



Presentation by Roberto Frenkel at the joint Brazilian Ministry of Finance and International Monetary Fund (IMF) High Level Conference on “Managing Capital Flows in Emerging Markets”

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Any policy recommendation is influenced by one’s conjectures about the future. Let me thus begin with my own conjectures about the prospects of emerging market economies.

It seems clear that the current wave of capital inflows to emerging markets is influenced by the high returns that assets from these countries offer in comparison with those from advanced countries. The low rates of growth and interest rates in advanced countries are most likely a transitory phenomenon. Their real and financial yields will both probably rise in a near future. In any case, I think that the high growth emerging markets have been experiencing since the early 2000s will last longer. This seems to me a more persistent phenomenon. Although growth rates of emerging markets and advanced countries had shown a high correlation since the 1980s, they started to diverge in the 2000s for the first time in the period of financial globalization (WEO, October 2010). This trend has persisted during and after the global financial crisis of 2007-08.

Besides the yield differentials, current capital inflows are determined by the reduction in the perceived risks in emerging markets. Regarding this factor,



important changes have been observed in the way these economies participate in the international financial markets since the Asian and Russian crises in 1997-98. One key change was the switch from current account deficits to surpluses in the balance of payments of many emerging markets, which also involved a change in the direction of net capital flows between advanced countries and emerging markets. Other relevant changes that reduced the perception of risks are the substantial accumulation of foreign exchange reserves and the implementation of more flexible exchange rate regimes. These changes helped reduce the segmentation of emerging market assets and also the risks of contagion and herd behavior within this class of assets. As a result, the reduction in the perceived risks also spread to those emerging market economies that kept running current account deficits or did not move towards more flexible exchange rate regimes.

The global financial crisis was a stress-test for emerging markets. With the exception of a few European countries, none of them suffered external or financial crises and there was no sovereign debt default. Moreover, the same pattern of international financial integration persisted after the crisis. The increase in the financial resources of the IMF and the flexibilization of its programs also played an important role in the prevention of crises in emerging markets. These new features seem to constitute a perdurable phenomenon. Overall, the results of the stress-test of the crisis and the changes in the IMF reinforced the previous perception about emerging markets. Thus, I see that the low risks associated to emerging markets will continue in the foreseeable future. Let me now focus on Latin American countries. Between 2003 and 2007, the region as a whole ran a current account surplus. In 2008, it turned into a deficit that widened up until 2010, when it reached a local maximum. In fact, Mexico, Colombia and most of Central American and Caribbean countries ran current account deficits all along the 2000s, thus the dynamics described before mostly resulted from the behavior of the rest of South American countries. Without changes in current economic policies, forecasts – including those of the IMF



(WEO, April 2011) – indicate that current account deficits in these economies will widen.

Does this tendency of increasing current account deficits represent a threat of crisis as it did in the past? I don't think so; at least, not in the foreseeable future. My conjecture is based on the changes experienced in the composition of the current accounts during the 2000s. Foreign debts in these countries tended to shrink substantially in this period. Thus, contrarily to the previous 30 years of financial globalization, the share of interest payments in the factor income account is significantly lower and most of the deficit is explained by the dividends of foreign direct investment. Thus, for a given current account deficit, the external fragility of the current composition is substantially lower than in the past. Current account deficits are now financed with foreign direct investment, with a high proportion of retained utilities.

From my conjectures, one may conclude that I am more optimistic than the IMF Regional Economic Outlook of the Western Hemisphere, April 2011 – which warned about the increasing current account deficits and the potential risks of a capital inflows reversal – and that I opposed the implementation of policies that reduce capital inflows and offset or mitigate their effects. That interpretation would be wrong. I believe that the implementation of these policies is crucial and urgent. The main reason why I think these policies should be implemented is because of the effects that capital inflows have on the real exchange rate, which represent a threat on economic activity, employment and more generally on the economic development of these countries. These real effects take time to become visible and are largely irreversible. In a nutshell, I am concerned about the current wave of capital inflows to Latin America because their effects are more likely lead to a Dutch Disease phenomenon rather than to external and financial crises. Furthermore, I think that these policies should be openly promoted, precisely because I believe that governments do not perceive the threat of a crisis as an incentive to implement them.



The future, by its own nature, is uncertain. Conjectures about the future – mine and all of them – necessarily have to deal with this uncertainty. Will the present favorable terms of trade persist? Will current external financial conditions remain? About these things we cannot certainly know. Economic authorities should be especially cautious in the face of uncertainty. In this regard, I think that the design of economic policy should stick to two principles. First, it should include all the elements to assure that the proposed goal is achieved in all the foreseeable scenarios. The second principle is to minimize the potential damage that an economic policy could provoke if the conjectures in which it is based are finally wrong.

Following these principles, a prudential attitude would suggest implementing measures to offset or mitigate the effects of capital inflows. These measures should be adopted not only to avoid the formation of domestic asset bubbles and control inflation but also because not adopting them could lead to external and financial crises, and consequently a huge damage, if terms of trade deteriorate or international financial conditions change. In this regard, I fully agree with the position that the IMF has taken recently about taking a prudential approach about capital inflows.

But a prudential economic policy design should broaden the consideration of potential negative effect of capital inflows and include those associated with the Dutch Disease. These effects should be taken as seriously as those associated to the risks of external and financial crises because they are largely irreversible. It is well documented both theoretically and empirically that a transitory real exchange rate appreciation can have long-lasting effects on the manufacture sector in the form of a permanent destruction of physical, organizational and human capital. Furthermore, a prudent management of the real exchange rate is a sound strategy even in the case in which the favorable terms of trade and international financial conditions were perdurable ex-post because conjectures about the future effects of the Dutch Disease are also uncertain.



Let's accept, for the sake of the discussion, the conclusions of a recent survey written by two researchers of the IMF (Magud and Sosa, 2010, cited by the REO of Western Hemisphere, April 2011) indicating that the studies on the effects of the Dutch Disease (meaning an equilibrium appreciation of the real exchange rate) on economic growth are inconclusive. The same survey points out, on the contrary, the existence of substantial evidence that Dutch Disease leads to a contraction of employment and activity levels in the manufacture sector. Furthermore, the article suggests the existence of robust evidence indicating that real exchange rate overvaluation, however defined, hurts growth. Based on this evidence, should we advise a country with a developing industrial sector to take the risk of passively accepting the effects of the Dutch Disease, dismantle the industrial sector and wait to reallocate the released labor into the service, agriculture and extractive sectors? Should a government of a developing country follow this strategy, even if the authorities are persuaded that the favorable external conditions will be long-lasting? A prudential approach would advise against such a strategy, not only because the empirical evidence is weak but also because we are facing a novel global context that we are still trying to understand.

Regarding the approach to the effects of the Dutch Disease I disagree with the position that the IMF has taken recently. Operationally, the disagreement revolves around the criteria that should guide the type of measures and degree of intervention aimed to offset or mitigate capital inflows and their effects. Which indicators should be used to gauge the interventions in the foreign exchange market, the stance of fiscal policy, the level of the interest rate and the implementation of capital account controls? Recent documents of the IMF mostly focus on indicators regarding the financial system and the tendency of the current account and leave for secondary or no consideration the evolution of the real exchange rate. This orientation prioritizes the reduction of risks of external and financial crises but neglects the risks of Dutch Disease.



In my opinion, the arguments supporting the orientation of the IMF are not strong. First, its documents and papers frequently refer to the “equilibrium” real exchange rate without a precise definition of the term. The definition of equilibrium real exchange rate has always been a controversial issue in economics. In a context of high capital mobility like today significant current account surpluses and deficits may last for very long periods, thus weakening the empirical and policy relevance of the equilibrium real exchange rate notion. Besides, the real exchange rate involves several currencies. Thus, if the real exchange rate of some economies are misaligned (as the IMF documents insistently stress) those of the rest of the world should also be. Recent references to the equilibrium real exchange rate do not go beyond the imprecise notion that current rates should be more appreciated than in the past because the terms of trade, the international financial conditions and other fundamentals have improved for emerging markets.

Beyond the theoretical difficulties to define equilibrium real exchange rates, there are others associated to their calculation and contrast with observed real exchange rates. A recent IMF research paper (Berg and Miao, 2010) estimates equilibrium real exchange rates using a Fundamental Equilibrium Exchange Rate Model with the income per capita and other usual variables (terms of trade, openness, investment, and public spending) as regressors for a panel of 181 countries during the period 1950-2004. The residual of the regressions are estimations of the degree of misalignment (either undervaluation or overvaluation relative to equilibrium). The authors compare these estimations with those obtained using the same sample with an equilibrium real exchange rate model defined as the purchasing power parity adjusted by income per capita as a measure of the Balassa-Samuelson effect (Rodrik, 2008). The correlation coefficient between the two estimations is 0.96. Because the degree of overvaluation and undervaluation is estimated from the residuals of the regressions, the periods and degrees of undervaluation and overvaluation tend to be very similar for different methodologies. To me, there is a clear empirical explanation for this result: regardless of the particular variables included in the



Fundamental Equilibrium Exchange Rate Model, the bulk of the explicative power of the regressions rests on the income per capita variable. Given that income per capita is mostly a time-trend variable the estimated series of equilibrium real exchange rates smoothly moves around the time-trend of observed real exchange rate series. As a result, estimated overvaluations and undervaluations are essentially deviations from the time-trend of the observed real exchange rate series. Based on this, my conjecture is that for whatever econometric model the estimated values for all countries in South America would be very similar to the time-trends of the series and would suggest that the observed levels of the real exchange rates for almost all of them were overvalued in 2010. Would this information be enough to inform the exchange rate policies of these countries? Probably not, because what we are really interested in is identifying the most adequate real exchange rate levels for different economic policy goals.

Past observations of the economy evaluated with different econometric models provide only a rough indication of the degree of overvaluation. We know, for instance, that current real exchange rates in most Latin American countries are similar to the most appreciated levels of the last 30 years. To assess whether these levels are or not adequate to the different policy objectives we need to complement this information with other indicators, as recent documents of the IMF suggest to do with financial indicators and the tendencies of the current account to evaluate the probability of future external and financial crises.

Evaluating whether certain degree of real exchange rate appreciation is tolerable enough to avoid Dutch Disease is more complicated. The negative effects of real exchange rate appreciations on the real economy manifest themselves gradually over time and when they become apparent they may be hard to revert. To begin with, the short-run effects of appreciation on aggregate demand are usually expansive. At the same time, gradual substitution effects reduce the demand for domestic industrial production. At the firm level there are incentives to substitute labor and domestic value added to protect competitiveness. The reduction of industrial employment occurs due to the closure of firms – mostly SMEs – and the reduction of personnel in the surviving ones. All these effects typically take



time to become apparent. Several studies of lasting real exchange rate appreciations in Latin America have shown that the negative effects on employment made evident with a lag of two years.

For these reasons, the authorities of a country that aims to offset or mitigate the effects of Dutch Disease have to anticipate its manifestations. In order to do this, they should have detailed information about the competitiveness of the industrial sector in order to assess the adequacy of the real exchange rate level. This is in my view a crucial and irreplaceable role of the government.

Let me devote my last comment to the instruments to offset or mitigate the effects of capital inflows. The large magnitude of capital inflows vis-à-vis the size of the foreign exchange and domestic financial markets in emerging market economies limits the ability of monetary policy to conduct sterilized foreign exchange interventions. Similarly, the volume of capital inflows is typically too large compared to the fiscal space of governments to influence the direction of the exchange rate using fiscal policy. Regulations of capital inflows, on the other hand, are not entirely effective, especially in economies that opened their capital accounts completely.

Given these limitations, it seems reasonable to implement fiscal, monetary and capital control policies simultaneously and coordinately. In particular, the coordination between economic authorities and central banks (absent in many Latin American economies) seems crucial to make them more effective.

Recent IMF documents are skeptical regarding the effects of buying interventions in the foreign exchange market carried by central banks. They disregard “early interventions” and suggest intervening only when the exchange rate has experienced a substantial appreciation so to dissipate expectations of further appreciation. I believe that the gremlin of the equilibrium real exchange rate got also into these opinions. The underlying rationale seems to be that agents “know” the equilibrium exchange rate and believe that markets will take the



exchange rate in that direction. This is a curious idea. Recent IMF documents warn about the possibility of bubbles in domestic assets and the domestic currency is one of them. Why should we neglect the possibility that exchange rate appreciation is the result of a bubble in the foreign exchange market?

The observed lack of effectiveness of recent official interventions in the foreign exchange market may be the result of the inability to change agents' expectation about the future evolution of the exchange rate. Strong interventions by the central bank making clear the authorities' will to manage the trend of the exchange rate could, on the contrary, influence private sector expectations and thus reduce selling positions and capital inflows. Thus, a key goal of central bank interventions in the foreign exchange market should be to alter market expectations. Interventions should make clear the power of central banks and their desire to orient the medium-run trend of the exchange rate.

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