



**BLAVATNIK**  
SCHOOL OF GOVERNMENT

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**Global  
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Governance**  
Programme



# **HIGH-LEVEL ROUNDTABLE ON FINANCE: HOW ARE EMERGING AND DEVELOPING COUNTRIES AFFECTED BY MONETARY AND REGULATORY SPILLOVERS FROM ADVANCED ECONOMIES?**

## Foreword

### **By Ngaire Woods and Max Watson**

Powerful economies in the world have been accused of creating havoc in the rest of the world economy as they seek to restore economic growth and stability in the aftermath of the 2008 financial crisis. Quantitative easing, the management of Eurozone sovereign debt, and new financial regulation have all created “spillovers” for the rest of the world.

Are the post-2008 global economic “spillovers” new? Are they menacing? How can they best be managed? These questions propelled us to invite policy-makers from emerging and developing countries, market participants, representatives of international financial and regulatory institutions, and academics to explore the impacts of advanced economy financial policies on the rest of the world. The aim was to consider not only monetary spillovers, which have been much in the headlines, but also the impact on capital flows and domestic financial systems of major regulatory changes affecting global markets – Basel III, EU Banking Union, Dodd-Frank.

Four themes emerged particularly strongly. First, the nature of spillovers has changed – becoming longer-lasting and also transmitting directly through bond markets and asset prices in ways that can pose issues of financial stability as well as external balance. Second, the combined impact of monetary and regulatory spillovers is affecting emerging and developing countries – including ‘frontier markets’ – in differentiated ways; but for all countries ‘self-insurance’ is becoming more costly and challenging as a way of coping. Third, this underscores the responsibility on key currency countries to internalise fully the impact of their policies on the balance of risks facing the global economy; to engage in constructive exchange on these dilemmas; and to furnish adequate swap lines to help assure stability in other countries. Fourth, the alternative to better managing spillovers is to risk fragmentation in the system, especially given a sense of frustration on issues of voice and representation: a more active fostering of regional networks offers one route to channel centrifugal forces into patterns that remain supportive of an open and dynamic global system – avoiding a growing recourse to defensive barriers and policies with potentially beggar-thy-neighbour effects.

This report presents an overview of the discussions in the workshop, and also brings together the short thought-pieces that several participants submitted prior to the meeting. We are enormously grateful to the Ford Foundation whose support of the Globalization and Finance project at the Global Economic Governance Programme made this meeting possible. We are indebted to Emily Jones, Deputy Director of the Global Economic Governance programme for her direction, and to Taylor St John and Geoffrey Gertz for their outstanding job organizing the meeting and writing up the report. Our thanks also to Adam Bennett, Russell Kincaid, and Jack Seddon.

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## PLEASE NOTE

All memos represent the authors' personal views, and should not be interpreted as representing the policy or views of their respective organisations.

# New Thinking on Spillovers

## Taylor St John, Geoffrey Gertz and Max Watson<sup>1</sup>

Monetary and regulatory spillovers provoke urgently important challenges for policymakers in emerging and developing countries. These challenges impel new thinking: better understandings of the channels spillovers travel and better understandings of what can actually be done about it are desperately needed. Drawing on expert views expressed during the high-level roundtable on 12 February, this piece highlights what is new about recent spillovers and outlines pragmatic ways forward – at the national and multilateral levels.

The first section argues today's spillovers are new in important ways. Today's monetary spillovers are continuous; they are no longer one-off shocks. The composition of flows has changed to include more bonds and local-currency instruments. New financial regulation causes spillovers – both intended and unintended – which have important and often underappreciated consequences.

The second section sets out national-level policy responses – and their limits. Reserve accumulation, capital flow measures, and exchange rate intervention can all be useful tools. Yet their usefulness is inherently limited: these tools can be costly, technically difficult, and may be ineffective even when used perfectly. In responding to new regulation, policymakers face a difficult choice: they may adopt, ignore, or adapt new global standards. Each of these responses entails a mix of costs and benefits.

The third section suggests pragmatic steps toward multilateralism that could help alleviate the dilemmas posed by spillovers. Recognition of shared responsibility for global stability from advanced economies would be a tremendously useful first step. For emerging market policymakers, regional approaches may provide promising avenues for cooperation – for pooling risk and for articulating shared policy positions. The interests of emerging markets and developing countries (EMDCs) have not been priorities in global regulatory debates. To cope with standards that may be inappropriate for their shallow markets, EMDCs and global standard-setting bodies should consider differentiating global standards – a “Basel III lite” may be more appropriate for many EMDCs. To better influence future global regulatory debates, policymakers are encouraged to identify the specific debates that affect their economies and take strategic forward-looking measures to ensure their needs are heard.

## WHAT IS NEW ABOUT TODAY'S SPILLOVERS?

MONETARY SPILLOVERS ARE CONTINUOUS; THEY ARE NO LONGER ONE-OFF SHOCKS.

Spillovers are no longer one-off ‘shocks’: spillovers, in terms of domestically problematic policy impulses, can continue over a period of several years. It may be more accurate to frame spillovers as an on-going process; officials in EMDCs take policy decisions – and target multiple policy objectives – in an environment of constant spillover.

Spillovers from monetary policy have a different time frame (and very different effects) than spillovers from fiscal policy. Monetary spillovers tend to be faster, more global, and much larger than those of fiscal policies. Monetary easing or tightening in a major economy transmits directly to domestic financial conditions and asset prices in EMDCs through international bond markets – particularly where that easing is focused on lowering the slope of the yield curve. By contrast, fiscal easing or tightening transmits largely through trade channels, and its effect is mainly on direct trading partners. While fiscal policies in advanced economies tend to be counter-cyclical, monetary policies have been pro-cyclical. It is monetary policies that drive a global search for higher yields, and result in more inflows into already fast-growing emerging markets. An emerging economy overheating due to rapid credit expansion fuelled by foreign capital inflows is not a new story. What is new is that this story is not thought to be temporary, or isolated: it is part of a continuing series of spillovers, with different time horizons.

Spillovers require central banks to balance different – and at times contradictory – objectives with a limited toolkit. The ‘old’ dilemmas associated with capital flows remain – including most fundamentally the tension for monetary policy between inflation targeting and external competitiveness. Central banks may give the view that their focus is inflation and the domestic economy. Yet today many central banks may also target the exchange rate, attempting to lower volatility and support financial stability. This means they have two targets but only one instrument. For instance, central banks have attempted to address the exchange rate in some African countries in response to large portfolio flows. These flows are volatile, and exchange rates experience even more intense volatility owing to the thinness of the markets for these currencies.

Participants also noted that monetary policy dilemmas may be particularly difficult to address in an economic upswing. Raising policy rates risks increasing capital inflows and fueling an externally funded credit boom, while lowering rates can provide incentives for domestic financial institutions to lend recklessly and hence exacerbate a domestically-funded credit boom. The upward pressure on the exchange rate can also potentially damage export industries. The policy dilemmas are equally acute for outflows at a time when growth

<sup>1</sup> The authors are indebted to the workshop rapporteurs: Adam Bennett, Russell Kincaid and Jack Seddon.

is weakening. Rather than supporting demand by loosening monetary and fiscal policies, the risk that foreign investors will flee forces policy makers into interest rate hikes and fiscal tightening.

Finally, some participants noted the political pressures facing central banks and other officials have changed. It is no longer the politics of one-off shocks: spillovers have merged into the politics of the everyday. These pressures may come in particular from exporters and from importers, whose interests may pull in conflicting directions. For instance, the pass-through of the exchange rate to domestic inflation is very large. This pass-through is also asymmetrical. Currency depreciation pushes inflation up but currency appreciation does not lower inflation. Instead, importers' profits increase. This asymmetry causes political pressures to be placed on the central bank to act when the currency depreciates but not when it appreciates.

#### THE COMPOSITION OF FLOWS HAS CHANGED: MORE BONDS AND LOCAL-CURRENCY INSTRUMENTS.

The transmission channels of monetary spillovers form a complicated web, more diverse and complex than ever before. EM economies have different types and levels of financial integration, and spillovers into these economies are similarly divergent. Even within one country, various spillover influences can pull in different directions. Today a country's government can experience a feast in bond market financing while its medium-sized enterprises undergo a famine in bank financing.

With those caveats noted, participants broadly agreed recent flows included more bond financing and more local-currency instruments than flows in previous periods. Identifying these changes in composition is straightforward, but untangling their full implications is not. Little is known about the transmission of monetary policy – both in terms of magnitude and the outside importance of the US. The nature of the links between advanced and emerging market bond yields and equity prices, for example, are not as well understood as trade links and are evolving more rapidly due to financial globalization.

The growing importance of bond market transmission channels means that middle-income countries typically have been the worst affected. Low-income countries are affected primarily through spillovers in trade and commodity price channels, and only secondarily through bond markets. Shallow, fragile local bond markets amplify negative financial market outcomes. It is the volatility of flows – as opposed to their volume – that is the primary concern.

The increasing proportion of flows into local currency bonds (as opposed to the dollar denominated ones common in part periods) has mixed effects. On the positive side, local-currency issuances result in lower balance sheet risk to the country. Local currency instruments are also presumed to have a lower risk of capital stops. Some participants questioned this,

suggesting that perhaps it just transferred the exchange rate risks to lenders, who may not engage in a traditional “sudden stop” of lending but instead pull out of markets entirely – which some argued was evident in the events following the Fed's mention of tapering in May 2013.

Relatively little is known about how local currency instruments interact with or are affected by global flows. When flows were primarily dollar-denominated, there were clear understandings of who held the risk and who could take action to control those flows. With local-currency instruments, who holds the risk and what degree of maturity transformation is taking place? Is there more risk out there and has it been shifted into hands of those who can least handle it? Some participants probed even more fundamental concepts – is the idea of an equilibrium exchange rate still useful? During 2003-8, emerging markets were a pull factor for capital inflows, but after 2008, advanced economies were a push factor. Now neither force exists, putting exchange rate equilibria into flux and making it hard to assess whether currencies are over or under valued.

#### REGULATORY SPILLOVERS ARE A MIXTURE OF THE INTENDED – AND UNINTENDED – CONSEQUENCES OF NEW FINANCIAL REGULATION.

Regulatory spillovers are the untold story: while monetary spillovers receive attention, many regulatory spillovers have gone largely unnoticed. In practice, however, new regulation results in many consequences for emerging markets. Three particular examples illustrate some of the varied forms possible for regulatory spillovers: subsidiaries, know-your-customer requirements, and trade finance.

Subsidiaries are an important part of the banking sector in many EMs. For example, around 90 percent of Romanian banks (by assets) are a subsidiary of a parent bank in the Euro area. The regulatory decisions taken within the Eurozone, therefore, have major implications for the Romanian banking system. Yet Romania is not in the room at the European Central Bank, and plays no part in the decision-making. Nor is this an isolated example. The Dodd-Frank legislation is another prime example of domestic regulation with extraterritorial effects.

While domestic regulation is often intended to effect subsidiaries, such regulation may have unintended consequences as well. A visible example of this is Anti-Money Laundering (AML) legislation. Anti-money laundering and know-your-customer requirements for banks in advanced economies have limited their operations in African countries – and made it more difficult to find banks willing to be counterparties for African deals. AML rules have increased the cost of intermediation and transfers in particular jurisdictions, making it uneconomic for many banks to operate there: the resulting drying up of finance is an unintended consequence of domestic regulation.

Regulatory spillovers also occur in unanticipated ways from international standards and norms: Basel III's potential impact

on trade finance illustrates this possibility. Basel III was not thought relevant for low-income countries, particularly since banks in these countries are typically well-capitalised. However, new liquidity ratios in Basel III make project and trade finance more expensive for banks in advanced countries: this in turn means trade finance may be more limited and expensive.

## II. WHAT CAN INDIVIDUAL EMDCS DO TO ADDRESS SPILLOVERS?

EMDCs have a range of tools at their disposal to lessen the pain from spillovers. That said, acting alone can only get you so far in addressing monetary spillovers. The tools available are imperfect and costly, and even taken together may not be sufficient. On regulatory policy, the key question for EMDCs is whether to adopt, adapt or ignore new global regulations. Yet here too each path contains significant costs and risks.

### MONETARY SPILLOVER NATIONAL STRATEGIES: RESERVE ACCUMULATION, CAPITAL FLOW MEASURES, MACROPRUDENTIAL REGULATION AND EXCHANGE RATE INTERVENTION.

The range of tools available to EMDCs to dampen the effects of spillovers is greater today than it was a decade or two ago. Self-insurance through reserve accumulation remains a popular choice for countries seeking to deter speculative attacks, yet a number of other options have also (re)gained attention in recent years. Today, in addition to reserve accumulation, EMDCs are responding to spillovers by instating capital flow measures, limiting both the inflow and outflow of foreign capital to the economy; by adopting macroprudential financial regulation to limit systemic risks in the banking sector; and by intervening in foreign exchange markets – either sterilised or unsterilised – to maintain stable and competitive exchange rates. This range of tools allows countries to craft responses based on their particular needs and capacities.

These tools, however, all have their drawbacks. To begin with, they are not always effective. Capital flow measures, for example, tend to lose efficacy over time, as creative private actors find ways around them. Given that today's spillovers appear to be continuous rather than one-off shocks, capital flow measures may therefore ultimately be of limited use in combating spillovers. Similarly macroprudential measures are technically very difficult to execute, particularly as a countercyclical tool to dampen credit booms. And self-insurance through reserve accumulation is less effective when all countries pursue it simultaneously, resulting in an arms race where it is never clear how much is enough.

Second, the tools are costly. Exchange market interventions and reserve accumulation, for example, involve fiscal costs and sterilisation challenges. A central bank can miss out on returns by pursuing a sterilised intervention, as foreign exchange reserves earn nothing while domestic repo

operations can earn 10–15% returns. This in turn lowers central bank transfers to the government, with implications for the country's budget. Particularly for poor countries, these costs can be important and should not be taken lightly.

Third, countries are constrained in their use of these tools, by domestic politics, international treaty obligations, and a fear of market signals. Domestically, countries may find it politically very difficult to apply countercyclical measures in order to dampen market upswings, especially when powerful interests benefit from the expansion. Internationally, many countries have signed bilateral investment treaties (BITs) and preferential trade agreements that guarantee foreigners the right to currency transferability, which arguably would preclude countries from adopting capital flow measures and perhaps certain macroprudential regulations. Finally, a number of participants from developing countries noted that they would be extremely cautious of implementing any measure which might signal to global markets further trouble to come, such as limits on capital flow outflows: foreign investors might be spooked by these measures and seek to immediately withdraw their capital, actually worsening the outflow problem.

In sum, then, while these tools are useful, their usefulness is inherently limited. They are only partially effective, costly, and constrained, and – even taken together – are unlikely to form an adequate response to global flows.

### REGULATORY SPILLOVER NATIONAL STRATEGIES: ADOPT, IGNORE OR ADAPT NEW GLOBAL REGULATION?

The new financial regulatory standards emerging out of the 2007–08 global banking crisis – at the domestic level, such as the US Dodd–Frank bill, and multilaterally, such as the Basel III guidelines – have for the most part not been designed with EMDCs in mind, and EMDCs have largely been left out of debates over their design. Yet given the global nature of finance, these regulations will undoubtedly affect EMDCs, and thus the countries must strategically choose how to respond to them. At a basic level, the three options countries face are to adopt, ignore or adapt new global regulations.

Adopting the regulations means implementing new global standards as they are agreed, and buying in to the global regulatory regime. The advantages of adopting are that countries could signal to international markets the stability and safety of their domestic financial markets. As global banks would prefer to only have to deal with one set of regulations, they may pressure EMDCs to adopt these new global rules (and reward those that do with greater capital flows.) Also, in choosing to adopt EMDCs would be better able to influence the debate (though admittedly this may still be only marginally). The significant downside to adopting, however, is it would mean implementing global regulations which were not designed for the particular needs of EMDCs, and thus may not lead to the efficient allocation of capital within their economies.

Ignoring the regulations means setting domestic financial regulations based solely on the concerns of the domestic financial market, rather than implementing any international standards. The advantage here is that countries could directly tailor financial regulation to their own circumstances. The disadvantage, however, is that global financial institutions may decide it is not worth the cost of operating in small jurisdictions with distinctive regulations and decide to withdraw. Additionally, if countries opt out of new regulatory regimes they are unlikely to have any voice over their design.

Adapting the regulations means adjusting global standards to meet country-specific needs. The advantage of this middle path is to allow EMDCs to participate in the global regime while still modifying international standards to reflect differences in financial depth. Yet, the further countries move away from a set global standard, the more global banks will need to adapt their reporting and compliance measures, thereby creating greater costs which will perhaps lead to lower capital flows.

Selecting amongst these options will depend on a country's level of financial development, its desire to attract global capital, and the size of its domestic market (and thus its bargaining power). Finally, it's worth noting that all three of these options may leave some EMDCs worse off than the status quo. Returning to the status quo, however, is impossible. Ultimately, decisions to adopt, ignore or adapt new standards are closely linked to the question of how much, if any, influence EMDCs can have in setting global standards, a topic taken up in the following section.

### III. WHAT STEPS TOWARD MULTILATERALISM COULD HELP EMDCS ALLEVIATE THE DILEMMAS POSED BY SPILLOVERS?

Given the limits to the national strategies for coping with spillovers discussed above, what – if any – forms of multilateral cooperation or coordination are desirable and feasible to shield EMDCs from the harmful effects of monetary and regulatory spillovers? Today's financial interdependence means spillovers are inevitable and can be at best imperfectly alleviated by national strategies. However, there is no appetite for a highly centralised, hard law international agreement on financial cooperation, such as a global monetary policy committee. In light of these realities, what concrete steps could countries – individually, collectively, and working through international organisations – take to develop and strengthen multilateral solutions to monetary and regulatory spillovers?

#### RECOGNISE SHARED RESPONSIBILITY FOR GLOBAL STABILITY.

Advanced economy monetary policymakers have domestic mandates. They have consistently denied any responsibility for spillovers into emerging markets. Yet, properly interpreted, the mandate of the Federal Reserve and other

advanced economy central banks should take account of the effect of their actions on other states, at least to the extent that these spill back to their own economies and change the balance of risks affecting the global setting. There is also a need to engage actively in policy dialogue to exchange views on the nature and implications of such spillovers. If the US fails to accept any de facto responsibility for spillovers, it risks alienating EMDCs. This runs counter to the strong interest of the US in sustaining an open international financial order.

What should the US and other advanced economies do to ensure that major markets remain open? As an urgent first step, all the key currency central banks need to be more open-handed in extending swap agreements to countries where their currency is economically important in domestic markets. In particular, the US needs to keep providing swap lines to EMDCs in need of crucial dollar liquidity.

Other steps are surely needed as well: earlier this month, the G-20 called for US policy to be more “carefully calibrated and clearly communicated.” This means the US should actively explain its thinking in the G-20, IMF Board, IMFC, and regional and bilateral fora. More broadly, all advanced economies should engage in meaningful formal and informal monetary consultative processes, and support EMDCs' own regional arrangements, such as the Chiang Mai Initiative.

#### RELY ON REGIONAL APPROACHES – BUT ALSO RECOGNISE THEIR LIMITS.

Given the lack of political appetite for substantial new global initiatives – such as changes to the IMF's Articles of Agreement – many participants placed greater emphasis on regional solutions, where there appears to be more space for pragmatic and creative responses to the dilemmas posed by spillovers. Moreover, not only are regional responses more feasible, they may also be more desirable: not every monetary or regulatory policy demands a global response, and for many countries on many issues, regional solutions may provide more fruitful cooperation.

The Chiang Mai initiative in East Asia, for example, which establishes currency swap lines amongst members, has proven to be a useful regional mechanism which could perhaps be replicated elsewhere. Similarly on banking regulation, in the absence of viable global alternatives, regional groupings may be best placed to implement regulations across borders. There are already many regional organisations in place – such as the East African Community (EAC) and the Economic Community of West African States (ECOWAS) – providing the initial institutional infrastructure to develop regional solutions to monetary and regulatory spillovers.

Yet regional solutions are not a panacea. To begin with, regional responses are prone to a covariance of risk: if many countries in a region are facing similar challenges, a regional insurance pool may be of little help. Furthermore, as one participant noted, regional institutions may be ill-suited to the crucial

task of surveillance: politically it may be far more difficult for a country to tell its neighbour that its house is in disrepair than for the IMF to do so. Another participant argued that a regional approach would leave many countries exposed, as not all countries are members of functional regional groupings – thus some countries, many of whom are small and vulnerable economies, could fall through the cracks.

#### DIFFERENTIATE GLOBAL STANDARDS WITHIN A UNIFIED FRAMEWORK.

At the heart of debates over multilateral responses to monetary and regulatory spillovers lie the trade-offs between centralised and fragmented approaches to international coordination. Highly centralised systems, in which there is one set of rules implemented as consistently as possible across all countries, create predictability and eliminate the possibility of banks seeking arbitrage advantages across jurisdictions. Yet centralised systems also force one universal standard on countries with very different financial markets and implementation capabilities. Fragmented systems, on the other hand, where each country goes its own way, may allow policies to be directly tailored to a country's individual needs, but they will be incapable of effectively addressing truly international challenges, such as the risks posed by global systemically important financial institutions (G-SIFIs).

While these trade-offs between centralisation and fragmentation cannot be fully surmounted, some systems will be better than others at alleviating their harmful effects – yet it is not clear these approaches are the ones that are to date being espoused. For example, Basel III does not have differentiated standards for EMDCs, despite the fact that, as discussed above, many EMDCs may be compelled into adopting them. Many participants at the conference endorsed the idea of a “Basel III light” for EMDCs, which would follow a similar framework to the Basel III standards for advanced economies but would take into consideration the shallower financial markets and particular implementation challenges of developing countries. This would allow EMDCs the benefits of following a global standard, yet one designed to reflect their distinct needs.

A differentiated approach to global standards will not solve all problems. EMDCs will still need to respond to the way global standards are applied in advanced economies, as these standards will still have consequences for EMDCs. Second, differentiation may provide cover for sophisticated actors to evade standards in ways that reduce systemic stability.

#### IDENTIFY WHERE COORDINATION IS REQUIRED AND STRATEGICALLY INFLUENCE GLOBAL DEBATES.

Emerging markets are not high up on the priority list during global regulatory debates. Typically, only representatives from the very largest emerging markets are even in the room. When their representatives are absent, it leads to at least two governance failures: limited awareness of key developments by relevant EMDC policymakers, and disproportionately low

profile for the issues of greatest importance to EMDCs. Given the out-dated governance of international institutions and the intractable nature of debates to reform them, increasing representativeness is an unrealistic proposal. So what can be done?

One participant suggested a strategy of enhanced pragmatism, or a series of small measures that would improve things. As a first step, policymakers need to identify which regulatory discussions are crucial to their national interest. This requires a clear articulation of their economic situation, and a straightforward answer to the question: how might this proposed regulation affect our economy? Equally, it requires the institutions acting as the de facto global coordinator in a given issue area to give greater priority to identifying how reform proposals might affect EMDCs.

Another participant noted that developing countries had largely been reactive in global debates on monetary and regulatory policy, and needed to become more proactive. This would entail a second step: recognising where their national interests overlapped with those of other actors, and adopting a coordinated strategy to advance these interests. Within the existing architecture, regional bodies may be the best place for identifying and coordinating common interests. These regional bodies may serve as an important step toward global coordination, or they may be useful ends in themselves – to pool risk or act as agents of restraint as well as to articulate shared policy positions.

Finally, at the global level, some participants noted EMDCs have not used the voice that they have (often recently) earned. While some participants argued this hesitancy makes sense given that policymakers from these countries often perceive themselves as a new, small shareholder in a given institution, others believed this influence must be used to greater effect. Two particular strategies were suggested. One, EMDCs should where possible form negotiating blocs or caucuses in order to advance their interests. These blocs should not necessarily align along EMDC versus advanced economy lines: cross-regional, interest-based groupings may be feasible and highly effective. Second, as EMDCs are important profit centres for many global financial institutions, they could use this leverage over private firms to influence debates in the US and EU, and thereby ensure their needs are heard.

## CONCLUSIONS

The challenges posed by spillovers are new and immensely complex. During the roundtable and in this report, our aim has been to identify workable strategies for dealing with monetary and regulatory spillovers. Much more work is needed to understand the challenges posed by spillovers and to alleviate their consequences, so these conclusions are inherently preliminary. Among the key messages emerging from discussions at the roundtable were the following:



The impact of monetary spillovers from advanced economies has become longer-lasting, and transmits to a greater extent through bond market and asset price channels – thus posing issues of domestic financial stability as well as external balance in emerging market countries, and complicating the policy challenges that they face. The limits on ‘self-insurance’ measures are increasingly apparent.

Advanced economy central banks need to internalise fully the potential feedback to their own economies, as well as the impact of spillovers on the balance of risks facing the world economy – concerns which are amplified where their policy-makers rely excessively on monetary policy. They also need to provide adequate bilateral swap lines, and to engage responsibly in dialogue on spillovers and their consequences.

The major changes in global and advanced economy regulation that are underway currently – Basel III; EU Banking Union; Dodd-Frank – also affect capital flows to emerging market economies, as well as the contours of their domestic banking activities. More account needs to be taken of the specific needs and constraints faced by these economies, perhaps including a ‘Basel III Lite’ template.

‘Frontier markets’ and other developing countries are also affected importantly by macroeconomic and regulatory spillovers, but the pattern of impact is different: trade and commodity price channels are more important; new banking regulations may be particularly ill-matched to these less institutionally developed economies; and even modest shifts in financial flows can have a disproportionate impact in their shallow financial markets.

These trends in the global economy threaten greater fragmentation: with a weak sense of participation and voice in global regulatory and financial fora, emerging and developing countries are more likely to retreat behind capital flow barriers and to develop country-specific palliatives where regulatory measures are ill-adapted to local conditions. A more active development of regional fora could help channel these centrifugal pressures in ways that lead to managed change in the global system, rather than disorganised and dysfunctional fragmentation.

# Notes on Policy Dilemmas for Emerging and Developing Countries from Advanced Economy Monetary and Regulatory Policies

## Tamim Bayoumi

IMF<sup>1</sup>

Given the Roundtable is aimed at creating free discussion, this note aims at providing wide-ranging analysis of possible spillovers from advanced economy policies on emerging and developing countries, outlining any Fund view on their importance.

**WHY WORRY ABOUT MONETARY TAPERING NOT FISCAL CONSOLIDATION?** Before discussing the policy dilemmas for emerging and developing economies from advanced economies' policies, it is useful to first outline the channels through which these spillovers occur. Looking first at macroeconomic policies, the spillovers from advanced economy fiscal policies have received less attention than monetary policies. This reflects two differences.

First, while monetary and fiscal boosts in the heat of the crisis were clearly helpful for the world economy, fiscal policies subsequent to the immediate crisis have been generally counter-cyclical for emerging and developing economies, monetary policies were pro-cyclical. In particular, the macroeconomic support provided by quantitative easing initially in the United States and the United Kingdom and subsequently in the Euro area and Japan has occurred at a time when emerging and developing economies output and credit were growing rapidly. Hence, already fast growing economies were being given a further boost from advanced economy monetary policy, while fiscal policy was giving the opposite effect.

The second difference between fiscal and monetary policy is more subtle but equally important. Fiscal policy acts primarily through domestic demand and only to a second degree via asset prices (as, say, bond yields react to higher domestic demand and government debt). Since trade is closely linked to geographic proximity (the gravity model is an excellent predictor of trade), this means that the spillovers from fiscal policy are generally local. US fiscal policy will largely affect Mexico and Canada, the Euro area will largely affect Eastern Europe and the United Kingdom, and Japanese fiscal policy China and Korea.

By contrast, monetary policy acts primarily through asset prices—interest rates and exchange rates. But the cross-country links between asset prices are less well understood than trade links. It is well known that global financial conditions are heavily influenced by advanced country monetary policies and hence that monetary policies have a much more global impact than fiscal policies. Pre-crisis there seems to have been a reasonably stable relationship between changes in U.S. policy rates and U.S. bond rates, and between U.S. bond rates and those in a wide range (geographically) of emerging and developing countries.

It also seems clear that U.S. financial conditions matter more than those in other advanced economies even taking account of differences in GDP, reflecting the depth and liquidity of U.S. markets. But the exact nature of the links between advanced and emerging market bond yields and equity prices, for example, are not as well understood as trade links and have probably been evolving more rapidly due to rapid financial globalization.

In sum, it seems likely that the influence of advanced economy monetary policies on emerging markets is both more global and much larger than those of fiscal policies and more focused on the United States (strikingly, such links are seldom incorporated in standard macroeconomic models). This suggests that the switch to tapering in the United States may be inducing a significant additional downward push to emerging and developing countries at a time when many have growth and financial cycles which are already weakening.

**POLICY DILEMMAS COMING FROM QUANTITATIVE EASING/TAPERING.** The uncertainties about the transmission of monetary policies, both in terms of the absolute magnitude (why are global bond yields so correlated?) and the importance of different countries (how much more important is the United States than, say, the Euro area?) have been only compounded by the crisis and the policy response. The crisis itself matters as it is well known that asset prices have “fat tails” compared to the standard normal distribution, and those correlations of asset prices rise when bad events occur in such markets. In short, financial fragility is associated with unpleasant amplification of negative financial market outcomes.

In addition, the zero bound constraint led to unconventional monetary policies that targeted the term spread. Given the importance of international bond and equity market investors for many emerging and frontier markets, the fact that the policies were aimed specifically at the longer end of the yield curve may have increased policy spillovers.

The way this all played out in practice was that quantitative easing was accompanied by significant capital flows to emerging markets. While the support to global growth was welcome (especially over the crisis), capital inflows create monetary policy dilemmas for recipients, particularly in an economic upswing. Raising policy rates risks increasing capital inflows by providing a better rate of return and fueling

<sup>1</sup> The views expressed in this paper are mine, and do not necessarily represent those of the IMF or IMF policy.

an externally funded credit boom, while lowering rates can provide incentives for domestic financial institutions to lend recklessly and hence exacerbate a domestically-funded credit boom. The upward pressure on the exchange rate can also potentially damage export industries. The policy dilemmas are equally acute for outflows at a time when growth is weakening. Rather than supporting demand by loosening monetary and fiscal policies, the risk that foreign investors will flee forces policy makers into interest rate hikes and fiscal tightening.

These dilemmas are further complicated by the issue of whether these inflows were largely structural as a result of a fundamental revaluation of relative growth prospects and default risks between advanced economies and emerging markets or more temporary money seeking higher yields than were available given ultra-easy monetary policies in advanced economies. While the answer remains unknown, there does seem to have been a change in behavior. Simple calculations in the Fund's Global Financial Stability Report of inflows to emerging markets over the period of quantitative easing relative to earlier trends suggests the additional inflows from such policies could be some \$350 billion.

The inflows from advanced economies to emerging and frontier markets also had several features that distinguished them from earlier periods of high capital inflows. First, the flows had a somewhat different composition, being tilted towards bond markets rather than via banks or equities/foreign direct investment. This means that some of the traditional ways of controlling such flows were less effective. In addition, a much larger proportion of the flows were into local currency bonds rather than dollar denominated ones.

These inflows were also more focused on local currency products. Indeed, foreign ownership in local currency bond markets has risen markedly in many emerging markets in recent years. This lowers balance sheet risk to the country by avoiding the increase in indebtedness that accompanied dollar appreciation in the past (e.g., the 1980s debt crisis). However, it transferred the exchange rate risks to lenders, who may not simply engage in a traditional "sudden stop" of lending but rather will actually pull out of markets. Indeed, such outflows seemed to occur after the financial surprise accompanying Fed taper talk in May 2013. High frequency data on mutual funds (heavily weighted towards retail investors) showed a rapid pull back from emerging markets.

However, subsequent balance of payments data suggest little pull back. This leaves two open questions. First, why did exchange rates depreciate so much? Was the May event simply a classic sudden stop, or did professional investors use derivatives markets to hedge their exchange rate risk so the depreciation pressures came from these transactions that put pressure on exchange rates without actually sales of assets. And, if it is the latter, did domestic investors take the exchange rate risk, enhancing balance sheet risks? In addition, did emerging market corporate take advantage of low rates

in advanced countries by borrowing directly in these markets through subsidiaries. Such offshore borrowing has been a significant part of past emerging market crises (e.g., Mexico in the mid-1990s). In short, the size of borrowing could be larger than measured and the local currency content of borrowing could be lower than suggested by official balance of payments data.

In addition to inducing capital inflows into emerging markets, loose financial conditions in advanced countries could also have affected commodity process. This is linked to the concern that commodity prices are being increasingly financialized—that demand for commodities is increasingly affected by financial investors looking for a more diversified portfolio. This could add to the current weakness in commodity prices as growth slows in China, a process that could be exacerbated by the usual cobweb cycle as higher prices induce a delayed increase in supply that will put further downward pressure on prices.

A final macroeconomic issue is the impact of asynchronous exit from quantitative easing. It seems clear that the United States and possibly the United Kingdom will exit well before Japan or the Euro area. This should help buffer the impact of Fed tapering since it provides less downward pressure on global financial conditions. Just as the closely-grouped announcements in the latter half of 2013 of OMT by the ECB, QE3 by the Fed, and QQME by Bank of Japan may have helped push investors into emerging markets prior to the Fed taper shock in May 2014, an asynchronous exit may lengthen out any reversal of policy-induced capital flows to emerging markets.

**REGULATION.** Financial regulation is another important area of policy action since the global crisis. While this agenda has been spearheaded and implemented by organizations with significant representation of emerging markets (the G-20 being the spearhead and the Financial Stability Board and Basel Committee the implementers), in practice this initiative has been regarded as being driven by the views of a few advanced economies with major international markets. Hence, it is probably legitimate to add these changes to the impact of advanced economy policies on emerging markets and developing countries.

The thrust of the new regulations is to ensure that banks do not engage in speculative behavior that creates unacceptable risks to balance sheets. Concerns emanate from potential unintended consequences, particularly since while in theory the new regulations are being brought in gradually, in practice financial markets are generally benchmarking market prices off the future tougher regime so the tougher regulations have to a large extent been telescoped into the present.

Concerns over financial regulation center on four issues. The first is deleveraging by major advanced economy banks. Over the pre-crisis boom of the 2000s many (mainly European) banks used balance sheet expansion to aggressively compete

in areas such as trade finance and project development. Tougher capital rules are leading to a reversal in this trend, potentially leaving some areas of international finance with less funding and higher costs.

The second is market liquidity. The new Basel capital rules put a significant capital cost on banks holding assets in their own name. The background to this is of course the tremendous expansion in such holdings by broker-dealers in the run up to the crisis. But in modern financial markets it is not clear whether any other financial institutions have the same incentive to provide liquidity as broker-dealers, risking rapid erosion of liquidity in times of stress—as some have argued occurred in May 2013. Separately, emerging markets worry that liquidity is also being eroded as the new liquidity ratio and over-the-counter derivatives reforms that increase demand for “high quality assets” that are relatively scarce in their shallower domestic markets.

A third issue is maturity transformation. Bankers argue strongly that the new Basel rules penalize banks for turning short-term deposits into long-term loans for project finance or for mortgages. While such a move makes banks safer, it may be eroding the funds available for longer-term projects, including infrastructure in emerging and developing economies. While other institutions with a better match of maturities (such as pension funds and insurance companies) may well be able to fill the gap over time, they are currently not equipped to do the type of risk evaluation routinely done by banks. The fact that financing for infrastructure is an issue at the G-20 suggests this may be a significant issue.

A final regulatory issue is the extra-territorial effects of domestic regulations in advanced economies. Many emerging market regulators fret that banks with a presence in advanced economies are constrained from doing normal business in their markets. This is because domestic rules often apply to the worldwide activities of banks, to avoid banks getting around domestic rules by moving risky activities offshore. However, what is regarded as risky activity in deep and highly liquid advanced economy markets may be an important component of market activity in smaller and less liquid emerging markets.

While all of these concerns may well come under the category of growing pains from the changes in business models induced by tougher bank regulation are ironed out, they create very real current and future policy dilemmas for emerging market policy makers.

# How are Emerging and Developing Countries Affected by Monetary and Regulatory Spillovers from Advanced Economies?

**Piroska Nagy**

EBRD

## PREAMBLE

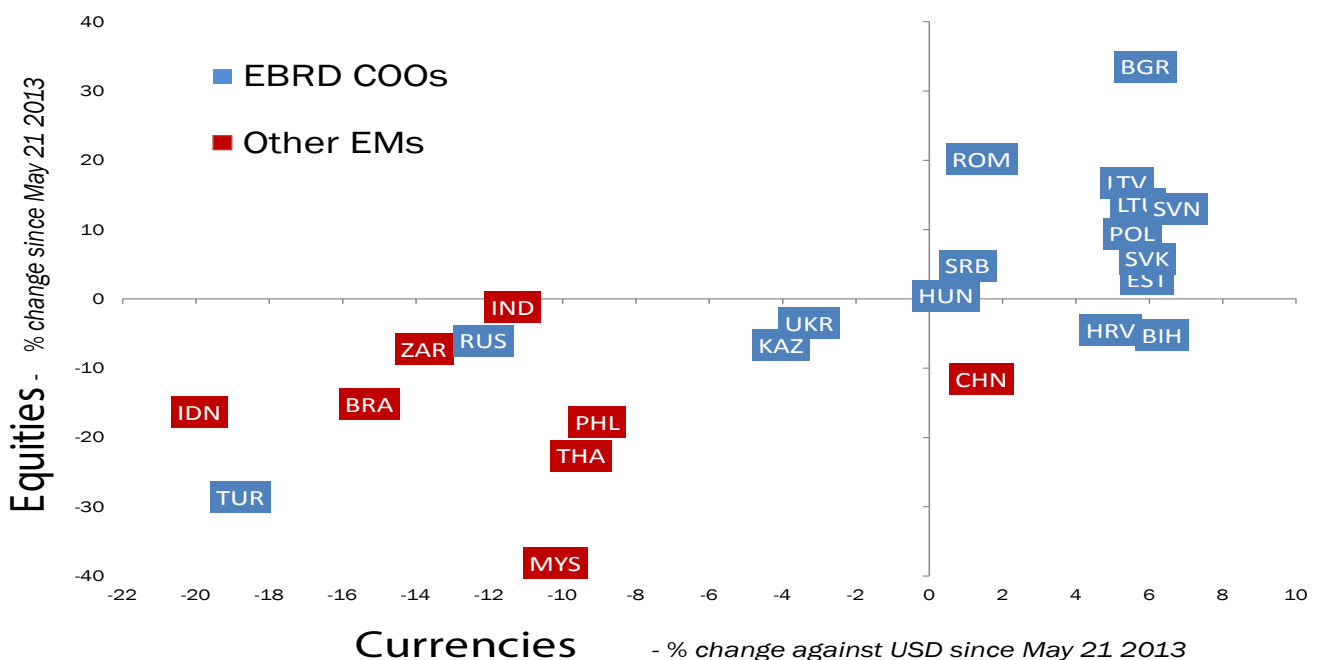
This note focuses on emerging European markets (EEMs), defined as Central, Southern and Eastern European post-communist emerging market economies west to the borders of the Russian Federation. It argues that the shorter term spillovers from advanced country policies should be reasonably managed in this region, particularly if the ECB can support any liquidity needs of well-performing non-eurozone EEMs countries at times of heightened market volatility. The longer term impact in the form of regulatory spillovers from the banking union, if successful, should be actually positive. The biggest risks in this region are not from negative policy spillovers from advanced economies but the spreading of domestic risk of rising national etatism.

## SHORT TERM ASPECTS

**Thus far EEMs have been largely spared from the impact of the ongoing emerging market volatility, with the exception of Turkey and Ukraine.** Since May 21 2013, the start of the tapering talk, most EEMs have outperformed other EMs and many in Central Europe actually have seen gains in stock markets and a strengthening of their currencies (see chart). The reasons have to do with (i) improved economic fundamentals following the shock of 2009/10, including reduced reliance on portfolio inflows; (ii) less capital inflows than other EMs during the quantitative easing period beforehand in part because of the 2008/9 shock and then the crisis in the eurozone, with which EEMs are closely intertwined; and (iii) the recent positive news from the eurozone (timid recovery, adjustments at the periphery, progress on the banking union project).

**The exceptions, Turkey and Ukraine, share clear external and domestic vulnerabilities.** External financing vulnerabilities are in the form of large current account imbalances and major rollover risks in 2014, for Turkey the latter is also in the form of portfolio capital. Each country is in the midst of domestic policy uncertainties. The combination of these two elements makes them particularly vulnerable.

## Currencies and equities in most EEMs have outperformed key emerging markets



**Economic policy response of these countries has been broadly appropriate thus far but persistent market volatility is likely to test them further.**

*Turkey's* central bank hiked its policy rate markedly and also decided to return to a more conventional monetary framework. The latter clearly showed that gimmicking with monetary frameworks (interest rate corridors and alike) that markets don't "understand" ultimately doesn't work. Exchange rate devaluations have also helped ease pressures on currencies. *Ukraine's* main problems are primarily domestic, as the struggle between pro-Russian and pro-Western Ukrainians continues. The local currency depreciated significantly since late-December to its lowest level since September 2009 notwithstanding currency interventions and capital controls, and CDS spreads widened sharply to over 1,000 basis points. Reserves are getting dangerously low.

**Looking forward, market volatility is likely to continue through 2014 as a result of not only tapering but, almost as important, the slowdown in EM demand; no progress with structural reforms in most EMs; and cross-border deleveraging for EEMs.** China's slowdown itself will reduce global demand significantly and the commodity super-cycle appears to be over. For EEMs an additional factor will be a possible pickup in ongoing cross-border deleveraging in the aftermath of the publication of the ECB-led asset quality review and stress tests later in 2014.

**In this context, for EEMs good domestic policies including policy buffers (self insurance or through the IMF) remain key.**

**Policy coordination matters and it would be particularly important from the ECB particularly in its new dual role of monetary and regulatory authority:**

- The ECB should avoid premature "exit"/monetary tightening and, should conditions confirm, act proactively to pre-empt any deflationary cycle;
- The ECB should provide swap facilities against local currency collateral for non-euro zone countries with strong policy record (Poland, Romania) to strengthen buffers against market volatility.

## LONGER-TERM CONSIDERATIONS

### CAPITAL FLOWS

**As the tide of capital inflows reverses, the unfit are being exposed,** so goes the general assessment. True, but for equity investment it will also show "who has the best swimming suit". Capital flows are reversing and stock market valuations across-the-board decline, but the underlying return on investment and capital remains the same. Long-term investment opportunities will be clearer which, if macro conditions allow, will attract FDI.

**Indeed the key factor is the direction of FDI.** For EEMs, FDI has reduced relative to the 2008/9 crisis but stayed positive through the hardest times and there are reasons to believe that it may pick up again:

- Over the longer term what matters are good domestic policies and a business friendly environment and EEMs have fared broadly well even under the duress of the global, and then the Eurozone, crises.
- As China slows down and its wage costs are rising, EEM's relative attractiveness has increased. We have seen some return of FDI from East Asia.

**Regulatory spillovers from the banking union project for the EEMs should be overall positive.**

Given that EEM banking sectors are dominated by eurozone-based banks, a materially stronger cross-border supervision that is expected under the single supervisory mechanism/ECB should be a major improvement relative to the current national home-bias that has led to market fragmentation (the Vienna Initiative has helped at the margins in the interim).

**However the banking union must become comprehensive and credible in its supervisory, resolution, and deposit insurance mechanisms.** This process is far from over, though progress, considering the speed and effectiveness of policy making in the EU, has been impressive.

**The biggest risk in Emerging Europe may actually be not external but the domestic risk of nationalist etatism.**

Foreign ownership is dominant in virtually all sectors across the region, following privatisations to advanced European entities in the 1990s (after failing everything else – mass privatisation, insider privations). This model has served EEMs well, despite its vulnerabilities. In 2010 one EEM country has declared a partial "re-localisation" of its banking system and the energy sector and supported this with punitive taxing and pricing policies that appear to aim at destroying foreign business values for national takeover. If this works such policies might have negative spillovers to other countries.

# Global Economic Spillovers into Africa<sup>1</sup>

## Mthuli Ncube

AfDB

Africa is increasingly interconnected with the rest of the world through trade and financial linkages. Africa's real export value has quadrupled between 2000 to 2010, with Europe as the main export destination followed by the United States and China. In 2012, 60% of the African countries have export to GDP ratio of 30% or more while 80% of them have export to GDP ratio of more than 20%. Moreover, Africa's financial linkage through private capital flows, FDI, remittances, and official development assistance (ODA) has increased significantly during the last decade. External financial flows hit a record high in 2012 at US\$185.2 billion and expected to surpass the US\$ 200 billion mark by 2014. The flow of foreign direct investment (FDI), portfolio investment, ODA and remittances have quadrupled since 2001 (AfDB, 2013).

The growing economic linkages raise the important issue of growth spillovers. Historically, Africa's growth pattern has been highly linked with global economic growth. The recent financial crisis has demonstrated the strength of the inter-linkages. Following the global economic slowdown in 2009, average economic growth was slashed from an average of about 6% in 2006-08 to 2.5% in 2009 with per capita GDP growth coming to a near standstill (AfDB, 2010). Some estimates show that for every percentage point decline in the world real GDP growth, the sub-Saharan African economies contract by 0.4 to 0.5 percentage points. As the world economy is still struggling to recover while the global growth prospects are far from stellar, it is important to analyze the global growth spillover effects into Africa more deeply.

We develop a global vector autoregressive (GVAR) model, with 46 African and 30 foreign countries that cover 90% of world GDP, to examine the growth spillovers coming from the Euro zone and BRIC countries. The GVAR modeling approach, advanced by Pesaran et al (2004) and Dees et al (2007), has become an important empirical tool to understand growth spillovers. The GVAR model is a multivariate and multi-country framework used to investigate cross-country interdependency. It is also capable of generating forecasts for a set of macroeconomic factors for a set of countries to which they have exposure risks. To our knowledge, this is the first attempt to include almost all African countries (46 out of 54 for which major macroeconomic data is available) in a GVAR framework.

<sup>1</sup> Based on Gurara and Ncube (2013)

## EURO ZONE SHOCK SPILLOVERS

Our results indicate that growth spillovers from the Euro zone have significant effects on African economies. The spillovers effects vary with the economic characteristics of the countries. As expected, adverse growth shocks affect resource dependent and fragile states more than the rest of the African economies because of the inherent nature of these economies.<sup>2</sup> Our results suggest that a percentage point decline in Euro zone real GDP growth could lead to 0.34 percentage point decline in output growth in the investment driven economies (emerging African economies) while the comparable effects on the oil dependent (oil dependent factor driven), non-oil resource dependent (factor driven), and fragile states are to the tune of 0.6, 0.5, and 0.45 percentage points, respectively.

## BRIC SHOCK SPILLOVERS

Turning to the BRIC growth shocks, a negative shock affects fragile states more severely as compared to the rest of the continent. A percentage point decline in the BRIC's growth rate could have a 0.23 percentage point adverse growth spillover effect on fragile states while the spillover effect is limited to 0.09 percentage points in the case of investment driven economies. Both oil and non oil factor driven economies would also be affected by the slowdown in the BRIC's economies to the tune of 0.17 and 0.18 percentage points of GDP growth, respectively. The overall impact of the BRIC's economic slowdown is, however, lower than that of the Euro zone given that Europe is still Africa's major trading partner.

## MACROECONOMIC EFFECTS

The adverse global growth spillover has important macroeconomic implications. Our results indicate a decline in the inflation rate and a depreciation of the nominal exchange rate following the contraction of the domestic economy and fall in exports earnings due to the global slowdowns. The decline in inflation rate is however a short-lived one. The Inflation rate would rise as the depreciating exchange rate passes through prices over the medium term. Inflationary effects would be felt in most of the African economies within a period of one year. A policy response to tame inflation may further contract these economies.

## QUANTITATIVE EASING SPILLOVERS

The G-4 economies – US, Euro zone, UK, and Japan – responded to the global slowdown in the form of quantitative easing (QE) to stimulate their economies. The collective magnitude of monetary easing may have unintended consequences in other countries, especially in emerging countries. In Africa, the flow of 'hot money' from the developed world affected the exchange rates and inflation. Higher liquidity flows to developing countries could raise inflation mainly through commodity prices, and the increased lending capacity

<sup>2</sup> See Appendix for the country classifications.

of the banking system in developing countries. Our results indicate that the QE program led to mild inflationary pressure and appreciation of nominal exchange rates in Africa. The impact on exchange rates seems to be more important than the inflationary impact as the exchange rate is an adjusting variable in an open economy context. The combined effect leads to real exchange rate appreciation with all its adverse impact on trade balance. Our result is consistent with the beggar-thy-neighbor effect of domestic monetary policy on foreign countries. The QE policies are hurting some African countries although by a smaller magnitude.

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## APPENDIX: COUNTRY CLASSIFICATIONS

### **Fragile State (AfDB CPIA <3)**

Burundi  
Central African Republic  
Chad  
Comoros  
Congo, Dem Rep  
Congo, Rep  
Cote d'Ivoire  
Djibouti  
Eritrea\*  
Guinea  
Guinea-Bissau  
Liberia  
Sao Tome and Principe  
Sierra Leone  
Somalia  
Sudan  
Togo  
Zimbabwe

### **Investment-Driven (Emerging Economies)**

Botswana  
Cape Verde  
Egypt  
Kenya,  
Mauritius  
Morocco  
Namibia  
South Africa  
Tunisia

### **Factor-Driven Economies**

#### **Oil Exporters**

Algeria  
Angola  
Equatorial Guinea  
Gabon  
Nigeria

#### **Non-oil Exporters**

Benin  
Burkina Faso  
Cameroon  
Central African Republic  
Ethiopia  
Gambia  
Ghana  
Lesotho  
Libya  
Madagascar  
Malawi  
Mali  
Mauritania  
Mozambique  
Niger  
Rwanda  
Senegal  
Seychelles  
  
Swaziland  
Tanzania  
Uganda  
Zambia

# Global Spillovers and EMEs

## Alok Sheel

Economic Advisory Council to the Indian Prime Minister<sup>1</sup>

### MONETARY AND FINANCIAL SPILLOVERS

The current global debate on monetary policy is centred on whether it should target financial stability in addition to the domestic business cycle. With relatively tightly regulated financial markets, where concerns presently are more developmental than regulatory, the counterpart debate in EMEs centres on reconciling two widely held economic policy formulations, namely the Mundell-Fleming 'Impossible Trinity' and the 'Taylor Rule'. The problem has become all the more compelling in a rapidly globalizing world where large, volatile capital flows lead to misaligned and volatile exchange rates that threaten macro-economic stability. The recent currency crisis which constrained Brazil, Turkey, Indonesia and India to tighten policy rates amidst collapsing growth, makes the case for reconciling the 'impossible trinity' with the 'Taylor Rule' of monetary policy all the more compelling.

Ceteris paribus, if a country runs a current account deficit, its currency should depreciate against those of its trading partners. There are, however two major circumstances, one emanating from the current account (the 'dutch disease syndrome'), and the other from the capital account ('southern cone syndrome') under which this reasoning does not hold. The latter is more germane here because large and volatile capital inflows into EMEs have become a far more frequent phenomenon as a result of loosening of financial regulation, innovation, globalization and monetary policy spillovers. Cross-border capital flows to EMEs have increased manifold since the seventies following the oil price hikes and export-led growth strategies adopted by several East Asian economies. The first manifestation of this syndrome in developing economies was the wave of financial liberalization which led to a debt-fuelled recycling of petrodollars by American banks in the 'southern cone' in Latin America.

While large capital inflows can sustain large current account deficits for some time, over the medium to long-run they tend to magnify external imbalances and lay the ground for external payments crises. There are also large capital flows into countries running account surpluses. Once the capital surge abates, and particularly in the event of a sudden stop, there is a likelihood of a sudden, rapid and accelerated correction in exchange rates, with the nominal exchange rate

depreciating sharply, and the Real Effective Exchange Rate (REER) overshooting its neutral (long term 'fundamental') rate. This can cause short term macro-economic instability, such as higher inflation, a loss in international confidence and credit downgrade that could compound the reversal in capital flows and even precipitate an external payments crisis.

What pushes capital into EMEs, and what triggers sudden stops? While fundamentals and the prospects of higher returns are certainly contributory factors, it is now becoming increasingly clear that the major factor driving flows in and out of EMEs has little to do with the fundamentals of recipient countries but yields in the source countries, in particular the US which has the biggest and deepest financial market in the world. While the asymmetry in flows -- particularly outflows -- can to some extent be explained by differing fundamentals, the inflows, and outflows, seem to come in waves, and across a wide swathe of countries.

Large global imbalances themselves should not result in destabilizing flows. They are nothing new, and capital account flows have traditionally been simply the counterpart of current account balances. However, the cocktail of loosening of financial regulation, innovation, globalization and the extant international monetary system have combined to open up a growing gap between gross capital flows and net flows that reflect current account balances. It is not entirely coincidental that the capital stop in the southern cone in the early eighties, in East Asia in the late nineties, and across a broad sweep of EMEs since May 2013, followed a tightening of monetary policy by the United States Federal Reserve. With the integration of financial markets and globalization the spillovers of US Fed monetary policies are only increasing because of the overarching dominance of the dollar in the international monetary system. The Fed's policies therefore hugely determine the direction and velocity of cross-border capital flows. No other central bank comes even close to exercising this influence across its own borders.

Over the years the US dollar has effectively become the global reserve currency. As a result US monetary policy has a determining influence on the direction and quantity of global capital flows. This in effect gives the issuer of the global reserve currency the flexibility to soak up capital when it needs it most, and to export it out when it suffers from excessive domestic liquidity. Through this mechanism the US can fund literally unlimited amounts of external and internal deficits without being penalized by markets as happens in the case of other countries. Open capital accounts, espoused by the IMF, only facilitates this funding and magnifies the 'exorbitant privilege' of the US dollar.

<sup>1</sup> These are personal views.

It has long been argued, from the days of John Maynard Keynes, that the extant international monetary system has a structural flaw in that it lacks a mechanism, market based or otherwise, to induce surplus countries to adjust. This can lead to the persistence of large external imbalances that are potentially destabilizing. Recent history however indicates that this is not entirely correct, as there is also little pressure on countries with reserve currencies, and especially THE global reserve currency, to adjust even when they run large current account deficits, on account of the large external demand for their currencies. The latter is also consistent with the 'Triffin Paradox', by which the reserve currency issuer is expected to run larger and larger current account deficits to meet the growing needs of global liquidity. This is manifestly not true in the cases of currencies like the Japanese yen and the Swiss franc. Both countries have run current account surpluses over the last decade and a half. Similarly, even while its currency was becoming important in the composition of the global portfolio of reserve currencies, the euro was running a roughly balanced current account position with the rest of the world. This is because it is really the dollar that is accepted as the de facto global reserve currency by markets, even though the IMF may have classified other currencies also as reserves.

In effect, the US Federal Reserve acts as the global central bank. Policy easing by the US Federal Reserve, both prior to and following the global financial crisis, led to a surge in capital inflows into emerging markets, appreciating their currencies. There were intervening periods of sudden stops, as US monetary policy changed course, resulting in sharp currency depreciation, sudden stops and external payments crises. This happened in the eighties in Latin America, in the nineties in East Asia, and is now affecting EMEs globally. International financial markets in EMEs appear to respond more to US Fed actions than to economic fundamentals in EMEs.

According to the impossible trinity, a country can have only two of the following three: Fixed exchange rate, monetary independence and free capital flows. A free monetary policy means that it is free to respond to the domestic business cycle. The Taylor Rule is a rule bound – as opposed to discretionary – monetary policy by which the central bank adjusts its short term policy rate based on a mathematical formula using differentials between a country's potential GDP and actual GDP, and inflation target and actual inflation. The Taylor Rule and its variants are now used by almost all advanced country central banks. The author of the rule, John B Taylor of Stanford University, is of the view that it is relevant for developing country central banks also. Many developing countries have indeed started using the Taylor Rule.

In advanced economies the Taylor Rule responds to the domestic business cycle. Monetary policy in developing countries, on the other hand, is in addition constrained to respond to the external financial cycle, which distorts the application of the Taylor Rule. Thus, if domestic growth concerns warrant low interest rates, a sudden stop in capital inflows may induce them to keep interest rates unduly high to attract foreign capital, thereby magnifying the downturn in the business cycle. In other words, they end up trying to negotiate the impossible trinity. Raising interest rates at such times rarely works because the stops are frequently not country specific, and in any case foreign investors are more concerned about capital losses than higher interest income.

Domestic debt in EMEs is backstopped by their central banks. External deficits denominated in international reserve currencies are not. The dependence on market support makes them susceptible to external payments crises in the event of market revolt if deficits are perceived to be excessive and unsustainable. This happened on a large scale in Latin America in the early eighties, in East Asia in the late nineties, and across a broad swathe of EMEs currently. This threat of external payments crisis compels developing countries to frequently use monetary policy for managing external imbalances, in addition to managing the domestic business cycle. They need separate instruments, as part of a consistent policy framework, to target the external financial cycle so that their central banks retain monetary independence.

## REGULATORY SPILLOVERS

Compared to monetary spillovers, the direct impact of the ongoing financial regulatory reforms on EMEs has been relatively benign so far. Surprisingly, despite the general decline in cross-border claims on financial assets amongst advanced economies, especially in Europe, capital flows to EMEs are back to pre-crisis highs. In the case of Asia, for example, aggregate inflows to 10 large Asian economies fell to 1.7% of GDP during the global financial crisis of 2008–2009, from an average of 8.4% in the previous three years. But inflows rebounded sharply in 2010–2012 to 7.4% of GDP. These flows were in excess of what they could absorb, and had to be consequently cycled back to advanced economies through reserve accumulation. The recent sudden stops were also associated with monetary actions in advanced economies – the US Fed taper – rather than with any regulatory actions. It would therefore appear that capital flows to EMEs appear to be far more impacted by monetary policies in advanced economies than their regulatory reforms.

Looking ahead, the indirect spillover of regulatory reform on Emerging Markets over the longer term could, however, be more substantial. While the rationale for tightening capital adequacy norms for the banking sector in AMEs where the recent financial crisis originated is self-evident, the case for immediately migrating from Basel II to Basel III in EMEs is not. Their financial systems were and remain quite different. The primary drivers of leverage in advanced market economies (AMEs) and EMEs are strikingly different. Galloping leverage in AMEs through shadow banking in the run up to the recent global financial crisis was an attempt to increase returns on capital through increased trading of claims on real economy assets in an environment of low returns. This led to a rapid expansion of financial assets as a proportion of their GDP. High credit growth in the more tightly regulated EMEs, like the PRC and India, on the other hand, was primarily through deposit-based banking to finance high rates of investment and growth.

While the concern in advanced economies relates to regulatory laxity that puts their financial system at risk from bubbles, the concerns in EMEs before the crisis were developmental rather than regulatory, as they strove to move away from a repressed to a less regulated financial system. This position has not changed, especially since their financial systems withstood the global financial crisis reasonably well.

The moot point, therefore, is, whether EMEs should immediately move to a regulatory framework calibrated to risks in AME financial systems that could pull scarce savings away from investment necessary to sustain current levels of high growth to cover non-existent risks. The argument in favour of common regulatory norms is to avoid arbitrage. This alone is not very convincing because any capital migrating to a more regulated environment would incur additional costs, as regulation is a proxy tax. The cost of capital is already high in EMEs. Enhanced capital requirements of Basel III are almost guaranteed to keep it high in the foreseeable future.

EMEs have so far been largely bystanders in the global debate in Basel and in the G20 on financial regulatory reform, possibly because their deposit-and-lending based financial systems are structurally very different from the more market-based systems in advanced economies. They however need to be better engaged at the rule-making stage and at least negotiate a regulatory carve-out for the phase-in of Basel III, especially since advanced economies are lagging behind them in implementation. According to a recent assessment by the BCBS, G20 EMEs are actually ahead of advanced countries in implementing Basel III. This not only puts them in the vanguard of Basel III related financial instruments that are still little understood by markets, thereby introducing new risks in their financial systems, but could also extract a high developmental cost through foregone growth.

# How are Emerging and Developing Countries Affected by Monetary and Regulatory Spill-overs from Advanced Economies?

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## SUMMARY

Full-blooded liberalisation of global capital flows has lost its appeal, and disquiet about the volatility of capital flows is likely to grow as changing US monetary conditions – tapering for now, and whatever follows afterwards – create a more stressful financing environment for emerging economies (EM). That's because of the super-sized role that US monetary policy plays in driving flows to, and from, EM. A partial solution to this problem might be to find ways of reducing the disproportionate role of the dollar in international finance. To this end, it is worth paying attention to the prospects for the renminbi (RMB) to be a bigger global player, since it could provide a substitute reserve asset to EMs, and an additional source of financing. But under the current 'rules of the game', China's capital account will need to be fully liberalised in order for the renminbi properly to gain the status of a reserve currency, and China is apparently unwilling to accept full liberalisation, for a long time at least. In other words, China won't immediately help to solve the problem – excessive volatility in global capital flows – because of its own fear of the problem. What might be needed, then, is a convergence around a new definition of what constitutes a 'freely usable' currency<sup>1</sup>. To speed this process up, it might make sense for the community of academics and policy advisers to begin pushing for a round of international monetary coordination that clarifies a new consensus on the meaning of currency convertibility.

### 1: FULL-BLOODED CAPITAL ACCOUNT LIBERALISATION HAS LOST ITS APPEAL

The track record of fully liberalised capital flows isn't good. The incidence of banking crises and currency crises globally has been much higher since the early 1970s than it was under Bretton Woods, and there seems to be little evidence that financial opening has had much of a positive impact on growth or welfare in developing countries (Mohan et al, 2013; Obstfeld, 2009). It seems less than a coincidence that two of the world's best economic performances in the past 20 years – China's and India's – took place against a

background of extremely closed capital accounts.

Yet the failure of fully liberalised capital flows has come into focus slowly over the last 20 years. Sure, the 'long' 1990s was full of crisis: Mexico 1994, Asia 1997, Russia 1998, Brazil 1999, Turkey 2001 and Argentina 2001. But these crises didn't by themselves demonstrate the failure of globally liberalised capital flows. Indeed, the conventional analysis at the time is that these crises happened in countries where policymakers simply tried to hold on to too many elements of the 'impossible trinity': they sought to maintain *both* fixed exchange rates *and* independent monetary policy in a world of globalised capital flows. The problem, in other words, wasn't global financial volatility; but rather the failure of countries to equip themselves to deal with that volatility.

So, EM policymakers drew two lessons from the 1990s, neither of which really encouraged them to close their capital accounts. The first lesson was that crises resulted from having too few of the foreign reserves needed to stabilise managed exchange rates during periods of capital outflow. And the second was to avoid fixing exchange rates at all. (And in any case, fixed exchange rates fell out of fashion because Inflation Targeting arrived on the scene to provide an alternative way of anchoring inflation).

So in the 2000s, EM policymaking relied on less fixing of exchange rates, and more accumulation of FX reserves as a form of self-insurance. Although controls on capital inflows had been mildly fashionable in the early 1990s, it's only really since 2009 that a number of countries have assembled a range of tools to prevent capital coming in the first place. Brazil set the pace in October 2009 by raising its IOF tax on bond and equity inflows, and a variety of measures were subsequently introduced by China, Colombia, Indonesia, Korea, Peru, the Philippines and Taiwan. And while capital controls in the early 1990s had been considered racy, their use has now moved beyond controversy. By the end of 2012, the IMF itself was arguing that 'capital flow management measures can be useful' as long as they are not being introduced to avoid macroeconomic adjustment. (IMF 2012). And that's because it has seemed, at various points during the past four years, blindingly obvious that much of the foreign money entering EM was speculative in nature, highly reversible, and contributing little to proper capital formation in these countries.

But what we've learned since May 2013 is that this new policy mix – have plenty of reserves, float your exchange rate and impose modest controls on speculative capital inflows – might not be too helpful in protecting an economy from global 'risk-off'. Take Brazil. On the face of it, Brazil did everything 'right', and yet its currency was (and remains) extremely exposed. Not only did Brazil impose restrictive controls on capital inflows from October 2009, but also has plenty of external reserves (the public sector has been a net external creditor

<sup>1</sup> For the purposes of inclusion in the SDR, for example, the IMF considers the yen, the dollar, the euro and sterling as 'freely usable' currencies, but not the renminbi

since 2007), a very low net public debt burden and has an inflation-adjusted policy interest rate, among the highest in the world, that 'should' have been high enough to prevent capital outflows in 2013. Maybe the answer lies partly in Brazil's weak policy fundamentals and diminishing growth prospects. But the reality is that you don't have to have weak policy fundamentals to be a victim of capital flows volatility.

And there's an additional factor that heightens vulnerability these days: a growing intolerance to accept a collapse in growth as the price that needs to be paid for external stability. When capital starts flowing out of an economy, it's the market's way of saying 'we don't want to finance your deficit anymore'. Yet the policymaker's willingness to close the deficit depends on why the deficit exists in the first place. If a country's current account deficit results from domestic overheating and explosive import growth then, sure, the policymaker will be happy to tighten the monetary and fiscal stance. But domestic overheating is emphatically not the reason why the 'fragile five' – Brazil, Turkey, India, Indonesia, South Africa – have deficits. Deficits in these countries exist not because of overheating, but rather because of a sustained collapse, over the past couple of years, in export growth: EM has received a negative external shock from declining import growth in the developed world. And the fact that growth is weak makes governments and central banks reluctant to tighten policy. Is that reluctance correct? Often in international finance we see a struggle between the case for 'policy autonomy' and the case for 'market discipline'. There might one day be a danger of losing too much of the latter. But that isn't the immediate problem.

## 2: DISSATISFACTION WITH CAPITAL FLOWS VOLATILITY WILL GROW

It is too optimistic to think that the stresses that became evident in 2013 have come to an end, and that's because of the scale of cross-border flows into EM during recent years. Capital controls or no capital controls, net portfolio inflows to EM, expressed as a share of GDP, were higher in 2010–2012 than they had been at any time since 1993 – the year preceding the Tequila crisis. And the reason for the recent surge in flows is pretty much the same as it was in the early 1990s: extremely loose US monetary policy. The IMF thinks that the 'excessive' portfolio inflow into EM since 2009 has been close to \$500 bn (IMF 2013). Sure, there are structural factors that shift the demand curve for EM assets to the right: a steady decline in global 'home bias', and the overall growth of the global fixed income market. But cyclical factors probably explain a lot.

This elephant in this room is the super-sized role of US monetary policy in driving capital flows to, and from, EM. This is a theme that's been evident since at least the 1970s (though the dollar's importance in international finance seems to have held up better in the past 40 years than the US's role in shaping the overall system of international relations). What that

means is that further steps the Fed takes in withdrawing monetary stimulus are likely to continue to suck capital from EM.

And now there might be a new, paradoxical, twist to the way tighter US monetary policy affects EM, and it results from the accumulation of US Treasuries on EM's sovereign balance sheets. Around 60% of EM's \$7 trillion-plus of fx reserves are denominated in US dollars (IMF 2013), and in 2012, EM's position in US Treasuries and Agency debt was some \$3.8 trillion, or 35% of marketable US public debt outstanding; up from around 25% in 2002 (Table 1). EM's very large position in US fixed income might help to create a negative feedback loop in which changes in US interest rates are reinforced by the behaviour of EM central banks. What I have in mind is this: when US rates fall, capital flows to EM; EM central banks buy US Treasuries, and so US rates fall, and so capital flows to EM. And when US rates rise, capital flows out of EM; EM central banks sell US Treasuries, and so US rates rise; and so capital flows out of EM. The paradox is this: EM thought that holding more reserves might reduce its vulnerability to changes in US monetary policy. To some extent, of course, this is true. But the possibility of a negative feedback loop raises the risk that the impact of changes in US interest rates is amplified by the behaviour of EM central banks. Reserves accumulation was supposed to insulate EM from swings in US monetary policy, but this feedback loop paradoxically suggests otherwise.

**TABLE 1.**  
**EM HOLDINGS OF US SECURITIES**

	2012	2002
Total EM holdings of US Treasuries and Agency debt (\$ bn)	3,800	815
EM nominal GDP (\$ bn)	24,500	6,300
EM Exports of Goods and Services (\$ bn)	8,200	1,900
US marketable public debt outstanding, including Agency debt (\$ bn)	11,100	3,200
<i>EM holdings of US Treasuries &amp; Agencies as a share of EM GDP</i>	16%	13%
<i>EM holdings of US Treasuries &amp; Agencies as a share of EM XGS</i>	47%	42%
<i>EM share of US Treasuries &amp; Agencies as a share of UST stock</i>	35%	25%
<i>EM share of US Treasuries &amp; Agencies as a share of EM external debt</i>	63%	39%

Sources: US Treasury, IIF

## 3: CHINA'S ABILITY TO HELP IS CONSTRAINED

In this context, China's role is worth watching for two reasons. First, because capital outflows from China might provide a substitute source of financing for current account deficits across EM. Second, because the RMB's emergence as a reserve currency might provide a substitute anchor for global finance. As the Bank of England has put it, 'A new source of global liquidity from China could lead to several beneficial

effects, particularly during a period where the world's financial system is becoming increasingly fragmented and retreating into national borders' (Hooley 2013).

Although Chinese policymakers don't formally use the term 'internationalisation', it is probably the right way to describe the steady increase in the RMB's global usability – maybe better than 'liberalisation', which implies a full role for the market that China isn't quite prepared to accept. And the critical distinction for China is between the current account and the capital account. Plenty of progress has been made in making the RMB available for current account transactions. Any corporate can now use the RMB to settle trade, anywhere – some 15% of Chinese trade is now settled in RMB – and it is now the 11<sup>th</sup> most used currency in SWIFT (although its market share is still less than 1%, compared to 36% for both the USD and EUR). Yet the capital account remains rather closed.

Will China's capital account open sufficiently to become, in the IMF's terms, a 'freely usable' currency? Not if this means the full-blooded liberalisation that exists for, say, the dollar, the euro, sterling and the yen. China's recent announcements – at the end of last November's 3rd Plenum, or at the recent inception of the Shanghai Free Trade Zone – consistently assert its willingness to monitor and control speculative capital flows. Either China's approach will have to change, or the internationally accepted definition of 'freely usable' will.

China's exchange rate and capital account policies are trapped in a set of complex dilemmas. Since China has neither deep and liquid capital markets, nor an internationally accessed legal system, it doesn't possess the full set of prerequisites for a 'freely usable' currency that exist in the US or the Eurozone. What it offers instead is currency stability. This stability promotes the renminbi's trustworthiness as an international money, but it only does so at the cost of creating a magnet for speculative capital inflows. To minimise these inflows, the exchange rate would need to exhibit more two-way risk, and indeed the Chinese authorities would like to make it easier for Chinese firms and households to buy foreign currencies in order to generate that two-way risk. But as long as the RMB exhibits low volatility and a tendency to appreciate, Chinese firms and households will have little desire to sell it. There is a Catch 22 here – exchange rate volatility is needed to promote capital outflows, but capital outflows are needed to promote exchange rate volatility – and that Catch 22 results from a contradiction in the minds of Chinese policymakers: they want a more volatile exchange rate, and yet at the same time they don't.

It is the current 'rules of the game' of international finance that make China so ambivalent about opening its capital account, since those rules of the game adopt such a broad definition of what it takes for a currency to be 'freely usable'. Chinese policymakers probably sympathise with Helene Rey's view (Rey 2013) that you can't have autonomous monetary policy in global capital markets. And there are few countries that prioritise monetary autonomy more than China.

#### 4: A NEW SET OF RULES WILL BE NEEDED?

Global monetary leadership is a scarce commodity these days. Since Bretton Woods, the evolution of financial markets has substantially shifted the balance of power between governments and markets; and the US lost its dominant role in the global system (Cohen 2013). A collective action problem has resulted. Just as drivers pollute the air, 'external financing "pollutes" emerging economies with financial fragility' (Korinek 2011). So far, we've tried to deal with that problem by making it marginally more acceptable for countries to use capital controls. But it might make sense for their use to become more entrenched in the international financial architecture, and a round of international monetary coordination is probably needed to achieve this. The biggest benefit of this might be to draw China more rapidly towards the centre of international finance, offering EM an alternative source of financing, and a fall in these countries' dependence on swings in US monetary policy.

(This draft: 20 January 2014)

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# Spillovers and Policy Responses

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The focus on policy spillovers in recent years is a welcome side-effect of the crisis. The global nature of the crisis, and the attempts at a coordinated response to it, highlighted the growing importance of spillovers from policy actions by systemic countries. The G20 Framework for Growth launched at the Pittsburgh summit in 2009 focused on spillovers between systemic countries. But more recent IMF work<sup>1</sup>, and the policy debate, has concentrated more on the potential effects of systemic country spillovers on emerging markets and developing countries (EMDCs).

In many respects this is a repackaging of old debates, most especially the ‘Summers doctrine’ – which stated that policies which are good for the US are good for the rest of the world. This view flourished in the decade leading up to the crisis, when economic developments were generally very favourable, and incentives for international cooperation were few, despite efforts to get countries to address global imbalances.

But as international interlinkages have increased, spillovers have become more substantial in size. For example, in the 2012 Spillover Report the IMF estimated that an intensification of the euro area crisis would reduce global GDP by between 1.5% and 5.2%. As trade and financial linkages continue to grow, this trend will continue.

### ECONOMIC POLICY SPILLOVERS

Compositional and distributional differences have also become more complex, and important. The recent debate on spillovers has focused on the impact of monetary policy (especially unconventional policies such as QE, OMT and QQME) on emerging markets. Because these policies impact on asset prices, and stimulate capital flows, analysis of their effects also has to take into account market responses. Apart from the impact on bond prices, there have also been strong effects on currency markets and exchange rates.

Emerging markets have criticised the Fed’s QE policy in particular as leading to a falling dollar, portfolio flows from the US, and problems for economic management in the emerging markets. Because of the effects on exchange rates, the impact has also had differential effects on industrial sectors in the spillover recipient countries. And capital flows have predominantly gone to the countries perceived as the safest, so that spreads between the good performers and the poor

performers increased. A number of EMs have responded by introducing capital controls to reduce inflows, as well as macroprudential instruments to address domestic overheating.

The response from the US has been that the criticisms are misplaced. They argue that without QE the US economy would not have grown as strongly as it has, and that EMDCs have benefitted from this as a boost to their own growth. They also argue that with interest rates at the lower bound and fiscal policy hamstrung by politics QE was the only policy instrument available, and that their policy actions were not aimed at beggar-thy-neighbour exchange rate depreciation.

Although the technology for analysing spillovers has improved, there is still little agreement on the size – or in some cases even the sign – of spillover effects. There have been big exercises to improve the analysis. The G20 MAP process (relying heavily on the IMF’s technical support) has tried to look at international interlinkages. And the IMF has also invested in econometric models to support this effort. But the course of the international debate shows that there is still no consensus on the effects.

Nevertheless, the facts suggest that the effects of the most contentious policy – QE – have on balance been positive overall for most recipient countries. Although it is difficult to prove the counter-factual, the predicted effects – higher bond yields, a reduction in risk aversion and volatility, rising capital flows to EMs, and a falling dollar – appear to have come about. And certainly the market reaction to the first (and unexpected) discussion of tapering of QE was to reverse these trends.

The impact on developing countries is also likely to have been positive on balance, though rather smaller than for EMs. DCs will tend to have benefitted from higher global growth, primarily through the trade channel. And they may have been insulated from the more problematic effects arising from capital flows, which were concentrated on the EMs (and within those the better performing ones). But they are also likely to have been impacted by higher commodity prices – positive impacts on the commodity producing DCs and negative for the commodity importers (though again the net effect is harder to determine).

Even if on balance the impact for EMDCs is likely to have been positive, some of the effects have still been problematic. Where these have occurred, countries affected by spillovers have faced a choice as to whether to use their own policy tools to respond to or offset the spillovers. And how they respond to that challenge could also have a significant effect on how they are impacted by spillovers. Some of the responses by EMs to the spillovers from QE have included domestic monetary policy tightening, capital inflow controls, and macroprudential measures.

<sup>1</sup> For example, the WEO has focused on these issues, and the IMF now produces a regular Spillovers Report.



While the spillovers debate has focused on QE, EMDCs are also potentially affected by other forms of policy action by systemic countries (including large EMs). There has been less focus on these, partly because QE is new and has a specific set of effects which are perhaps easier to identify. Nevertheless fiscal policy actions and regulatory actions in particular are likely to have spillover effects.

Indeed recent research at the IMF (by Doug Laxton and others) suggests that when economies face extreme circumstances – for example, when interest rates are close to zero or banks are close to their capital adequacy limits – fiscal and macro-prudential policies become more powerful. In these circumstances spillovers to other countries are large, and the gains from international cooperation are also substantial.

Fiscal policy spillovers are more complex to analyse. But they are likely to operate mainly through fairly conventional demand channels. The 2013 IMF Spillover Report identified fiscal policy as having large impacts. It argued that avoiding the ‘fiscal cliff’ in the US early in 2013 meant that US and global GDP was significantly higher than it would otherwise have been (proving that the ‘Summers doctrine’ can be right!).

## REGULATORY SPILLOVERS

Another consequence of the crisis is that systemic countries have been very focused on improving regulation and supervision of financial institutions and sectors. This is undoubtedly correct, given the scale of output losses generated by the crisis. But again these policy actions can have large spillover effects, especially given the depth of cross-border financial linkages. It is probably helpful to distinguish between two types of spillover effects:

- effects from regulatory or supervisory actions on domestic institutions, which then have knock-on effects abroad
- the impact on global regulatory or supervisory norms or standards

Some spillover effects have already been seen from tighter restrictions on domestic institutions in systemic countries. For example, in Europe the general trend towards higher capital and liquidity requirements, coupled with home supervisors’ focus on banks’ core business, has resulted in a retreat from cross-border banking. Countries with a significant presence of foreign banks have suffered from withdrawal of banking capacity, to the detriment of the domestic economy.

The other impact from systemic countries on EMDCs is the potential effect of the development of global financial norms and standards on their financial systems. In effect systemic countries (through bodies such as the FSB, on which DCs are not represented) are setting standards which all countries are expected to adopt and adhere to. And systemic countries possess sufficient power to bring DCs into line with these global standards. There is usually some leeway for countries to adopt the new standards in a way that meets local requirements, but this is limited.

## CONCLUSION

Spillovers from systemic countries to EMDCs can take many forms. Most of the spillovers from economic policy actions in systemic countries are likely to be broadly beneficial for EMDCs, provided that they are aimed at enhancing growth in the origin countries and not at securing a competitive advantage. Nevertheless, EMDCs can be adversely affected in some areas and may need to take action in response, to offset the impact of the spillovers, provided that they have policy space to do so.

On regulatory issues, EMDCs can be adversely affected if actions by systemic countries cause their banks to withdraw from lending in EMDCs, or impose *de facto* global standards on them. In those circumstances EMDCs have limited power to offset those effects.

# The Ghosts of Spillovers Past, Present and Future

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Developments in the emerging markets over the past five years underscore the deepening financial interconnectivity between EM and developed market (DM) economies and the reflexive nature of policy responses and endogenous feedback loops.

The ghosts of spillovers past span a period covering the Japanese bust and US disinflation cycle in the 1990s, as well as the ballooning of China's current account surplus between 2002 and 2008. Against a backdrop of broad financial deregulation (both markets and institutions), a series of bubbles developed and then burst, starting with Japan in 1989, Mexico in 1994, Asia and Russia in 1997-98, the dot.com bubble in 2001 and finally US subprime in 2007-08. As one bubble was bursting, another was inflating.

The collapse of Japan's bubble triggered Yen depreciation and the expansion of Asian current account deficits. Subsequent Fed tightening fuelled the Mexican and Asian crises. In both cases, sharp real exchange rate depreciations prompted fast recoveries thanks in part to strong G7 economy growth, driven in part by reactive Fed rate cuts, the inflating of the dot.com bubble and real interest rate convergence within the Euro Area around the launch of the Euro. The latter served to cushion the economic impact of German reunification and reform. The bursting of the dot.com bubble tipped Argentina into default and led to extreme stress on Brazil. The Fed's response to the dot.com bust coincided with bubbles forming in Central and Eastern Europe, as well as the Euro area periphery. DM bubbles generally tended to cause significant fallout on both DM and EM economies and markets. EM bubbles, in turn, tended to be major DM market events, rather than economic events.

Something changed around the build-up of the US subprime bubble. The rise of China's current account surplus at the point of the country's entry into the WTO coincided with America's first deflation scare. The sum of the two served to reflate the US economy after the dot.com bust and to incentivize a return of capital flows to emerging markets following defaults and near-defaults by Argentina and Brazil, respectively. Alongside China's growing current account surplus, Germany's surplus rose to levels above 6% of GDP. In the period 2001-08, the correlation of China's current account evolution to that of the US and Germany was -0.7 and +0.94 respectively. This period marked a virtuous cycle for emerging markets, which had deleveraged and reformed, and a

virtuous period of financial integration within the Euro area. For the first time, there was a closer coincidence of bubbles in both DM (US subprime and Euro area periphery) and EM (Central/Eastern Europe/Middle East and, to a lesser extent, in pockets of Latin America and Asia).

Common factors appear to have been significant (and asymmetric) changes in real interest rates, financial deregulation (innovation and broadening access) and declining interest rate volatility. US and European monetary policy tended to treat several one-time positive shocks -- the integration of China and Eastern Europe into the market economy in particular -- as cyclical disinflation shocks, largely ignoring asset price behavior.

The ghosts of spillovers present stem directly from the fall-out of the US housing and credit crises. The preconditions for the present negative spillovers to EM pre-dated the collapse of Lehman by at least 5 years. With the onset of China's growth surge and a corresponding commodity price boom, EM policy began to drift from the mid-2000s after the reforms of the late 1990s and early 2000s. As real interest rates fell precipitously across EM, new rigidities developed in the non-tradables sector and many EM currencies had become overvalued when the subprime shock hit in 2008. The divergence between Central/Eastern Europe on the one hand and Latin America and Asia on the other is likely instructive for the future. Whereas all 3 major EM regions had suffered some loss of competitiveness in the run-up to 2008, it was only Central/Eastern Europe (and the Middle East) that experienced a sharp rise in credit growth and real estate bubbles. The clearest reason for this divergence was the differing behavior of real interest rates, which had declined much earlier in CEE.

After the collapse of Lehman Brothers, EM FX depreciations unwound the shock with limited effects on structural fiscal positions and private sector balance sheets. In a fashion similar to Ireland and Spain, it was not that most EM economies loosened policy explicitly, but rather that they failed sufficiently to lean against strong capital flows (or perhaps they simply lacked sufficient tools to deal with the deluge -- which raises a broader question about free capital flows and the usefulness of capital controls). EM economies with the highest nominal and real interest rates took advantage of the QE period to ease monetary policies in unprecedented fashion. By 2013, most EM economies had zero or negative real interest rates.

What made it possible for the emerging markets to ease policy so aggressively against a backdrop of persistent uncertainty over US and European growth prospects? The difference post-2008 was a leveling of the playing field in perceptions of what constituted a safe asset. DM investors flocked to EM due to the latter's strong balance sheets. Having already been encouraged to stimulate aggressively in the wake of the Lehman shock, EM economies experienced another flood of capital inflows. Out of fear of the effects of Fed QE, EM

central banks leaned against the inflows, not only by accumulating FX reserves but also (in part due to their already sizeable foreign reserve war chests) by easing monetary policy in unprecedented fashion. Reflationary monetary policy, the decline in DM and EM interest rates and the EM central banks' FX intervention policies led to a renewed collapse in interest and exchange rate volatility. By mid-2011, implied equity volatility (VIX) had fallen back to mid-2007 levels, and by mid-2013, implied US treasury volatility had fallen below the pre-crisis trough. It is noteworthy that in mid-January, the VIX was below the May 2013 pre-Fed taper trough, and bond volatility was again approaching the lows of 2013.

The results were predictable: a fast resumption of strong EM growth, windfall EM fiscal gains, a leveraging up of the EM private sector and an unprecedented risk transfer from EM governments to DM investors.

The post-2008 build-up of EM imbalances was reflexive, mirroring those of their advanced economy counterparts only a few years earlier. Policy drifted further from the early 2000s orthodoxy, with headline fiscal policies masking faster spending growth as a result of surging non-tradables sector demand. Inflation targeting regimes were compromised by attempts to ward off the effects of Fed QE on EM exchange rates. The cycle of EM official sector recycling of advanced economy private capital flows to advanced economy governments resumed. Except this time around, the recipients were a broader group at the expense of the US.

Of the many possible factors, three factors seem central to the recent spillovers to emerging markets, and the policy challenges posed by their potential reversal.

First, as asset price volatility, particularly for exchange rates and interest rates, declined, global capital flows grew well in excess of increases in global GDP. The result was looser financing constraints for many EM countries. Whereas previously, a 3% of GDP C/A deficit was considered the maximum "safe" size, suddenly a number of countries could run 5-10% of GDP C/A deficits with relative ease. There are good reasons to expect volatility to normalize at a minimum as the US exits from its unconventional monetary policies. Higher volatility necessitates a notional reduction in asset holdings for a given value-at-risk constraint. Moreover, when volatility rises, asset correlations often break down. Such a toxic cocktail of rising volatility and correlation breakdown served to undermine Long Term Capital Management in 1998.

Second, given the mammoth size of capital flows to the emerging markets, the potential liquidity mismatch between reversing institutional asset flows and bank intermediation capacity is substantial. The regulatory response to the 2008 financial crisis sought to reduce risks in the DM banking sector. Notwithstanding the many positive innovations associated with reduced bank leverage and skewed incentives, reforms to financial regulation have further reduced the intermediation capacity of the developed countries' banks, and indeed of their subsidiaries within the emerging markets. Real money

asset managers, in turn, effectively misprice liquidity, allowing access to instant withdrawals regardless of the absolute size of their AUM or indeed the riskiness of their investments (both in terms of liquidity and credit risk). (In contrast, hedge funds normally require at least 3 months' notice for redemptions. For the minority that could not meet redemptions in 2008 - in several cases, due to their illiquid EM exposures - temporary gates were imposed. These had the predictable effect of leading to larger redemptions from "liquid" hedge funds that had not imposed such exit constraints.)

In past bouts of financial contagion, a central feature has always been the presence of a common set of lenders. The mismatch between buy-side and sell-side is analogous to a classic maturity mismatch, where investors encounter difficulties in liquidating positions and, in return, are forced to sell more liquid assets in unrelated markets. Cliff effects can result from events as extreme as a sovereign default or capital controls, or as benign as a ratings downgrade or indeed a rise in the volatility of asset prices that leads to binding VAR constraints or higher margin requirements.

Finally, the self-insurance built up by many emerging markets in the form of large foreign reserves, reduced public sector debt and floating exchange rates must be placed in the broader context of a reduction in DM policy instruments to buffer EM shocks. The response to past DM spillovers to EM has been a significant ease in US monetary policy and at least some fiscal loosening. Space on both fronts is now more constrained.

Many emerging markets have still not come to grips with the possibility that post-2008 GDP growth and real interest rates were not the new norm, but instead might have been transitory. In turn, there has been a temptation to use self-insurance as a substitute, rather than as a financing bridge, for economic reforms. The international community has very little leverage over policy adjustments in EM until such buffers have been exhausted. Macro adjustments, when they finally occur, tend to be after substantial FX reserve sales.

One of the greater uncertainties going forward is the extent to which real interest rates must adjust as US monetary policy normalizes and, in turn, the extent of EM private credit losses. Credit uncertainties, especially in the wake of a substantial migration of private credit risk to DM public sector balance sheets, argue for emerging markets to preserve foreign reserve cushions to a substantial degree.

The ghosts of future spillovers relate specifically to China, about which complacency is shockingly high, and more generally to the broader consequences of political and market complacency that derive from the successes of financial crisis firefighting, inclusive of unconventional monetary policies.

Assumptions of financial stability within the emerging markets and potential spillovers from EM back to developed economies rest heavily on an expectation that Chinese growth will remain at levels not dissimilar to the past. Mechanical

estimates (which do not assume deleterious financial effects) suggest that every 1% point reduction in Chinese GDP growth shaves 0.15% points off global growth. A reversion to the global growth mean could accordingly shave 0.45-0.6% off global growth, assuming no negative endogenous feedback effects. Uncertainty alone related to a sharp slowdown in Chinese growth would likely prompt a sharp tightening in global financial conditions. At a point when conventional monetary policy has been exhausted and where unconventional monetary policy works primarily through the portfolio balance channel, serious contingency planning for such an event is lacking.

In sum, traditional spillover risks to EM look far more muted than in the past. EM public sector balance sheets are healthy, and external debt risks, traditionally defined, are low. Instead, a new, less recognizable set of familiar risks has arisen related to excessively loose financial conditions, financial intermediation imbalances and the misidentification of cyclical excess (low volatility and the persistence of strong Chinese growth) as structural “new normals.”

# Monetary Spillovers from Advanced Economies: Implications for Emerging Market Economies

**David Vines**

Oxford

## 1 INTRODUCTION: THE DOMESTIC ORIENTATION OF MONETARY POLICY IN ADVANCED COUNTRIES

Monetary policy in advanced economies has been highly accommodative during the past decade; this has had significant effects on emerging market economies. The conventional wisdom during the Great Moderation was that EMEs can defend themselves from such effects by monetary policy alone – a view that it is adequate for central banks to remain one-objective one-instrument institutions. In addition it was argued that there are no benefits from international coordination of monetary policy in these circumstances. There has been a similar view with regard to domestic financial regulation: a view that microprudential regulation of individual institutions in individual countries would ensure systemic stability. By contrast banking sector regulatory architecture has been characterised by international cooperation – the financial crisis led to four G20 working groups, and to the establishment of the FSB.

Since the crisis monetary policy in advanced countries has continued to have a domestic orientation. Monetary actions have been uncoordinated; actions since 2007 have been in response to domestic situations but have been influenced by the US. In 2009 international policymakers worked closely together, with both fiscal expansion and interest rate cuts. Then things changed: from 2010 onwards there has no longer been a reliance on fiscal expansion. Instead there has been a continued reliance on very low interest rates and on unconventional monetary policy: the US Fed and the Bank of England have quadrupled their balance sheets, the Swiss National Bank has also quadrupled its balance sheet to peg the Franc; and the ECB and BoJ have expanded their balance sheets by 55 and 87 percent

Liquidity Swap Facilities have been coordinated. But the provision of swap lines has been confined to central banks in advanced countries.

## 2 SPILLOVERS TO EMES: THE GLOBAL FINANCIAL CYCLE AND DOMESTIC VULNERABILITY

The result of spillovers during the Great Moderation, and since the crisis, has been divergent interest rate paths throughout the 2000s; the ‘Great Deviation’. Interest rates moved higher in EMEs, encouraging capital inflow. This has led to appreciation of exchange rates in EMEs.

The conventional view, that these spillovers are unimportant, relies on a Mundell-Fleming like model with uncovered interest parity, or UIP. If advanced countries embark on monetary expansion and lower the world interest rate, an EME can use monetary policy to resist the fall in the interest rate. This will cause currency appreciation. With UIP the country must end up having a similar interest rate to that in the US. But it can use its monetary policy to steer the exchange rate to the point at which currency appreciation offsets the effects of the lower interest rate so as to keep output unchanged (or to keep the desired point on an inflation-output tradeoff). This is the converse of the ‘impossible’ trinity: with floating exchange rates and capital mobility a country can have an independent monetary policy. The country is thus able to isolate itself from foreign spillovers. (Bernanke, 2013) As a result policy should not interfere with international capital markets, and international cooperation on monetary policy is not needed.

Rakesh Mohan and others have argued that this analysis is inadequate (Mohan and Kumar, 2013) and that monetary policy in advanced countries has instead led to volatility of capital flows to EMES, to excessive rate volatility, and to risks to financial stability. This claim appears to be correct: EME economies cannot, in fact, have not been able to resist the effects of the fall in the US interest rate. EME economies have experienced a financial boom from which they have not been able to isolate themselves and, at the same time, many exchange rates have appreciated excessively. Countries have become vulnerable to subsequent currency collapse. There have been domestic reasons for such vulnerability, arising from domestic booms. The risk is being exacerbated as the vulnerability arising for domestic reasons is added to by the tapering of QE which is causing global interest rates to rise. Floating exchange rates and a high degree of capital mobility have not made possible an independent monetary policy. The impossible trinity has become an ‘impossible dilemma’ (Rey, 2013 )

DeBelle (2013) puts this argument in a simple way: exchange rates have not moved so as to defend economies from external shocks, and so an additional policy instrument has been needed. This may well be the extent of the argument for countries like Australia. But there is more than this at work in emerging market economies. Domestic markets have shown a risk of bubbles, this is what has created domestic vulnerability. Risk on / risk off behaviour has made matters worse.

### 3 THE NEED FOR INDEPENDENT ACTION BY EMERGING MARKET ECONOMIES

Some have argued that, in these circumstances, the US should conduct its monetary policies with regard to needs of other countries – i.e. that these circumstances provide a ground for international cooperation in monetary policy making. (Mohan and Kumar, 2013.) Eichengreen and others have proposed International Monetary Policy Committee. But this is not feasible. The reason is not that spillovers are small or that policy-makers do not understand them. The problem is that conduct of monetary policy in this way by the US may damage the US's own interests. The needs of international financial stability and of domestic objectives may be at odds.

Furthermore, the management of aggregate demand in the US has important consequences for economic activity in the rest of the world. There has been a concern in emerging markets about excessive capital inflows due to loose monetary policy in the US and yet a wish for a higher level of economic activity and demand stimulus in the same countries. The worry about the tapering of QE has now led to a related worry in a reverse direction; there is a concern that the Federal Reserve does not allow the recovery to lead to a globally inflationary outcome, and yet a concern about capital outflows from EMEs.

These circumstances suggest that EMEs need to adopt domestic policies different from those advocated by the conventional wisdom during the Great Moderation. There are two difficulties. First exchange rates have not moved appropriately. As a result, although exchange rate flexibility is necessary, it must be coupled with a capacity to intervene supported by appropriate level of foreign exchange reserves, and with a well-thought-out implementation of judicious capital account management. Second, there has been a risk of bubbles domestically. This means that a combination of macroprudential policies is necessary, guided by aggressive stress-testing, including a constraint on leverage ratios where appropriate.

### 4 TAPERING OF QE, THE SLOW GLOBAL RECOVERY, AND FISCAL POLICY IN ADVANCED COUNTRIES

It is apparent that growth in advanced countries is returning very slowly; there are widespread worries about the speed and extent of the recovery. A slower fiscal consolidation – i.e. a looser fiscal position coupled with a clear plan for debt reduction in the future – would have meant that recovery could have become more pronounced more quickly. Such a looser fiscal policy would have meant that monetary policy needed to be less expansionary, and would have meant less need for unconventional monetary policy.

The spillovers on EMEs from QE would have been less. There would have been less capital inflow and less need for

macroprudential policies and controls on capital inflows in emerging market economies. It appears that a discussion of policy responses in emerging markets has needed to include a discussion of fiscal policy in advanced countries.

But now there are worries about the tapering of quantitative easing. Although recovery is inadequately rapid, fears about the effect of recovery on interest rates are leading to upturns in long term interest rates, which will further slow the recovery, even although short-term interest rates are not yet rising. This will also tend to worsen the capital outflow from EMEs and increase the difficulties discussed above; thereby further worsening the prospects for global recovery. There appears to be a market inconsistency here. Recovery is inadequately rapid, yet fears about the effects of recovery are in danger of further slowing the recovery.

Looser fiscal policy in advanced countries might well – other things being equal – lead to a more rapid increase in longer term interest rates and so to crowding out by that means. But it may be that what is needed is looser fiscal policy coupled with a guarantee by central banks of a sufficiently long period of very low short term interest rates, to enable a stronger recovery to take hold without longer term interest rates rising.

There are risks that such an adjustment of policy in advanced countries will not be well handled. If interest rates rise rapidly, or if slower recovery leads to increasing risk premia applied to investments in emerging markets, then this will tend to worsen the capital outflow from EMEs and increase the difficulties associated with exchange rate collapse which we have been discussing. This will increase the need for effectively judged policy action by emerging market economies.

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# EMEs' Response to Global Spillovers

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Traditional development theory took a benign view of capital inflows into developing countries as these filled two critical developmental gaps, namely a savings–investment deficit and foreign exchange scarcity. While developing countries continue to require large amounts of external savings to supplement their own in order to accelerate growth and development, a rapidly globalizing world with large external imbalances, sophisticated financial markets and growing monetary policy spillovers also result in large, volatile capital flows leading to misaligned and volatile exchange rates, sudden stops and external payments crises that threaten macro-economic stability. Capital flows to emerging markets are now back to their pre-crisis highs, despite declining growth, lower current account surpluses and rising public debt.

There are three key ways in which EMEs have dealt with global spillovers, although their sequencing and deployment have varied enormously across space and time. Since it is the most nimble, monetary policy is the first line of defence in EMEs that have floated their currencies to varying degrees. This response includes use of interest rates and greater exchange rate flexibility, coupled with adequate reserves that enable market intervention where required to deal with exchange rate misalignment and extreme volatility.

The second way is to use prudential measures to address financial stability concerns that may arise from failures and leakages from the first line of defence, such as domestic credit booms and asset price inflation. Higher reserve requirements, countercyclical capital buffers, and capping loan to value ratios in the bubble sectors (such as housing) and foreign currency lending are some of the policy instruments that have been used. The G-20 initiative to develop domestic currency bond markets and structural reforms that can increase the absorptive capacity of EMEs to direct capital inflows into investment in the real economy is part of the tool kit of this line of defence. Prudential measures however can be effective only so long as the inflows pass through a well regulated formal financial system and do not bypass it.

The third way is to impose short-term capital control measures (CCMs). This instrument has recently been recognized by the IMF as legitimate in extreme circumstances, and also endorsed by the G-20 at their sixth Summit in Cannes. CCMs are putatively leaky, and more effective when imposed on inflows than on outflows. There are two broad types of

capital controls, namely those that rely on market instruments to raise or reduce the cost of certain transactions, as appropriate, and administrative controls, that try to restrict or prohibit cross-border capital transactions.

All three lines of defence create distortions of their own, and at best throw sand in the wheels. A point may arise when the three lines together are unable to stop the capital flow juggernaut, and an external payments crisis and loss of market access follows. This is on account of a basic asymmetry in EMEs' ability to act against currency appreciation and currency depreciation. Since local currency is used in the former (acting against currency appreciation), their capacity is potentially unlimited. In the latter case (acting against currency depreciation), however, they are constrained by the size of their hard currency reserves. There are three tried and trusted options available with developing countries to deal with this, namely bilateral and regional swap agreements, IMF funding and, as was done on a large scale during the recent financial crisis, liquidity and swap facilities with the US Federal Reserve, the issuer of the de facto global reserve currency. There is considerable scope for streamlining all the three backstops: Regional arrangements need a suitable surveillance system and mutually acceptable governance structure to be effective, IMF instruments need to become more nimble and shed their 'stigma' image. One cannot, as a matter of course, expect bilateral arrangements, including US Fed swap facilities, to ever become transparent, rule-bound and a-political.

What more needs to be done? There is perhaps a need for streamlining the first line of defence, so as to limit the distortion of monetary policy by volatile capital flows on the one hand, and minimise recourse to short-term prudential and capital flow measures on the other. Ideally, only those prudential and capital control measures should be in places that are desirable and sustainable over the long-term.

Developing countries have found it impossible to use a single policy instrument – short term interest rates – to simultaneously target both the domestic economic cycle and global spillovers – the external financial cycle – at the same time. According to the widely accepted 'Tinbergen rule' a policy instrument can be effective only if it has a single objective. Despite this, EME central banks have been using a single policy instrument, namely the interest rate, to sometimes target domestic imbalances (the inflation-growth matrix) and sometimes external imbalances (the exchange rate-current account balance matrix), supplemented occasionally by market intervention, depending on which balance appears more pressing at the moment. This risks making the instrument ineffective, the policy inconsistent and magnifying rather than attenuating both domestic and external imbalances. Since there are two targets, a second policy instrument is required to achieve both objectives. They therefore need a new policy instrument that frees up monetary policy to target the domestic economic cycle. The interest rate is

<sup>1</sup> These are personal views.

clearly better suited to target domestic imbalances. Targeting a neutral Real Effective Exchange Rate (REER) through market intervention, on the other hand, is clearly better suited to targeting external imbalances. Unlike the nominal exchange rate, the REER is without doubt an invisible target which is difficult to compute. However such targeting would, first, ensure that the nominal exchange rate remains closely aligned to fundamentals, i.e it responds primarily to the current account and is not distorted by destabilizing volatile capital flows from time to time, even though they might at times make it easier to finance current account deficits over the short term. Second, by sequestering excessive inflows during episodes of excessive inflows, it enhances the war chest for combating disorderly adjustment which can boost market confidence relative to EME peers. Such a policy/instrument is also entirely consistent with Article 1(iii) of the IMF's Articles of Agreement that purports "to promote exchange rate stability".

A number of EMEs, such as India, have, as a matter of course, relied more on interventions in the foreign exchange market

to manage volatile capital flows. However, they neither target it consistently, nor are they consistent in the use of instruments to achieve their target. A consistent, well-articulated and effectively communicated exchange rate and/or reserve management policy which protects monetary independence has still to be worked out by EME central banks. The use of separate instruments to target domestic and external balances by the central bank must be done within an overall framework of policy consistency that attenuates conflicting outcomes. There would, for instance, be no conflicting outcomes when there is a need to tighten monetary policy and sell foreign exchange reserves, or inversely when there is a need to loosen monetary policy and buy foreign exchange reserves. There could, however, be some conflict when there is a need to loosen monetary policy and sell reserves, and inversely when there is a need to tighten monetary policy and buy reserves. In the case of such conflict the central bank would need to conduct sterilization/liquidity provision operations alongside market intervention so that the monetary policy stance is not compromised.

## APPENDIX

### USE OF PRUDENTIAL MEASURES

Preference	PMs	Specifics
1.	Cap on LTV ratio	<ul style="list-style-type: none"> <li>On housing loans (<b>CHN, INA, IND, MYS, TWN, THA, TUR</b>)</li> </ul>
2.	Increase in Reserve Requirements	<ul style="list-style-type: none"> <li>Applied generally on most, if not all, types of domestic and foreign deposits (<b>ARG, BRA, INA, IND, MYS, PER, TUR</b>)</li> </ul>
3.	Increasing or Implementing Countercyclical capital requirements	<ul style="list-style-type: none"> <li>Increase in capital requirements on new consumer credit operations (esp. personal credit, payroll-deducted loans and vehicles) (<b>BRA</b>)</li> <li>Introduced a capital conservation buffer, a countercyclical buffer, and a systemic capital. Raised the minimum capital adequacy ratio to 11.5% from 8% for large banks (small banks: 10.5%) (<b>CHN</b>)</li> <li>Introduction of capital surcharges for systemically important institutions, on top of Basel requirements (<b>SAF</b>)</li> </ul>
4.	Caps on foreign or domestic currency lending	<ul style="list-style-type: none"> <li>30% limit on short-term offshore borrowing of domestic banks (<b>INA</b>)</li> <li>Ceiling on FX mortgage lending set at 50% of total mortgage lending (<b>POL</b>)</li> <li>Limited credit to highly vulnerable sectors (mainly property credit, consumption credit, stock-related credit) (<b>VNM</b>)</li> </ul>



USE OF CAPITAL CONTROL MEASURES (CCM)

Preference	Non-discriminatory CFMs	Specifics
1.	Reserve Requirement (RR) on FCY or NR deposits	<ul style="list-style-type: none"> <li>• Unremunerated RR of 30% on short-term capital inflows for a year (<b>ARG</b>)</li> <li>• Unremunerated RR on domestic and FC deposits, FC liabilities with maturity less than 2 years (<b>PER</b>)</li> <li>• RRR on short-term FX deposits and other liabilities gradually increased (<b>TUR</b>)</li> </ul>
	Limits on exposure to FX derivatives	<ul style="list-style-type: none"> <li>• Ceiling on forward exchange position that can be held by resident and non-resident banks (ceiling set as a % of bank's equity capital) (<b>KOR</b>)</li> <li>• Holdings of onshore TWD derivatives (NDF &amp; options) by domestic and foreign banks limited to 20% of total forex positions (<b>TWN</b>)</li> </ul>
2.	Capital flows control through price or volume	<ul style="list-style-type: none"> <li>• Limit on short-term offshore borrowing of the banks at 30% of capital (<b>INA</b>)</li> <li>•</li> </ul>
	Levy on FCY Liabilities	<ul style="list-style-type: none"> <li>• Macprudential Stability Levy – Levy of up to 0.5% on financial institutions' non-deposit FCY liability balances (<b>KOR</b>)</li> </ul>
	Restricted holding periods of investments	<ul style="list-style-type: none"> <li>• Minimum holding period on Bank Indonesia bills (<b>INA</b>)</li> </ul>
	Capital requirements for FX credit risk	<ul style="list-style-type: none"> <li>• Higher capital requirement for banks to position foreign exchange forwards (<b>PHP</b>)</li> </ul>

Preference	Discriminatory CFMs	Specifics
1.	Capital flows control through price or volume on non-residents only	<ul style="list-style-type: none"> <li>• Tax on financial operations (IOF) for non-resident portfolio investment in equity and fixed income (<b>BRA</b>)</li> <li>• Fee on NR purchases of central bank paper, capital gains tax on NR investments in the stock market (<b>PER</b>)</li> <li>• Withholding tax on foreign purchases of treasury and money stabilization bonds (<b>KOR</b>)</li> <li>• Banned non-residents from placing funds in time deposits (<b>TWN</b>)</li> <li>• Withholding tax on capital gains and interest payments for government and state-owned company bonds earned by non-residents (<b>THA</b>)</li> </ul>

Country abbreviations: Argentina (ARG), Brazil (BRA), Chile (CHL), China (CHN), India (IND), Indonesia (INA), Malaysia (MYS), Mexico (MEX), Peru (PER), Philippines (PHP), Poland (POL), South Africa (SAF), South Korea (KOR), Taiwan (TWN), Thailand (THL), Turkey (TUR), Vietnam (VNM)

Source: Global Monetary Easing: Spillovers and Lines of Defence, by Wang Chua, Norhana Endut, Nozlan Khadri & Wee Haw Sim (Bank Negara Malaysia Working Paper Series WP3/2013, December 2013)

# How have Emerging and Developing Countries Responded in Practice to these Spillovers?

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I will focus in this memo on the challenges posed by spillovers in advanced economies to the frontier markets of Africa, which are embryonic emerging markets, and in particular to Uganda. The frontier markets of Africa have, since the start of the millennium, begun attracting portfolio capital flows into their financial markets; most of these flows are intermediated through the domestic banking system or invested in the government securities market. Although the scale of these portfolio flows is still relatively small (total offshore portfolio investment in Uganda is the equivalent of about 2 percent of GDP), financial systems in most of the frontier markets are shallow and hence portfolio flows can affect prices and liquidity in these markets.

During the global financial crisis in 2008 and 2009, frontier markets experienced an outflow of capital as risk tolerance among investors declined and liquidity conditions in advanced economies tightened. Since then, however, portfolio capital inflows have resumed, driven mainly by the large interest rate differentials between the frontier markets and advanced economies. Short term interest rates in most frontier markets are in double digits. Clearly the monetary policies of the advanced economies have contributed to the interest rate differential, but they are not the only cause; there would still be a significant interest rate differential even if monetary policies in advanced economies were closer to neutral and interest rates at historically more normal levels. This is because rates of return to capital are much higher in the frontier markets than in the advanced economies (the former have higher real growth and less capital intensive economies).

Portfolio flows to the frontier markets are volatile for several reasons. There are usually only a small number of significant players involved in each country (a few international banks and emerging market funds), so that a transaction by one player can have a major impact on the market on any day. Flows are sensitive to both perceptions of risk in the frontier markets, especially expectations about short term movements in the exchange rate, and market conditions in global markets. Increased risk aversion among investors in global markets and/or tighter global liquidity conditions can trigger rapid portfolio capital outflows from frontier markets, as was

seen at the time of the global financial crisis and again when there was turbulence in global financial markets in mid-2011.

The main impact of portfolio capital flows on the economies of frontier markets is through the exchange rate. Portfolio capital flows can exacerbate the volatility of the nominal exchange rate, which in many frontier markets is already quite volatile because of an undiversified export base. In thin foreign exchange markets, gross portfolio capital flows can dominate the market on a daily basis, and thus have a significant impact on the nominal exchange rate, even if net portfolio flows are relatively small over the course of a year.

Exchange rate volatility has consequences for competitiveness and inflation. Heightened exchange rate volatility exacerbates risks for traded goods producers, which have limited opportunities to hedge exchange rate risk. Furthermore, volatility makes long term real exchange rates more uncertain and thereby discourages private investment in traded goods industries. In most frontier markets, the pass through of exchange rate changes to domestic inflation is quite high, hence exchange rate volatility is transmitted to inflation volatility. The sharp depreciation of exchange rates in East African frontier economies<sup>1</sup> in the third quarter of 2011 contributed to the rapid rise in inflation in the region. For these reasons, policy makers cannot be indifferent to the impact of portfolio capital flows on the exchange rate. Even in countries which implement a floating exchange rate regime, policymakers are concerned both to avoid real appreciation which would damage external competitiveness and to avoid vulnerability to sudden capital outflows which might cause a sharp depreciation and thus raise domestic inflation.

In frontier markets such as Uganda, the macroeconomic response to exchange rate volatility has primarily involved sterilized intervention by the central bank in the foreign exchange market and the accumulation of foreign exchange reserves to self-insure against sudden capital outflows, when this has been possible. Although unsterilized intervention would be more effective than sterilized intervention in managing the exchange rate in the face of volatile capital flows, this would undermine the domestic policy goals of monetary policy (e.g. inflation and output stabilization). However, provided that capital mobility is not perfect, which is the case in frontier markets, sterilized intervention can still be effective in helping to manage the exchange rate.

In the case of foreign exchange purchases, the main drawbacks of sterilized intervention are twofold. First, it is very costly for central banks, which incur losses because of the differential between the interest rate paid on domestic securities to sterilize foreign exchange purchases and that earned on the foreign exchange purchased. At a time when central bank finances are under great strain because the low interest rates in advanced economies have reduced sharply their primary source of revenue, the interest earned on their foreign currency reserves, the additional costs of sterilizing foreign

<sup>1</sup> Kenya, Tanzania and Uganda.

exchange interventions can be a major financial burden for central banks. Secondly, central banks may lack adequate instruments to sterilize large foreign exchange purchases. Central banks mainly mop up domestic liquidity using very short term instruments in open market operations, such as 7-day repurchase operations. However, sterilized purchases of foreign exchange create structural liquidity (i.e. liquidity which remains in the market for the long term) unless these interventions are quickly reversed. In money markets characterized by large volumes of structural liquidity, short term instruments such as 7-day repos lose their effectiveness in influencing money market interest rates (the operating target of monetary policy in inflation targeting monetary policy frameworks). Consequently central banks need longer maturity instruments to mop up structural liquidity if monetary policy is not to be undermined. The Bank of Uganda has begun selling government treasury bills and bonds, which were issued to it for purposes of recapitalization, to sterilize structural liquidity.

Some frontier markets in Africa have implemented limited capital flow management measures to curb the volatility of portfolio flows and their impact on the exchange rate. For example, Ghana, Nigeria and Zimbabwe have imposed restrictions on non-resident holdings of government securities. Kenya imposed some restrictions on banks' foreign currency transactions during 2011 when capital outflows were depreciating the exchange rate. Uganda has not introduced capital flow management measures so far mainly because policymakers are not yet convinced that they would be very effective and because of a concern that this might send adverse signals to non-portfolio investors (e.g. foreign direct investors) about the openness of the economy.

Reforms to financial regulation in the advanced economies (e.g. tougher capital requirements) will probably have only minor impacts on frontier markets, for several reasons. The regulatory reforms themselves have been watered down as a result of pressure from the banking industry and are being phased in over several years. Many of the largest banks in frontier markets are subsidiaries of international banks, which will be subject to stricter regulatory requirements under Basel III both in their home markets and on a consolidated global basis. Nevertheless, this will probably have little impact on their subsidiaries in frontier markets (most of which are already subject to higher capital requirements imposed by the host regulator). These subsidiaries mainly fund their operations with domestically mobilized resources and rely very little on externally mobilised capital from their parent banks or other sources.

What lessons can we draw for frontier markets? Provided that these economies continue to generate rapid growth they are likely to attract larger volumes of portfolio capital (unless they chose to impose controls on capital flows) as their financial markets deepen and thus opportunities for investment in financial assets widen. As such they will become more vulnerable to capital account shocks and hence it will be prudent to hold larger buffers of foreign exchange reserves to protect the balance of payments against sudden capital outflows. Traditionally, targets for foreign exchange reserve holdings in African countries have been determined in terms of months of import cover only, but for the frontier markets it will be prudent to also take into account stocks of short term external capital. Holding larger foreign reserves has a cost, in terms of the resources available for domestic investment and the interest burden on central banks, but this cost must be balanced against the need to safeguard macroeconomic stability. Whether capital flow management measures can be an effective tool for frontier markets is a question which can only be answered when more empirical evidence becomes available. The difficulties and costs of sterilized intervention mean that central banks will have to find the right balance between external and domestic policy objectives. An exclusive focus on domestic policy objectives will neither guarantee macroeconomic stability nor be conducive to longer term development objectives for which external competitiveness is crucial.

# What Monetary Policy for WAEMU in the Context of New International Financial Regulation?

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Government of Togo <sup>1</sup>

The institutional reform of the West African Economic and Monetary Union (WAEMU) and the West African Central Bank (BCEAO) was adopted on 20 January 2007 and came into force on 1st April 2010. The measures take aim at “correcting problems in the implementation of certain texts” and at adapting policy to “international best practice.”

The reforms seek to better distribute tasks and duties between various agencies. To this effect, the conference of heads of state defines the broad policy orientations within the entire WAEMU area. Responsibility for monetary policy, which used to be a mandate of the council of ministers, is now transferred to an internal agency of BCEAO, the committee for monetary policy (CPM from its French acronym). Similarly, the job of the BCEAO has been clearly outlined. Article 8 of the Bank’s new statutes states “that the main goal of the monetary policy of the Central Bank is to ensure price stability. Without prejudice of this goal, the Central Bank brings its support to the economic policies of the West African Economic and Monetary Union (WAEMU) in view of healthy and lasting growth.” Moreover, the operational independence of the Central Bank has been strengthened, so much so that the BCEAO is free to set the inflation rate goal, and to formulate and choose instruments for its monetary policy (Article 4). Lastly, the reform takes into account the factor that is generally deemed the most important in terms of political interference in the economy, the funding of public deficit by the Central Bank: “The Central Bank cannot grant monetary funding to public treasuries, local collectivities or any of the public agencies of the member states of WAMU”(Article 36).

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The treaty that founded WAEMU in 1994 was an important push forward at the time of adoption, and WAEMU is today one of the most advanced and comprehensive regional integration experiences in Africa. However, the world has changed very much in recent years. New international financial regulations create the need to adapt monetary policy and financial regulation in WAEMU, and there is need to further improve the efficacy of the institutions that drove this progress.

- Efficiency requires that areas of competence be rapidly clarified and the institutional organization of WAEMU well defined, particularly in relation to the special agencies (BCEAO and BOAD) and of the *Conseil Régional de l’Epargne Publique et des Marchés Financiers* (Regional Council for Public Savings and Financial Markets);
- In this context, it is urgent to reconsider the two treaties – of WAMU and WAEMU – and merge them, in accordance with the original objectives, so as to ensure a better synergy of the institutions of the Union. This is all the more pressing because the new treaty of WAMU has now given to BCEAO independence relative to the states – with the remarkable inconsistency that, within the institution that will pilot the zone’s monetary policy, the CPM, the president of the WAEMU Commission has a mere consultative say, while France has deliberative powers.

# Monetary and Regulatory Spillovers from Vietnam's Perspective

## Que-Giang Tran-Thi and Tu-Anh Vu-Thanh

Oxford

### MONETARY SPILLOVERS

Despite the fact that Vietnam has already been fairly well integrated into the world economy, the country was not affected in any significant ways by the recent QE, OMT and QQME adopted by developed countries. Major economic phenomena in recent years – such as asset price bubbles during the 2006–2007 period, international capital inflow surge in 2006, high inflation in 2008, exchange rate overvaluation and interest rate hikes during the 2008–2009 period, and economic slowdown during the 2012–2013 period – were all mainly caused by the speculative nature of Vietnam's economy, its structural weaknesses, and macroeconomic mis-management, not by spillover effects from the post-crisis monetary policy of the EU, USA, or Japan.

### REGULATORY SPILLOVERS

Since 2009, the number of banking regulatory documents has increased significantly in Vietnam. As far as spillovers are concerned, the most noteworthy document is Circular No. 13 issued in 2010 by the State Bank of Vietnam (SBV) on prudential credit ratios. This Circular is an example of a positive spillover of good governance from developed countries to Vietnam. The rationale for the issuance of this circular is two-fold: First, Vietnam wishes to send a positive and credible signal to facilitate its deepening integration into the world economy. Second, faced with internal problems, especially weak governance and serious bad debts, Vietnam also needs to introduce better standards to improve the health of its banking system and strengthen the management and supervision of its regulatory apparatus. It is also worth noting that the pressure to comply with international financial standards in Vietnam has not come from its economic partners. Also, the presence of foreign banks in Vietnam is very limited (i.e., their market share is very small). Besides, under the principle of respecting Vietnam's ownership, global financial institutions like the World Bank and IMF did not exert any significant pressure on Vietnam to comply with post-crisis international financial standards.

While the basic principles of effective banking supervision presented by Basel Committee are widely accepted by both the SBV and commercial banks in Vietnam, the implementation of Basel I and Basel II in Vietnam has faced the following

dilemma: While the SBV wants to introduce advanced international standards in order to send a positive signal to international financial investors, they are in reality standards that the regulatory bodies are not ready to apply<sup>1</sup> and commercial banks are not willing to comply with<sup>2</sup>.

Even when modern international standards have been accepted, the application of these standards in developing countries does indeed face many difficulties. In particular, it is quite common to observe that the same terminology can be understood and interpreted quite differently in developed and developing economies. Reasons for this situation are many, ranging from differences in accounting standards to limited capacity of human resources in developing countries. Credit institutions which are subject to these regulations therefore can inadvertently or deliberately misinterpret the rules against the regulator's intention. As a result, official data compiled by the regulator or collected by foreign investors can be very far from reality and may not reflect the original concept. Here are some illustrative examples from Vietnam:

**Shortcomings of accounting standards:** Vietnam has a hybrid accounting system which has been shaped by Anglo-Saxon accounting standards, French and Soviet accounting systems, and accounting practices of the central planning period. In addition, in an environment with a serious lack of accounting transparency together with widespread tax evasion, it is quite common to observe Vietnamese firms, especially the SMEs, that have three separate accounting books (one for tax authorities, one for social security agencies, and one for internal use). Pham Hoai Huong (2010) surveys the application of ten key accounting standards in Vietnam and shows that the harmonization rate between the de jure Vietnamese Accounting Standards (VAS) and International Accounting Standards (IAS/IFRS) is only 57%.<sup>3</sup> The de facto harmonization rate can be much lower. The difference between VAS and IAS/IFRS in part comes from the fact that VAS was built primarily based on the IAS/IFRS standards issued in 2003 but has not been updated since. While the spirit of IAS is to measure fair value, and therefore encourage the use of judgment and estimates, VAS insists on using historical value and quantitative parameters. Besides, it should be noted that since Vietnamese asset markets are very non-transparent, it is very difficult to use fair value as the measurement basis of asset value.

**Shortcomings of concept definition and measurement:** If the regulator interprets Basel standards inaccurately, then

<sup>1</sup> For example, the standards related to the expansion of the market for foreign investors, easing ownership limits of foreign investors in the joint-stock banks, information transparency throughout the system, open to international audit and credit ratings.

<sup>2</sup> For example, the standards whose application require higher level of equity, tightening credit limits on a number of high-risk sectors such as real estate or security investment.

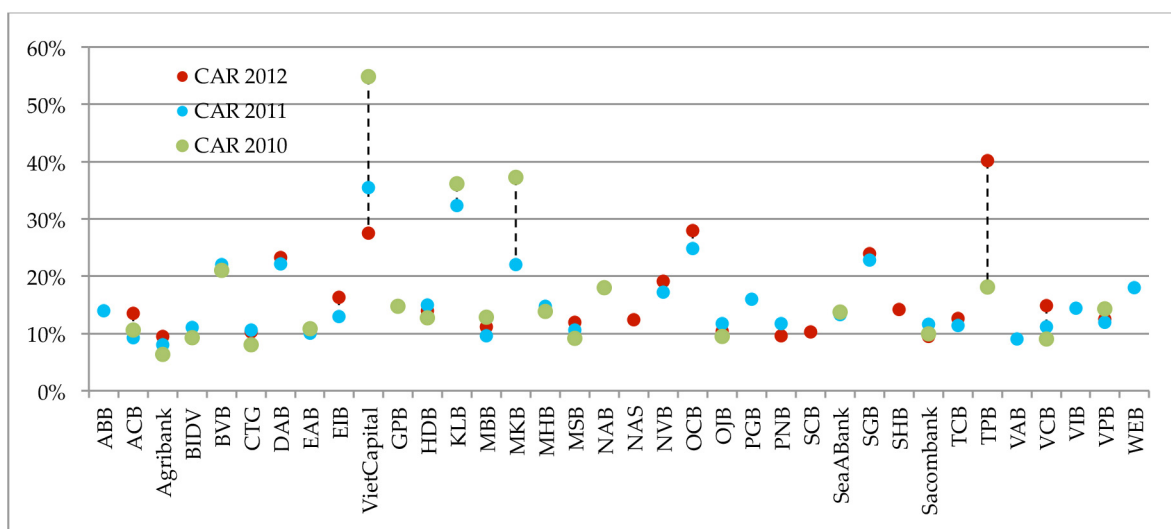
<sup>3</sup> Pham Hoai Huong (2010). "A comparative study of Vietnamese and international accounting standards," available at [http://espace.library.curtin.edu.au/R/?func=dbin-jump-full&object\\_id=192069&local\\_base=-GEN01-ERA02](http://espace.library.curtin.edu.au/R/?func=dbin-jump-full&object_id=192069&local_base=-GEN01-ERA02)

measurement criteria, regulations and prudential standards to ensure safe operation of credit institutions are not built properly. Consequently, banks are unable to comply, or even worse, in order to ensure compliance, banks have to play tricks and use accounting techniques. Below are some specific examples of gaps in regulation of minimum capital adequacy ratio (CAR), credit limits, and NPL classification and measurement.

*Regulations on minimum capital adequacy ratio:* This example shows the weakness of the Vietnamese regulatory body in interpreting and applying international standards. Circular 13 (2010) requires banks to maintain a minimum CAR of 9%. At first glance, this requirement even exceeds the minimum requirement of 8% stipulated by Basel II. Some officials in the Vietnamese regulatory authorities went even further to suggest that their regulation is indeed stricter than that of Basel III, which requires a minimum CAR of 8.5%.

However, Circular 13 does not specify the CAR for each level (or tier) of assets, while according to the Basel Committee, tier 1 capital ratio must be at least 4% under Basel II and 6% under Basel III. Moreover, if the countercyclical capital buffer reserve is included, then tier 1 capital ratio must be at least 11% according to Basel III. In addition, the value measurement in the Vietnamese accounting systems is different from international standards. The spirit of Circular 13 is mainly in line with Basel I, which takes into account only credit risk while ignoring market and operational risks. Ironically, but quite commonly observed, weak banks in Vietnam often have a very high CAR (see Table 1).

TABLE 1. CAR OF THE VIETNAMESE BANKS DURING THE 2010 – 2012 PERIOD



Source: Compiled from commercial banks' reports

The application of Circular 13 has resulted in many negative consequences. To meet the CAR requirements, banks must either increase capital (i.e., increase the nominator) or reduce credit risk (i.e., decrease the denominator). In the context of scarce capital, most capital increase is “virtual” (i.e., unreal) in nature, raised mainly through pyramidal or cross ownership arrangements. In addition, the pressure to withdraw capital to reduce credit risk in a short period of time (the deadline was only 5 to 6 months) forces banks to game the system by all kinds of accounting tricks. In short, the application of safety measures has not only imposed very high costs on both regulators and banks, but ironically also resulted in an even riskier banking system.

*Regulations on credit limits:* Circular 13 stipulates the total loan amount, the balance of the credit guarantee for a client or a group of related clients. However, in many circumstances, the identification of the so-called “related clients” is unclear. In addition, both the definition and accounting of banks’ financing are not well-defined. Consequently, these rules can be easily evaded by banks, for example by disguising conventional credits as investment trusts or corporate bonds. Connected lending, banks’ lending to their own subsidiaries, and lending to “backyard” companies by means of a complex nexus of pyramidal and cross ownership are a serious problem in Vietnam.

*Rules for determining bad debts or non-performing loans (NPLs):* Bad debt is a serious problem in Vietnam’s banking system today. The NPL ratio has increased rapidly in recent years, reaching a threatening level during the 2011–2012 period. However, it seemed that no one (SBV and National Financial Supervisory Council included) was able to provide a reliable estimate of the NPL size. In terms of NPL classification, Decision 493/2005 divides NPLs into five groups that on the surface look quite similar to international practices. However, the definition of NPLs and the classification of NPL groups in Vietnam are not consistent with international rules. As a result, the measurement of, let alone the solution to, NPL in Vietnam becomes a particularly difficult problem.

TABLE 2. THE EVOLUTION OF REGULATIONS ON DEBT CLASSIFICATION

Legal regulation	Validity	Taxonomy		Risk provision		NPLs
				Specific	General	
Law on Credit Institutions 1997	Remains in amended Law on CIs 2004 and Law on CIs 2010	General regulation on assets classification and requirement of risk provision		None	None	No specific requirement
Decision 48/1999/QĐ-NHNN	Replaced by Decision 488	Assets classification into 4 groups		0%, 20%, 50%, and 100%	None	No definition
Decision 488/2000/QĐ-NHNN	Replaced by Decision 493	Assets classification into 4 categories		0%, 20%, 50%, and 100%	None	No definition
Decision 493/2005/QĐ-NHNN	Replaced by Circular 02 but still valid until June 1, 2014	Debt classification into 5 categories		0%, 20%, 50%, and 100%	0.75% debt value for categories 1-4	Debt of categories 3-5
Circular 02/2013/TT-NHNN	Delayed validity to June 1, 2014	Debts are classified into 5 categories	Strict, detailed regulation on debt classification	0%, 20%, 50%, and 100%	0.75% of debt value for categories 1-4	Debt of categories 3-5

At present, all credit institutions (CIs) operating in Vietnam are required to classify their debts into five groups which are summarized in Table 3. The credit balance of CIs can be classified based on the debt terms (quantitative classification) or on assessment by CIs themselves of the borrowers' solvency (qualitative classification). Most banks use quantitative methods to assess bad debts based on the official date of unpaid debts. Using this practice, CIs can easily roll-over or hide their bad debts.

TABLE 3. A SUMMARY OF CURRENT REGULATIONS ON DEBT CLASSIFICATION

Category	Description	Decision 493 and Decision 18 Amendment		Risk provision	
		Article 6 (Quantitative method)	Article 7 (Qualitative method)	Specific	General
Cat. 1	Pass	Debts that are not due or less than 10 days overdue, assessed to be collectible with both principal and interest (including overdue principal and interest).	Debts assessed to be collectible with both principal and interest in full and in a timely manner.	0%	0.75%
Cat. 2	Special-attention	<ul style="list-style-type: none"> <li>Debts of 10 days to 90 days overdue;</li> <li>Debts that are rescheduled for the 1<sup>st</sup> time.</li> </ul>	Debts assessed to be collectible with both principal and interest, but borrowers reveal signs of weakening solvency.	5%	0.75%
Cat. 3	Sub-standard	<ul style="list-style-type: none"> <li>Debts of 91 days to 180 days overdue;</li> <li>Debts restructured for the first time (except those rescheduled for the 1<sup>st</sup> time in cat. 2);</li> <li>Debts with interest reduced or canceled because borrowers are not able to pay interest in full.</li> </ul>	Debts assessed to be uncollectible of both principal and interest in a timely manner and some loss of principal and interest is possible.	20%	0.75%
Cat. 4	Doubtful	<ul style="list-style-type: none"> <li>Debts of 181 days to 360 days overdue;</li> <li>The 1<sup>st</sup> time restructured debts that are less than 90 days overdue based on the 1<sup>st</sup> time rescheduling;</li> <li>Debts that are restructured for the 2<sup>nd</sup> time</li> </ul>	Debts assessed to be very likely to incur loss.	50%	0.75%
Cat. 5	Loss	<ul style="list-style-type: none"> <li>Debts of more than 360 days overdue;</li> <li>The 1<sup>st</sup> time restructured debts that are more than 90 days overdue based on the first-time rescheduling;</li> <li>The 2<sup>nd</sup> time restructured debts that are overdue based on the 2<sup>nd</sup> time rescheduling</li> <li>Debts restructured for the 3<sup>rd</sup> time onward, including those are not due or overdue;</li> <li>Deferred debts; debts to be resolved.</li> </ul>	Debts assessed to be uncollectible.	100%	0%

While the quantitative classification is simple and easily applicable, especially for small banks, it fails to assess the actual debt quality. Meanwhile, the qualitative classification based on credit ratings is consistent to international practices and credit management standards for a modern bank, but its application requires that banks develop an internal credit rating system that meets the SBV's requirements.<sup>4</sup> Qualitative methods can properly assess the quality of debt and reveal the bad debt situation. However, they require provisions that lead to reduction in CIs' profits.

The SBV see loopholes in regulations on NPL classification and deficiencies in current accounting practices that make it easier to avoid reporting NPLs, and hence, make it hard to resolve them. Accordingly, the SBV enacted Circular 02/2013/TT-NHNN dated 21/01/2013 on asset classification and risk provision to deal with risks in CI activities. In short, if Circular 02 is strictly adopted, the NPL classification and accounting standards in the Vietnamese banking system is basically identical to the international norms. However, the adoption of Circular 02 has been delayed twice because banks themselves are not yet ready, and the SBV is afraid that stricter regulations will truly reveal the weaknesses of the system, therefore creating risks that authorities cannot control.

## CONCLUSION

Standards to ensure safe operation of the financial system set by developed countries can potentially be useful for developing countries. However, when applying these standards, developing countries face many obstacles. First, the institutional infrastructure and governance arrangement are not compatible with those of developed countries making it difficult for developing countries to properly apply international standards.

Second, the half-hearted application, particularly under political calculation or pressure from interest groups, along with inherent weaknesses of the regulatory system may well lead to mistakes in the interpretation and construction of financial regulations, which in turn may lead to negative consequences (e.g., forcing banks to game the system and distorting the regulatory system).

Besides, the eagerness to apply international standards in order to send positive signals to foreign investors can also increase costs and cause negative consequences for the entire financial system. In the process of creating international standards, developed countries should pay attention to the road map and provide sufficient guidance for developing countries so as the spillovers are truly useful and effective.

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<sup>4</sup> For example, the NPL ratio for BIDV was 3.2% and 9.6% by quantitative and qualitative methods, respectively, in 2007



# Emerging Markets Self-Insurance: The Gains and Pains

## Xu Qiyuan

Chinese Academy of Social Sciences <sup>1</sup>

Generally speaking, although there are still some significant shocks, the emerging markets nowadays have much stronger immunity from spillovers from major economies.

### 1. EMERGING MARKETS HAVE MANAGED TO INSURE THEMSELVES THROUGH THE ACCUMULATION OF FOREIGN EXCHANGE RESERVES.

Before the new century, capital flew to emerging markets from other economies. However, there is a turning point around 2000. After that point, international capital continuously flew out of emerging markets in the form of increasing reserve holdings (see figure 1).

According to Pradhan and Taylor (2011)<sup>2</sup>, in 2000 the reserves held by emerging markets as a group totaled around 700 billion USD. By 2010, this figure was approaching 6 trillion USD!

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<sup>2</sup> Pradhan, Manoj, and Alan M. Taylor. "The Great Rebalancing" Emerging Issues, Morgan Stanley, 2011.

It is easy to understand that some of the economies, such as the ASEAN countries and China, have drawn lessons from the 1998 financial crisis and improved their immunity to the spillovers through the accumulation of reserves.

### 2. THE NEGATIVE EFFECTS OF THE SELF-INSURANCE SOLUTION

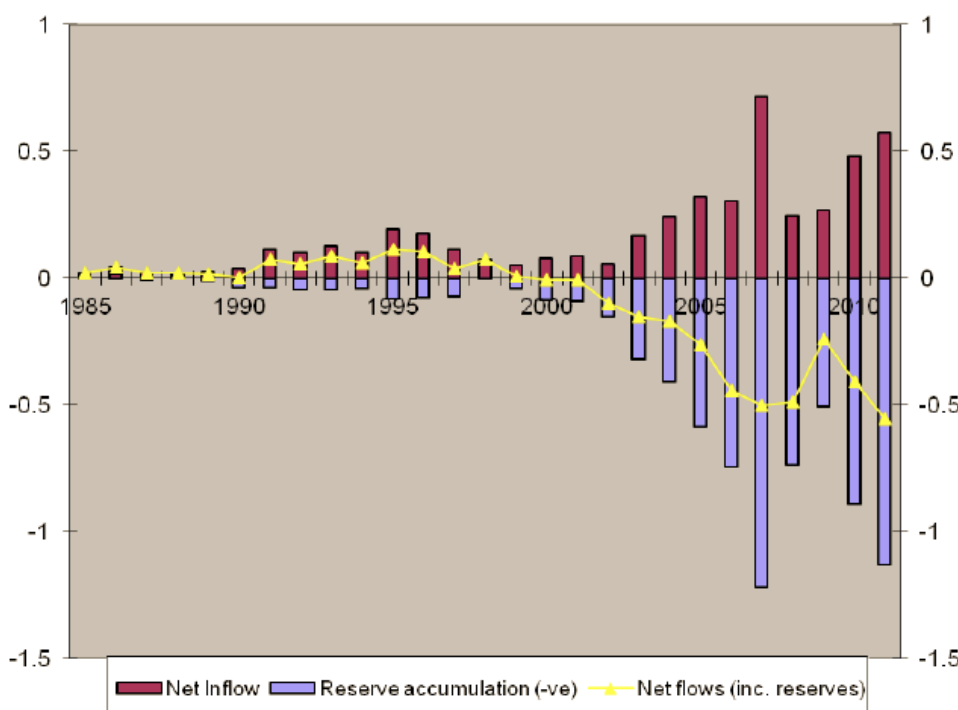
Firstly, not all emerging markets hold large reserves. For India, Indonesia, Brazil, South Africa and Turkey, which are called the "fragile five", their reserves are embarrassingly low.

Secondly, there are some negative externalities. When emerging markets successfully accumulated a large amount of reserves, they also contributed to the serious problem of global imbalances.

Moreover, economic growth rates are generally higher in emerging markets. This means the return on investment tends to be higher as well. But emerging economies are sending their capital to the US and other advanced economies. It is typically a kind of mismatch of the resources. Some the observers or officials think this cost is to some extent an insurance premium.

### 3. ALTERNATIVES TO THE SELF-INSURANCE SOLUTION

The creation of a supranational reserve currency could be one of the options. Yet there is a long way to go if this is to be realized. More practically, there could be some progress in the level of regional cooperation. For example, within the framework of ASEAN+3 (China, Korea and Japan), The Chiang Mai Initiative multilateralization and Asia Bonds Market are the backbones for strong regional cooperation. At the same time, the internationalization of China's yuan also provides a potential choice for a new reserve currency.



**FIGURE 1:**  
**EMERGING COUNTRY NET FLOWS AS % GDP**

Source: Stephen Grenville (2012), Rethinking Capital Flows for Emerging East Asia, Asia Development Bank Institute, Working paper Series No. 362, June.

# Strengthening the Global Financial Regulatory Architecture after the Crisis

## David Wright

IOSCO

The costs of this financial crisis have been very high. An estimated 15% loss of global GDP so far against trend; rapid increases in government debt and unemployment levels in the Western World; a fully fledged sovereign debt crisis in the Eurozone; the sum leading to massive distrust of global finance, made worse by the swathe of recent scandals such as evident collusion and manipulation of the IBOR benchmarks by some major financial firms and probably the forex and significant parts of commodity markets as well. This crisis was born and begun in the West, triggered by greed, weak regulation, weak supervision with shocking volumes of junk subprime securities peddled and distributed to most Western markets (but notably much less to emerging markets.) There is another view that the real trigger was global macroeconomic disequilibria, supported for example by Jacques De LaRosiere.

The global response, from 2009 onwards, has been focused on setting up and allocating important political and regulatory roles to the G20 and the FSB. The G20 is the political arm; the FSB primarily has a coordinating role to drive forward global financial regulatory repair working with the sectoral standard setters, principally the BCBS, IOSCO, IAIS and the IASB. The central banks however are in control chairing all the major FSB committees itself somewhat surprising as the world moves to more market based financing models.

However if it was all as straightforward as that maybe we would have made more progress after 6 1/2 years of this crisis. Regrettably leaders have spread regulatory mandates like confetti to another 14 organisations, some of them being the tin pot variety. There are too many work streams and a lack of prioritisation. On OTC derivatives alone there are 17 working groups between the FSB and IOSCO. There are now 22 trade repositories in the world to collect OTC derivative data which they are not sharing the result being financial regulators do not have a comprehensive set of data on counterparty exposures. An FSB OTC derivative aggregation task force has been set up to work out how to aggregate these data sets!

These negative examples should be balanced by the more positive. Capital levels according to Paul Tucker have been multiplied by 10 plus add ons agreed for G-SIFIs; liquidity premia has been imposed although the net stable funding ratio has yet to be finalized and the risk weights for assets made more convergent. Intellectual progress has been made on TBTF and resolution frameworks with widespread international agreement on using "bail in" instruments to avoid using taxpayer bail outs. In fact this is the key global policy for the whole global regulatory reform package - but unfortunately we are far away from a resolution system that can function on a cross-border basis. Trust is lacking among resolution authorities; ring fencing will be the natural reaction in crises, post-Lehmann, including in the US which is forcing subsidiarization of all major banking branches. And, critically nothing at the global level is legally enforceable and there is no disputes settlement.

The two other two jumbo files - shadow banking and OTC derivatives also require much further work. For OTC the main issue is trying to bolt together, ex-post, two legal systems, those of the EU and the US, which have not just very different legal cultures and methods but also are at different levels of development. Meanwhile the rest of the world is a bystander having little or no influence on the outcomes. The financial industry claims OTC markets are being distorted and some trade is switching location.

Shadow banking regulation is being addressed in silos without a convincing overall conceptual or integrated economic approach. Work streams cover securitization, MMFs, securities lending, repos, non-bank, non-insurance SIFIs. None of this is surprising since knowledge and data about these markets are thin. Neither regulators, nor market professionals fully understand the interconnectivities, the contagion channels - again, not surprising, since data is incomplete and academic research limited. Gillian TETT of the Financial Times recently commented that more polar research is being carried out than on understanding better how the global financial system functions.

The capital framework, cross-border resolution, shadow banking and OTC derivatives are the big-4 objectives for the G20 Brisbane summit in November according to the FSB Chair Mark Carney. There is a fifth priority in my view which is underplayed in importance namely requiring profound improvements to corporate governance in financial firms, changing their behaviour with strong incentives including far tougher sanctions regimes and mandatory jail sentences for serious offences.

I have not mentioned so far the regulatory effects of spillovers to Emerging market economies (EMCs). This is discussed in G20 and FSB circles but is way down the pecking order of priorities. EMCs do put forward consistent views on the global regulatory agenda. Their markets are mostly small, even though growing fast and EMCs do not act forcefully in the global regulatory meetings. The EU and the US

are the “regulatory shapers” who dominate global regulatory proceedings with the rest being “regulatory takers”. The Asia Pacific region is not organized as a bloc and has not yet defined its common interests, although there are some preliminary signals it is beginning to think how to do so. Likewise with Africa, the Middle East, Russia and Latin America. Bilateral EU-US financial regulatory domination mirrors the emerging bilateralism in trade agreements- a very unfortunate development weakening multilateralism and the WTO.

This checkered global regulatory reform picture also suffers another major flaw. The global regulatory institutions are weak. They have no rule making authority because they are not based on a Treaty. No one can resolve major cross border disputes (unlike the WTO) because there are no mechanisms to do so. If jurisdiction X or Y refuses to apply a standard correctly there is nothing that can be done in spite of such behaviour being a manifest breach of its FSB Charter commitments. The implementation tool box at global level contains only soft tools - transparency, monitoring, peer pressure, coloured diagrams and prayer. This is clearly insufficient. The risk is we end up with “pickandchoose.com”

If we fast forward 10-20 years, assuming no major calamity, there will be many more big capital markets. So today’s small global regulatory matrix of a few big markets with different interpretations and applications will be replaced by a 10 by 10 matrix (or larger). In such a scenario there is a real danger that significant systemic regulatory fragmentation will emerge. In this future world EU equivalency requirements and US constrained discretion could be matched, or countered by China, Russia, Brazil, Indonesia, India etc doing exactly the same. There will be a race to legislate first and capture first mover advantage bundled together with equivalency requirements for third countries.

There are 3 global regulatory institutional options for the future. The first is the status quo which in my view is a recipe for growing fragmentation. The second is an International Treaty that yields some mandatory rule making power to a global body, notably for global systemic issues and SIFIs. This should include a binding disputes settlement procedure and an effective sanctions regime (which is difficult to conceive). This however is very unlikely given the position of the United States and its evident political and historical discomfort with multilateral institutions. The third is what I call “ Enhanced Pragmatism” - a series of practical steps to build greater global cooperation and regulatory convergence. The main elements of this could be:

1. Greater granularity of standards to reduce regulatory degrees of freedom on implementation;
2. Symmetric political and legislative time tabling and enhanced early cooperation to diminish first mover advantage;
3. Stronger supervisory cooperation and intensity at all levels, especially cross-border;
4. Non-binding disputes settlement along the lines of the WTO panel approach.

These steps, however, should be on a path to build global financial regulatory institutions in the future based on an International Treaty with binding powers.

Christine Lagarde, the Managing Director of the IMF discussed in her recent Dibleby lecture in London the need for new forms of multilateralism - collective, social, more representative and inclusive. She said a “new multilateralism” is non- negotiable. But she asked “are we up to the challenge?”. I fear not.

# The Global Financial Regulatory Architecture

## Cyrus Ardalan

Barclays

### BACKGROUND

In 2008, global financial markets experienced, arguably, the worst crisis in history bringing global markets close to a complete melt down. The response of politicians and policy makers was, by historic standards, swift and comprehensive, setting out a framework for a new order in financial regulation.

The financial crisis was a result of a complex interplay of a number of independent and interconnected factors. Leverage was excessive, the financial structure -- capitalisation and liquidity -- of banks was weak in relation to the riskiness of their balance sheets and difficult to unwind in a crisis, financial markets had become too complex, interconnected and lacked sufficient transparency and there was no effective resolution mechanism for financial institutions in difficulty.

The origins of the financial crisis were in the developed countries notably the US and Europe. The emerging markets -- in particular those in Asia, having experienced their own crisis a decade earlier -- had relatively well regulated banking sectors that emerged from the crisis relatively unscathed. The global regulatory agenda has therefore been driven by the specific circumstances of the developed world, albeit the impact is global.

### THE NEED FOR A MORE CO-ORDINATED FINANCIAL ARCHITECTURE

The appropriate scenario for the future architecture of international financial regulation must draw on the lessons learned from the crisis and its origins. The crisis revealed significant weaknesses in the way financial markets had evolved over the past three decades and the ability of the regulatory architecture to keep pace with these changes. Whilst markets were positive and economies growing, the prevailing regulatory philosophy was one of light touch regulation and a belief in the efficacy and self correcting nature of markets. Whilst regulators often spoke with each other, there was limited co-ordination as a fragmented framework for overseeing financial regulation was most consistent with the prevailing philosophy.

The crisis exposed flaws in this view and pointed to the need for a much more comprehensive and coordinated approach. The G20 agenda reflected a consensus across a broad range of countries that a new financial regulatory framework was required and that this had to be implemented on a global basis to succeed.

The need for such a coordinated approach has been driven by a number of important factors:

- 1 Global capital flows are large and have a significant impact on the real economy and are an important contributor to global economic growth. Emerging markets have a strong vested interest in promoting a regulatory framework that supports capital flows through an efficient and stable intermediation process. Following the crisis we have seen a dramatic decline in these flows as the volume of global capital flows has fallen 70% from the \$11.8 trillion in 2007. There is therefore a global and collective interest in having well functioning capital markets and global capital flows.
- 2 Financial markets are highly interconnected with domestic developments having potentially significant extra-territorial and contagion effects. Financial crises in Asia or even small, relatively self contained markets such as Iceland and Dubai have had far reaching consequences - let alone a crisis emanating from the global financial centres of the US and Europe.
- 3 A number of financial (bank and non-bank) intermediaries are of such size and complexity that they pose a global systemic risk and a failure of any one of these can have dramatic consequences for the global economy. This has now been clearly recognised in the work being done on systemically important banks with 29 identified as GISIF's, as well as insurance companies and non banking and insurance intermediaries.
- 4 Capital markets are becoming an increasingly important channel for financial intermediation. The growth of the securities markets, marking to market of financial assets and availability of information in real time has significantly amplified market reaction the risks of contagion, market volatility and the importance of market physiology. The notional amount of derivatives contracts outstanding has grown to over \$693 trillion by the end of June 2013 according to the Bank for International Settlements. Much of this and activity in the fixed income markets has been conducted over the counter. The combination of market pricing and lack of transparency on the structure of markets and volumes of transactions have significantly increased the likelihood of rapid changes in market volatility herd behaviour.

## THE ELEMENTS OF A FRAMEWORK

The crisis highlighted a number of key weaknesses in the architecture of the financial system notably:

- Inadequate resilience of financial institutions -- capital, liquidity, leverage
- No credible resolution mechanisms -- bail in, recovery and resolution plans
- Lack of transparency in financial markets -- especially in OTC markets for derivatives
- Unregulated shadow banking sector -- securitisation, money market funds, repos
- Weak governance and poor conduct -- accountability, values
- Insufficient attention to appropriate supervisory framework: prudential vs. conduct vs. macro-prudential considerations

The weaknesses of the prevailing regulatory framework at the time of the crisis were therefore multiple and complex. Each of these factors will require different solutions with an appropriate framework that is flexible enough to recognise national differences yet strong enough to provide certainty and co-ordination. To do so it will need to incorporate a number of key elements.

The first is for the framework to distinguish between those regulations that are best co-ordinated centrally and those that can be handled more effectively locally or at a national level. Co-ordination at a global level should focus on areas of global systemic importance and issues that impact cross border flows, such as prudential standards, particularly for globally important systemically important financial institutions, cross border resolution and the infrastructure for globally traded securities such as derivatives. Matters of a domestic nature relating for example to various aspects of retail banking, conduct, and supervisory framework are best managed at a local level.

Secondly the framework of co-ordination should have the principal of mutual recognition/substituted compliance and achievement of equivalence of outcomes embedded in its DNA. As characteristics of sovereign states differ, economic and institutional structures in countries differ in order to address these differences. Therefore attempts to achieve a common set of rules and regulations may be futile and counterproductive. In the context of the G20 reform agenda, extra-territorial aspects of derivatives regulations and in particular the central clearing and reporting requirements in the US and the EU and their unintended consequences in Asia for European firms are a good example of the challenges we are currently facing. The G20 framework should allow for local discretion but within a centralised framework.

Thirdly the framework must be based on close coordination and mutual trust between regulators. This will be of particular importance in dealing with cross border resolution issues and

avoiding of duplicative and inconsistent regulations. Enhanced dialogue amongst regulators, not only throughout the policy development process, but throughout the implementation process remains key.

Finally the framework will need to have an appropriate governance and oversight structure to ensure legitimacy. Legitimacy is critical if framework is to have broad based acceptance and adherence. This will need to be based on a decision making process that represents the interests of all parties concerned. In light of current developments, inevitably this leads us to question the actual level of legitimacy of the G20 as it currently stands, and prompts us also to ask the question whether a revision of its structure is needed? In addition, should we consider the emergence of new groups (for example APAC, IOSCO) as a response to the need to address regional/national differences?

## THE INSTITUTIONAL FRAMEWORK

The 2008 crisis led to a rapid and decisive response under the auspices of the G20. It provided the political impetus to ensure the basis of the regulatory framework that is being currently implemented globally. However, whilst the G20 was the right forum at the right time for effective crisis management it does not and cannot provide the basis for an enduring framework. In its Head of Government role the G20:

- has worked best in a crisis environment and has lost its effectiveness as the conditions have normalised
- has a broad mandate whilst the necessary changes to the regulatory framework requires specialist and full time expertise
- does not necessarily provide the appropriate governance and representation needed for regulatory change

Many of the elements of the required institutional framework are, unsurprisingly, already in place. Their role needs to be explicitly recognised and they need to be given the authority and resources to fulfil the role that needs to be undertaken given the realities of today's financial markets. The various institutions involved also need to work in a coordinated manner.

However, a question remains regarding the need for the establishment of an institution to set standards and ensure there is consistency in the interpretation and application of regulatory provisions. This would include adoption of best practices in supervision and training, consistency in the definition of financial variables e.g. RWA's, leverage, and development of domestic markets. IOSCO provides elements of this but needs to be better resourced and given greater authority.

Although the BIS and FSB have been certainly fruitful in terms of providing a forum for the discussion of a global recommendations for the introduction of a, for example, new capital regime, both have faced challenges in terms of the actual implementation of such framework.

## CONCLUDING REMARKS

The size complexity and interconnectivity of financial markets require a more coordinated approach to regulation. Many of the elements of the required framework are already in place. However experience shows that there are still challenges for the effective introduction and implementation of a uniform approach to financial reform.

Significant risk of fragmentation remains a threat to the right functioning of financial markets. Given the global nature of finance and the increasing level of globalisation, enhanced coordination is increasingly essential.

Although the developed countries play a dominant role in global financial markets, emerging markets have a critical interest in having an efficient and stable global intermediation process. Moreover the rapid growth of these countries and their financial markets will result in these countries playing an increasingly important role in global markets. The interests of these countries must therefore be adequately represented in any framework.



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