BANCO CENTRAL DO BRASIL

5th Summit Meeting of Central Banks on IT – Banco Central de Chile
November 15, 2013

Global Liquidity, Capital Flows and Inflation Targeting: Central Banking in the Post-Crisis Global Economy

Keynote Address by Alexandre A.Tombini[1]

[1] Governor, Banco Central do Brasil (BCB)

INTRODUCTION

Five years into the crisis, we could perhaps say that while the global economic outlook is still complex, we are beginning to see a candle light at the end of the tunnel and we are also better equipped to draw a few analytical and policy lessons from what happened. We are in a transition period: the normalization of global financial conditions is already underway, but its pace is still unclear. While growth prospects are generally improving in important advanced economies, the improvement has been uneven. In the US, recent indicators point to moderate growth. There are promising signs from the new policies being implemented in Japan, while the Eurozone presents a mixed picture.

Emerging market economies are facing an interesting albeit not surprising challenge. They have at the same time to: (a) continue country-specific structural reforms and growth model adaptation (e.g., China, Brazil, India, etc.); (b) maintain financial and price stability; after having policy-engineered their V-shape recoveries, controlled their inflationary consequences and managed destabilizing large capital inflows; (c) calibrate their responses to this transition period of exiting from unconventional monetary policies, using their uneven policy room for maneuver and their preparedness; and (d) make the best possible use of the foreseeable changes in relative prices including their own asset prices; these changes are either occurring or in the making, in the light of the expected shifts in global monetary conditions in the coming months.

I will focus my remarks tonight on three issues:

(1) how we prepared ourselves with policies put in place in Brazil and other EMEs over the last few years to sail through a period of intense capital inflows and to be well positioned for the exit from unconventional monetary policies;

(2) notwithstanding that preparation, what has been the impact and the response to the start of the normalization of monetary conditions; and

(3) what are the few analytical and policy lessons learned in the last few years with regards to the inflation-targeting framework for monetary policy in the context of the post-crisis challenges.

THE POLICY RESPONSE TO LARGE AND VOLATILE CAPITAL INFLOWS

Let me begin by revisiting the rationale of the policies that many emerging markets put in place during the most expansionary phase of advanced economy monetary policies. We have policy space today due to our preventive, cautious and prudent policies that preserved macro-financial stability through the adoption of a pragmatic approach towards capital inflows over the last few years.

It is now a well-understood and documented story: ample global liquidity due to easy monetary policies in advanced economies resulted in exceptionally intense capital flows to emerging market economies. And we know that large and volatile capital inflows can potentially lead to economic and financial instability. They are associated with excessive credit expansion, lower quality of loan origination, increased financial system exposure to exchange rate risk, asset price distortions, including excessive exchange rate appreciation, and inflationary pressure, as excessively easy global monetary conditions can boost domestic demand independently from the desired domestic policy stance. In a nutshell, excessive flows are a fertile terrain to grow excessive financial exuberance.

The textbook policy response for my country and other EMEs was to use its floating exchange rate regime, which helps to smooth economic and financial adjustments, while conducting sterilized interventions and international reserves accumulation, which reduces exchange rate volatility and builds a foreign currency liquidity buffer to prepare for reversals.

But the intensity of this inflow episode was special as were the circumstances and policy responses in advanced economies[2]. Therefore, Brazil and other emerging markets pragmatically complemented their response and other textbook (aggregate demand) policies with the implementation of specific macroprudential policy measures to prevent the exuberance deriving from these large inflows to threaten financial stability. The adoption of specific measures of this new toolkit obviously depends on how each of us assesses its own local credit and asset market potential vulnerabilities. Some EMEs

[2] See IMF spill-over reports and in particular, IMF (2013b) and Ostry and alii. (2012).

imposed tighter limits on financial institution and household leverage. In East Asia, for example, policies included loan-to-value and debt-to-income ceilings on real estate lending. In Brazil, we increased capital requirements on riskier consumer loans and imposed a minimum payment floor on credit card balances. And we also imposed taxes on capital inflows and a reserve requirement on banks' foreign exchange spot positions.

The important outcome was that this pragmatic response worked. Therefore, macroprudential measures, including those that target specific capital flows directly, became an important part of the policy framework to address sudden floods and sudden stops. In complement to traditional macroeconomic policy responses, these measures showed that they can help ensure macro-financial stability. There are many quarters, ranging from academia to the IMF itself[3] that are increasingly subscribing to this view. However, there are also reputational costs to implementing these policies, which I will address a little later.

But what do we mean by "it worked"? In Brazil's case, it means the following: (a) macroprudential policies contributed to bringing down the pace of credit expansion to more sustainable levels; (b) they were successful in improving the maturity and composition of international financing; and (c) they also reduced foreign exchange volatility.

Therefore, the combination of strong fundamentals and our pragmatic policy response left emerging market economies such as Brazil better prepared for the eventual exit from unconventional monetary easing. But the question is better prepared for what?

Let me now turn to the second topic of my remarks which is the…

[3] For example, Rey (2013) and the IMF papers listed in the references.

Impact Of Normalization On Brazil And Other EMEs

Let me begin by noting that the process of normalization of monetary conditions underway in global financial markets is, overall, a positive development for emerging market economies. Despite market volatility, it reflects the gradually improving outlook for the world's largest economy. As global growth and global trade recover, emerging market economies will benefit.

We knew that, despite the best efforts to communicate an exit strategy from unconventional monetary policies, the beginning of any discussion about "tapering", i.e. the possibility of a reduction of asset purchases such as what occurred in May, would lead to a re-pricing of risk and a global sell-off of emerging market assets. It indeed happened as we anticipated. Emerging market economies have generally seen depreciating exchange rates, increasing sovereign bond yields and credit default swap spreads, and in many cases falling stock market prices.

In Brazil's case, the sell-off has manifested itself mostly as a search for protection, more than actual outflows. Most of the selling pressure has come from foreign real-money investors seeking to hedge their portfolios from currency devaluation, Brazilian companies hedging their foreign exchange liabilities, and foreign companies hedging their exposure to local assets. There is no foreign currency shortage in the domestic spot market, which the Central Bank monitors continually. And therefore, at the Central Bank of Brazil, we responded to the change in global financing conditions in a classical fashion, through policy tightening, exchange rate flexibility and using accumulated buffers to reduce volatility, avoiding abrupt changes that potentially threaten financial stability.

Accordingly, by mid-August, we announced a program of daily FX interventions through foreign exchange swaps and dollar credit line auctions, totaling in 2013 nearly USD 100 billion equivalent and scheduled through the end of the year, providing currency hedge for the private sector. Here the picture is mixed for emerging markets. Some are certainly feeling more the volatility than others. It depends on fundamentals, resilience, position in the cycle with its associated policy response, credibility of the buffers and willingness to use them timely and with a clear unambiguous communication.

In sum, while the prospect of interest rate normalization as economic growth recovers in core economies is a net positive, it does create transition risks. The lesson I take from the last few months is that emerging market policymakers need to show that they are ready and capable of stepping in and providing the public goods of financial and price stability.

Let me now turn to the third and last topic of my remarks, that is …

Inflation Targeting In The Post-Crisis Global Economy

As a growing and abundant new literature –together with new practices-- is now showing, the 2008 crisis and its aftermath have called into question the balance and interaction between two components of macroeconomic stability: financial and price stability. They are both necessary, but taken individually, they are not sufficient to ensure overall macro stability that fosters sustainable growth. Therefore, the debate raises the issue of what new contours could take an inflation targeting framework for monetary policy that could also address financial stability when complemented by possibly the new macroprudential toolkit. Central banks and financial regulators both failed to counteract the buildup of systemic risk in the financial system. Therefore, this failure has brought the inflation targeting regime under scrutiny since it has been the monetary regime of choice in many central banks including in emerging markets. The first lesson of the crisis was a greater appreciation of the importance of financial stability as a component of macroeconomic stability.

There are many directions in the ongoing debate[4]. One direction is to consider a division of labor along the lines of a separation principle: monetary policy using an IT framework would address price stability; and macroprudential policy would be used to mitigate financial systemic risk. Another direction is to ask whether monetary policy should explicitly incorporate a financial stability objective, and be more proactive in response to perceived risks to financial stability. Therefore, in considering the role of monetary policy in

4 Studies from an emerging market perspective include IMF (2013a) and Agénor and Pereira (2013).

addressing financial stability, this direction would consider new policy-reaction rules for central banks that would be augmented to include a financial or credit gap argument of some sort.

We are certainly in Brazil –but also elsewhere-- reflecting about these analytical lessons from the crisis. Due to our history of greater volatility, emerging market economy central banks such as Brazil's never relegated financial stability concerns to a secondary status. Our inflation targeting framework had always been complemented by strong financial sector regulation and prudent foreign exchange policies.

To be fair, very pragmatically, in the post-crisis environment of unprecedented global liquidity, emerging markets somehow implicitly used this separation principle: we used macroprudential policies in order to counteract the effects of intense and volatile capital flows on credit and asset markets; and this allowed monetary policy under the IT regime to maintain its focus on price stability.

However, this pragmatic policy mix might be effective, but is not without costs, especially because we still do not fully know how some of these macroprudential tools work[5]. That introduces important issues of credibility for central banks and poses challenges for the formation of expectations about the yield curve that are critical for monetary policy.

Therefore macroprudential policy, particularly measures that target capital flows, combined with traditional monetary policy creates significant communication challenges for central banks. In this respect, macroprudential policy can easily be misconstrued, obscure policy intentions and distort expectations.

CONCLUDING REMARKS

Allow me to conclude by drawing some general lessons from this quick overview of central banking for emerging markets in the post-crisis global economy:

[5] See IMF (2013a).

(a) the judicious usee of macroprudential tools can provide an additional degree of freedom to conduct monetary policy aiming at price stability at home while preserving financial stability;

(b) the debate will have to continue regarding the ways to ensure that the complementarity between the two instruments does not confuse and undermine market confidence; and

(c) the importance of making progress in developing a framework for financial stability policy is paramount. This would involve refining our macroprudential policy tools, developing new ones, and improving our understanding of how these tools impact the financial system and the economy.

References

Agénor, P.R., and L. A. Pereira da Silva (2013)," Inflation Targeting and Financial Stability: A Perspective from the Developing World", an e-book by CEMLA and Inter-American Development Bank, October 2013.

International Monetary Fund (2011a) Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework. Strategy, Policy and Review Department (February).

International Monetary Fund (2011b) Macroprudential Policy: An Organizing Framework. Monetary and Capital Markets Department (March).

International Monetary Fund (2012) The Liberalization and Management of Capital Flows: An Institutional View. Washington DC: International Monetary Fund, November, http://www.imf.org/external/np/pp/eng/2012/111412.pdf.

International Monetary Fund (2013a), "The Interaction between Monetary and Macroprudential Policies", January 29, 2013, http://www.imf.org/external/np/pp/eng/2013/012913.pdf

International Monetary Fund (2013b), "2013 IMF Spill-over Report" August 1, 2013, http://www.imf.org/external/np/pp/eng/2013/070213.pdf

Ostry, Jonathan D., Atish R. Ghosh, Marcos Chamon, and Mahvash S. Qureshi. 2012. Tools for Managing Financial-Stability Risks from Capital Inflows. Journal of International Economics 88 (November): 407–21.

Rey, Helène (2013), "Dilemma not Trilemma: the Global Financial Cycle and Monetary Policy Independence", paper presented at the Jackson Hole Economic Symposium, August 2013.