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

Andrés Velasco
London School of Economics
School of Public Policy
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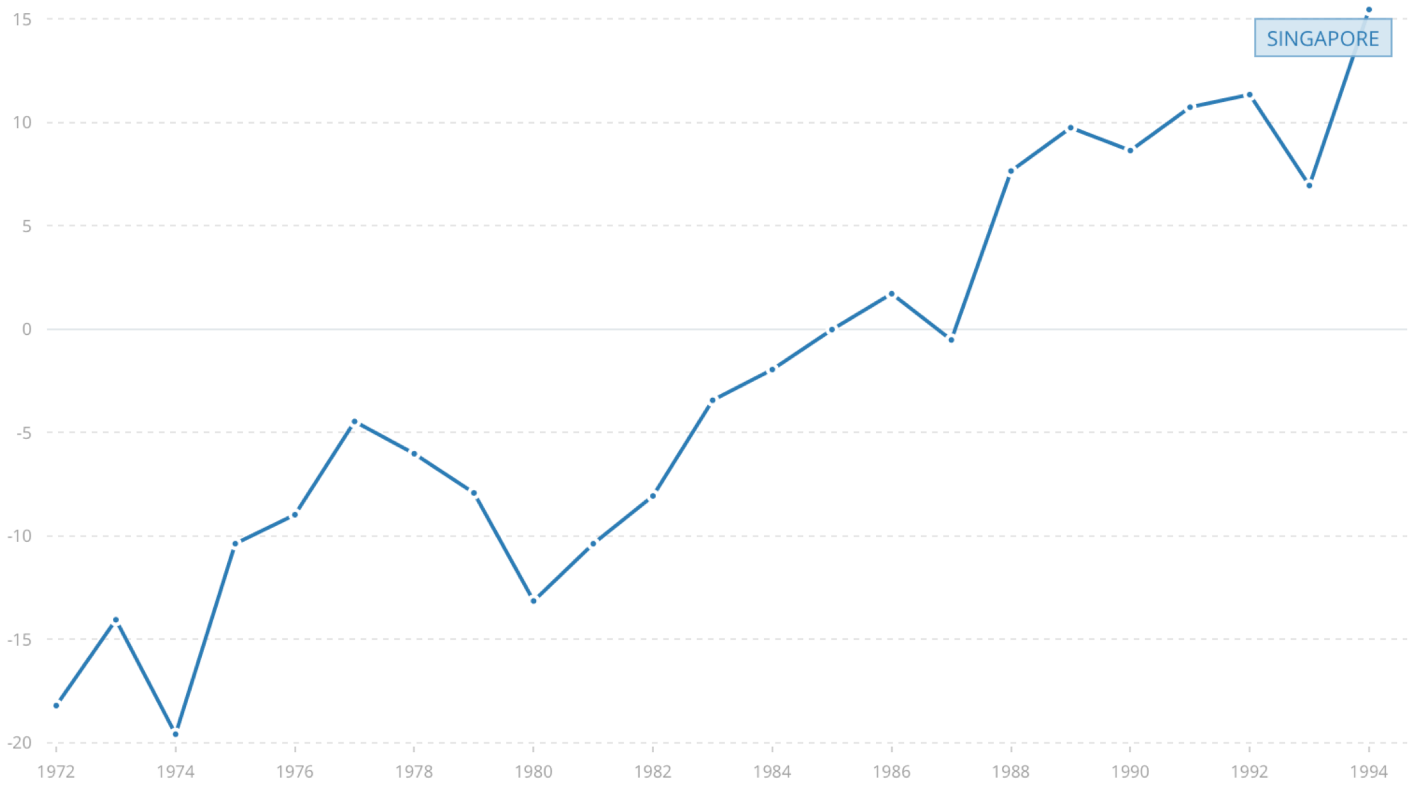
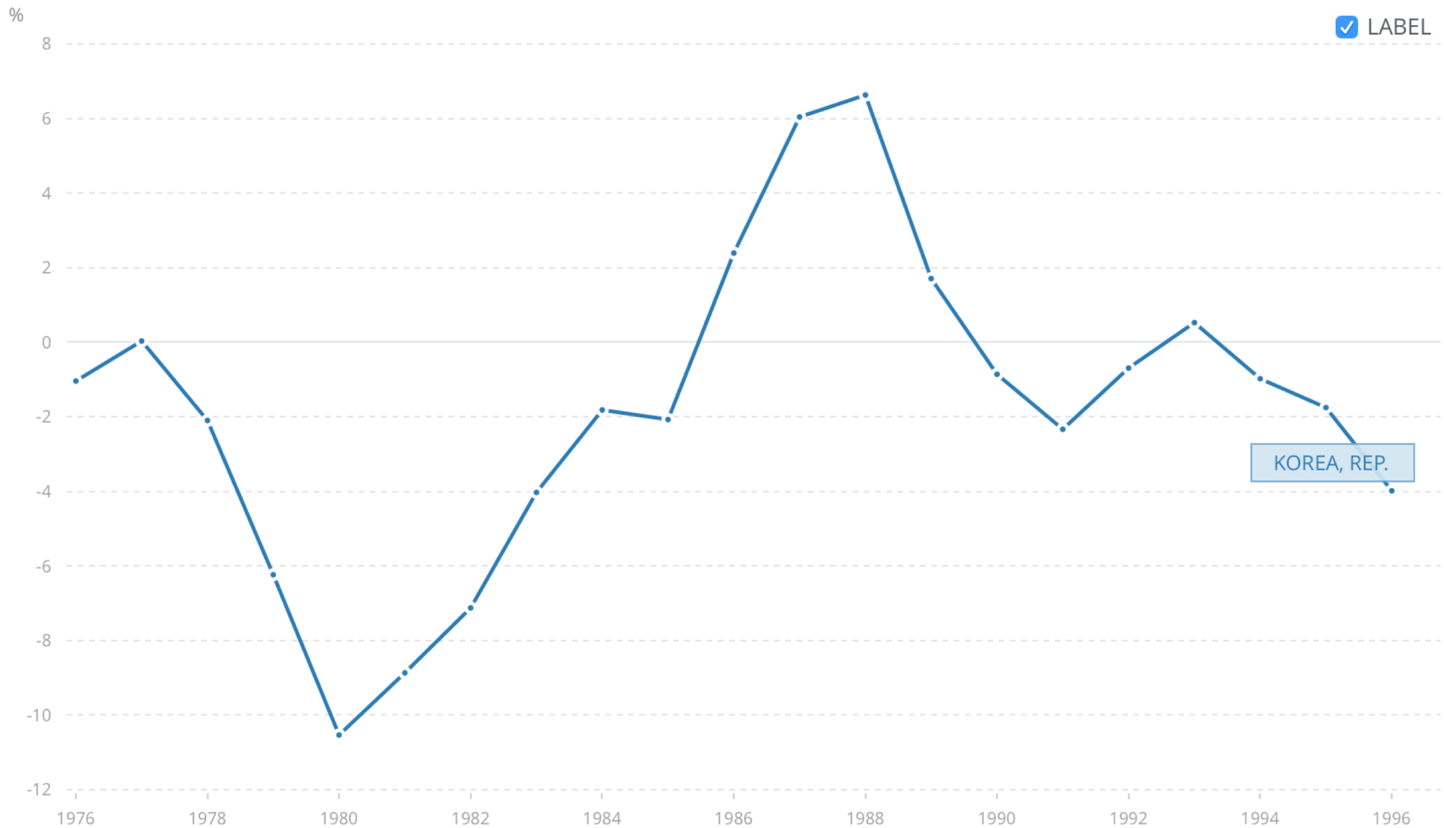
The challenge

- 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



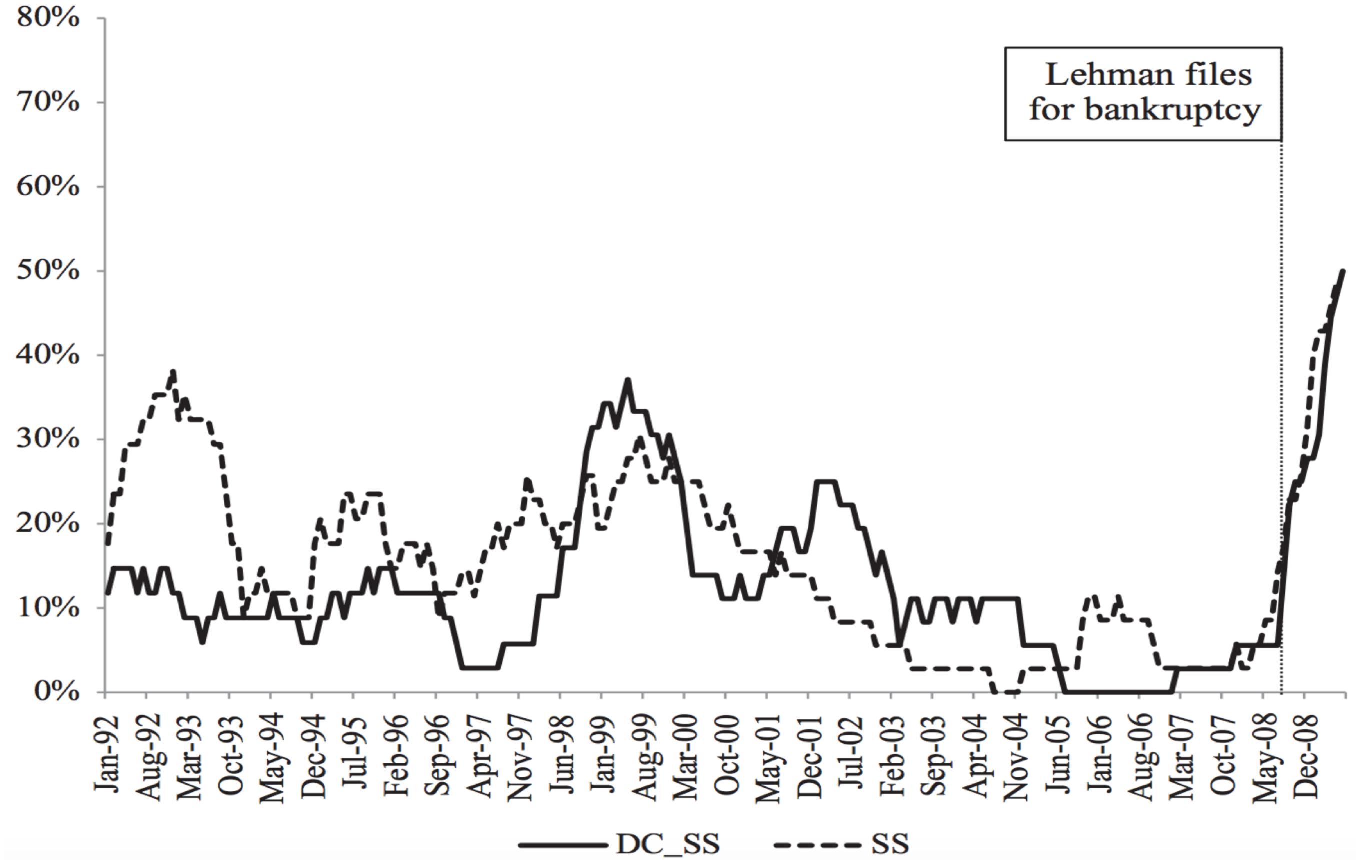
The task

- To make the world safe for countries to act like Korea and Singapore
- We are very far from that ideal today
- Why?

The problem

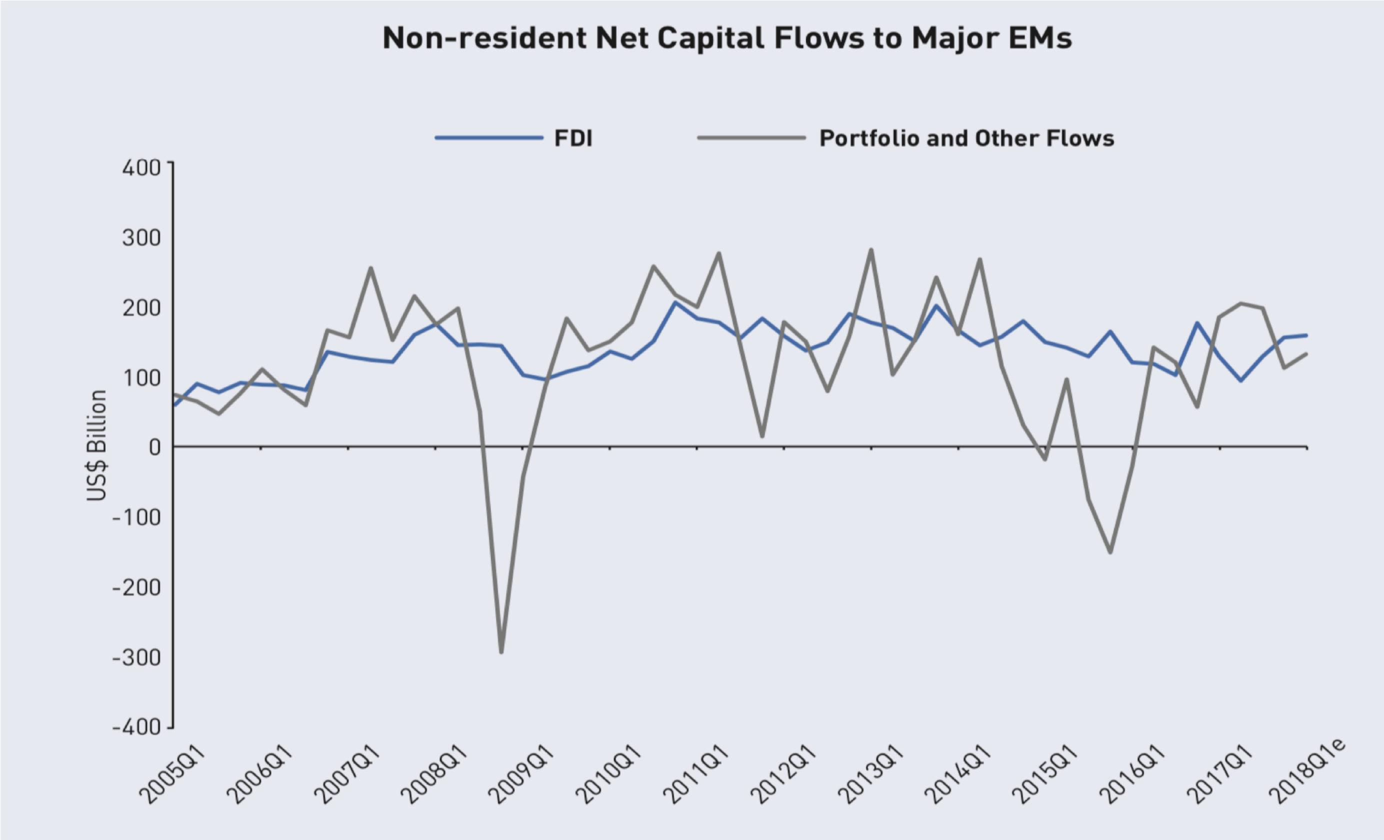
- For EMs (and also perhaps for non EMs), capital flows are only partially a function of country characteristics and policies
- The world financial cycle (prompted largely by US monetary policy)
- Predisposition toward sudden stops and the inevitable current account reversals

The sudden stop epidemic



Source: Calvo (2014)

Capital flow volatility

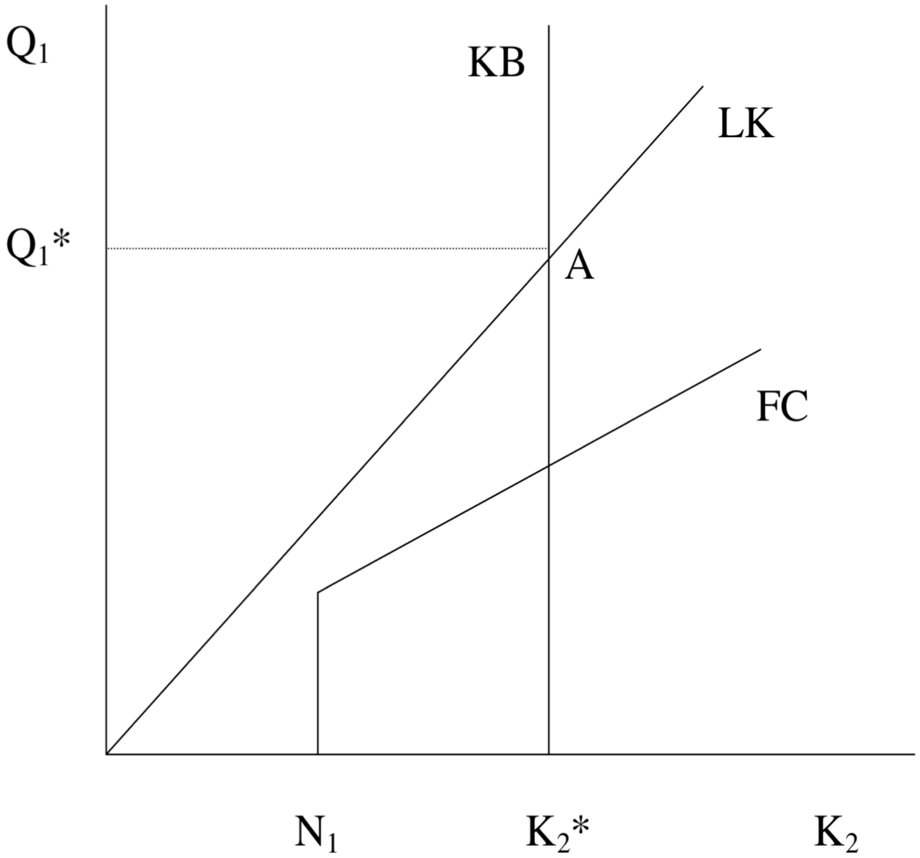


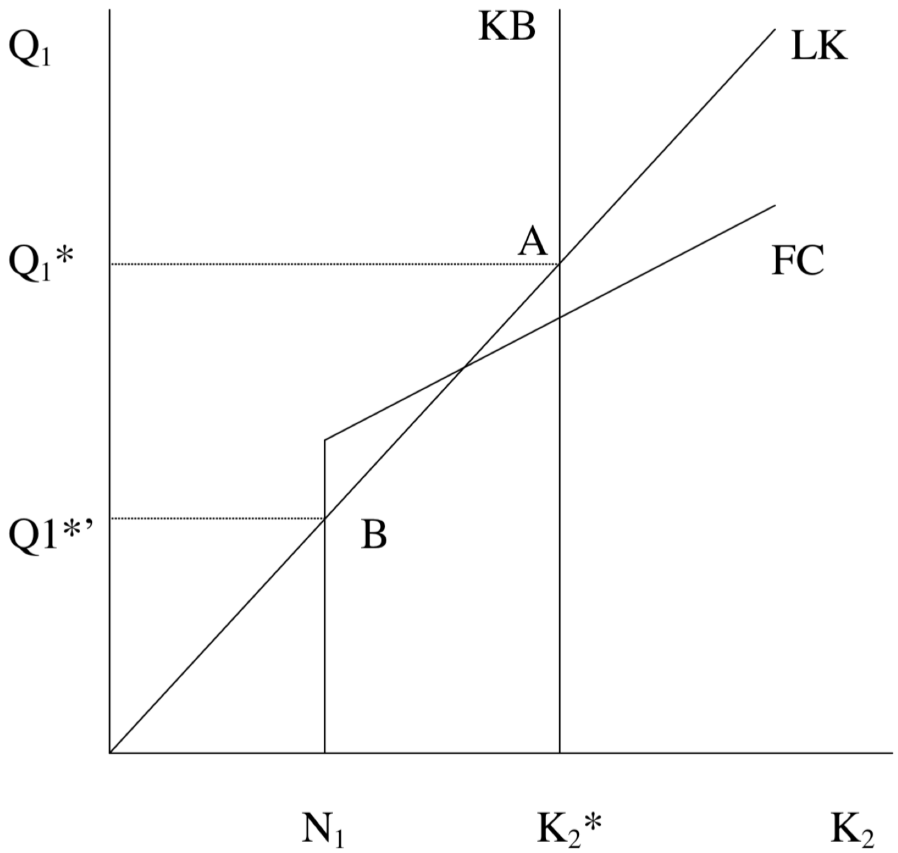
Source: Institute of International Finance

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)





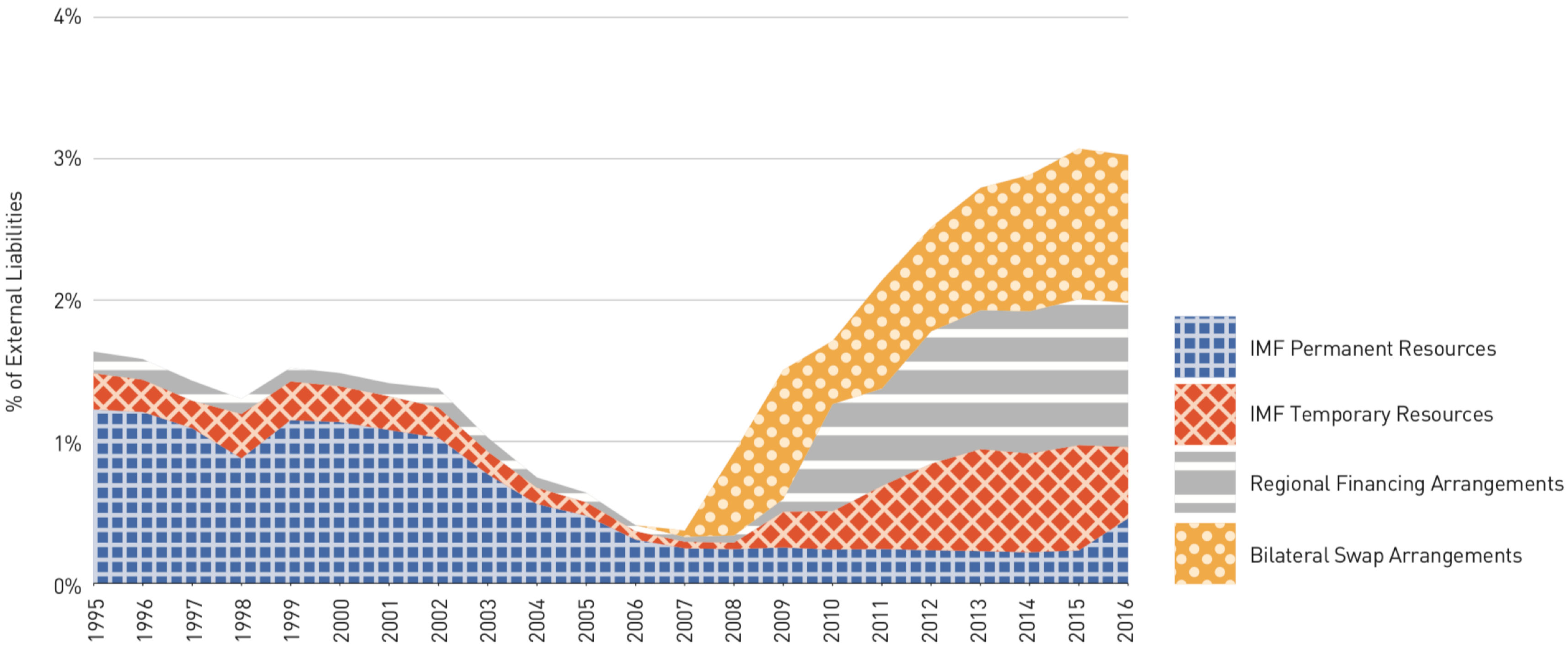
Policy implications (1)

- 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



Source: IMF and Bank of England

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!