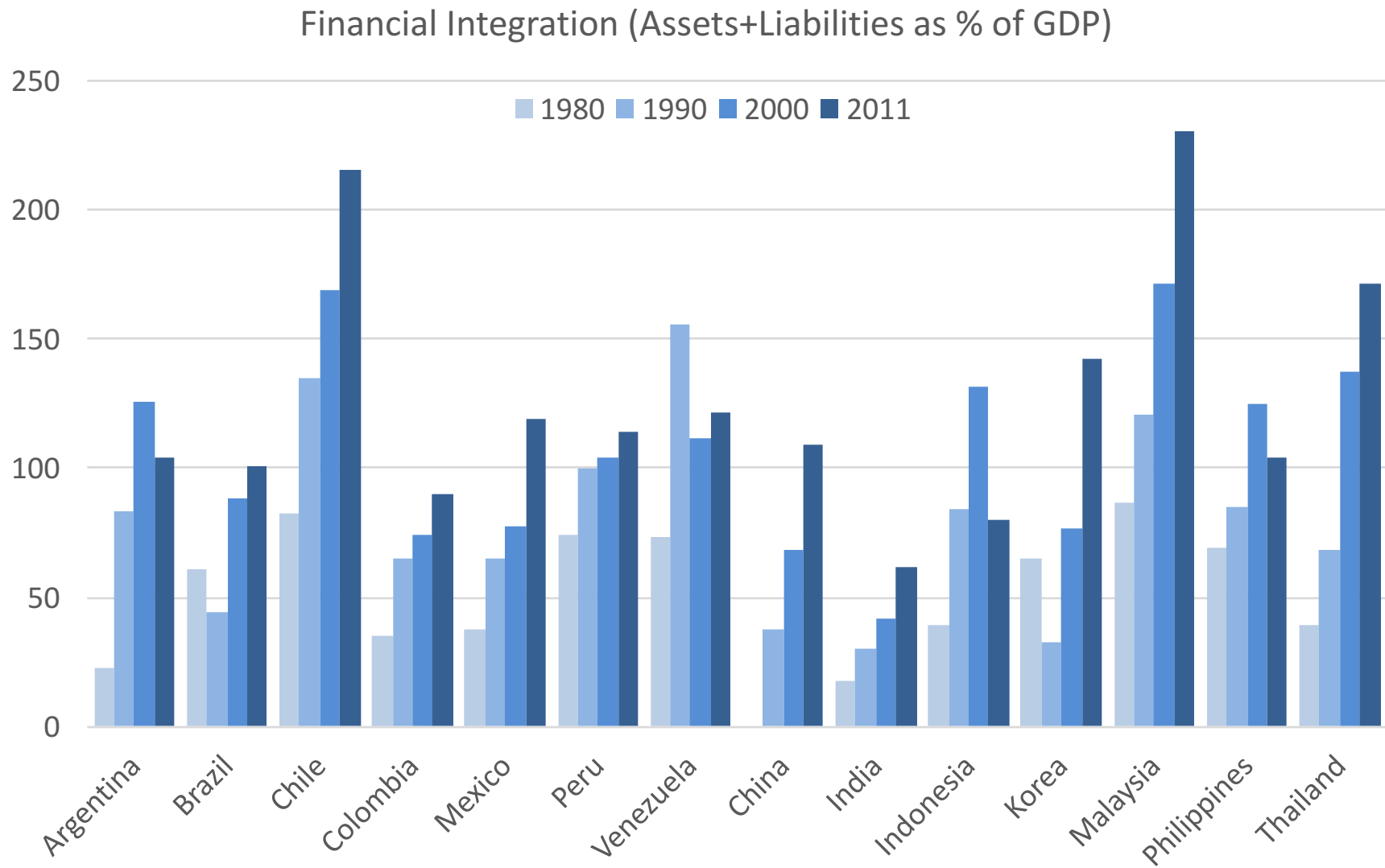
Capital Controls and Financial Integration

- Old question, what first?: domestic or international financial liberalization. Financial or trade opening.
- Lesson: strong domestic financial system to benefit from financial integration. (some evidence that capital account opening is good for growth if institutions are strong).
- Capital account opening is irreversible. Gates are not applied to all types of inflows and hence are more likely to be evaded.
- Gates on outflows: emergency measures following currency plus banking crisis (Iceland, Malaysia)

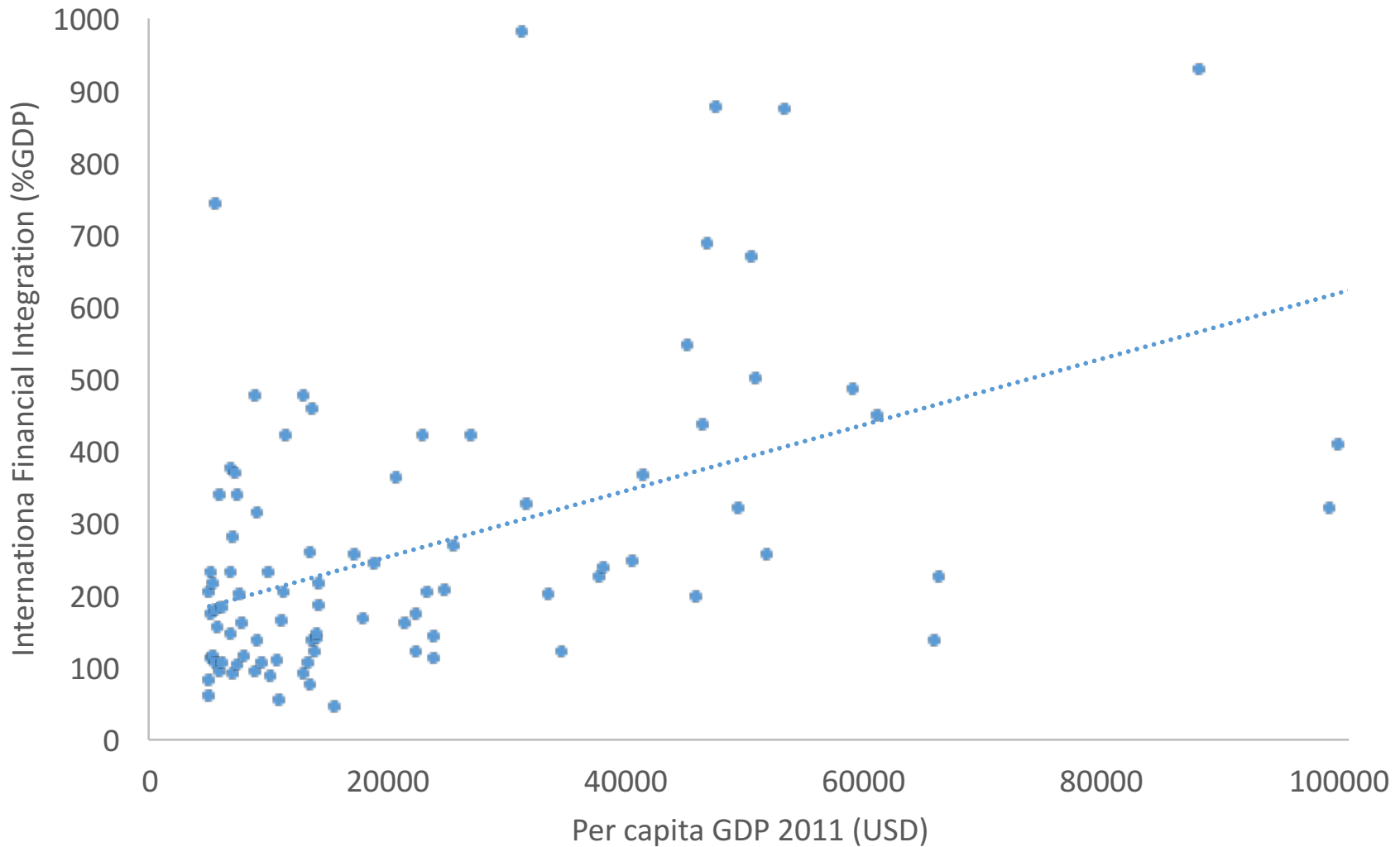
Capital Controls and Financial Integration

- Most evidence on capital controls shows some effectiveness on financial variables, not much in exchange rates. Composition of inflows (Kim and Lee), but evidence on exchange rates is limited.
- Macroprudential-capital controls measures in Korea has been effective in curbing flows, but only in the banking system, not regarding bond flows (Kim and Lee). But do bond flows affect financial stability (Pecking order)? Why to control them: exchange rate pressures or FS?
- For exchange rate volatility and level: foreign exchange rate intervention (Gagnon and Addler et al., 2015): 1% of GDP intervention causes a real depreciation of 1.5% and half lifetime between 1 and 2 years. Effects are relevant, but do not last forever and may lead to permanent accumulation of reserves. How does this fit with currency manipulation? Stabilization, insurance and competitiveness.
- Finally: regardless of policy objectives, development leads to financial integration, and this has happened among emerging markets. So it is better to be well-prepared.

Financial integration has increased



International financial Integration and GDP per-capita



Source: Lane and Milesi-Ferretti database and WEO. Countries with GDP per-capita more than 5000 USD and IFI less than 10 times GDP.

Conclusions and policy implications

- Financial integration will go on, so be prepared.
- SOEs can follow independent monetary policy, but cannot avoid the global financial cycle. But that this not imply that MP can stem a credit boom. Its role is not to safeguard financial stability.
- IT plus flexible exchange rates work, but avoiding excessive appreciation could call for reserve accumulation.
- Macroprudential tools: capital controls or general regulation (banks capital)? Particularly relevant to face new periods of capital inflows surges.
- Significant risk: surges of capital inflows leading to financial booms, vulnerabilities and crisis. No strong evidence this happened during the global financial crisis, at least in Emerging Asia and Latin America.