Proposal: Capital Flows and Boom-Bust Cycles in Emerging Markets*

Philip R. Lane
Trinity College Dublin

August 2013

This proposal focuses on the interaction between capital flows and monetary policy in emerging markets. In one direction, the response of capital flows to shifts in domestic interest rates is a key transmission mechanism for monetary policy. In the other direction, the "global capital flow environment" is an important external exogenous factor that influences financial conditions in emerging markets. This two-way interdependence means that central banks in emerging markets must develop a very keen understanding of the behavior of international capital flows, both in terms of preserving financial stability and delivering price stability. Moreover, the cross-country spillovers embodied in cross-border capital flows mean that global policymakers need to maintain a close interest in the international systemic implications of the monetary policy decisions of emerging market economies.

A wave of recent work has highlighted the importance of global factors (in short hand, fluctuations between 'risk on' and 'risk off' regimes) in determining the financial environment facing emerging markets (see, amongst others, Chen et al 2012, Forbes and Warnock 2012, Bruno and Shin 2013). The period since 2003 is especially interesting since emerging markets have faced three distinct stages: (a) the global liquidity boom of 2003-2007; (b)

*Proposal for NBER/CBT Project "Monetary Policy and Financial Stability in Emerging Markets."
Email: plane@tcd.ie.

the acute global financial crisis in late 2008 and early 2009; and (c) the recovery phase since mid-2009. Furthermore, the post-2003 period provides a 'clean' laboratory setting, in that it is free from domestically-generated crises in emerging market economies and so it is a good period to examine the role of international factors as exogenous shocks for emerging economies.

This paper will closely examine these three stages in order to understand the interplay between capital flows and monetary policy. Specifically, the focus in relation to the 2003-2007 boom phase will be to ask whether monetary policy helped some countries to mitigate the impact of the global liquidity boom on the domestic macro-financial environment. (The flip side of this question is whether monetary policy in other countries amplified the financial boom.)

Next, we will examine monetary policy during the 2008-2009 global crisis in order to establish the conditions under which monetary policy was deployed in a stabilizing fashion and under which monetary policy proved to be ineffective or harmful. Finally, we will examine the 'normalisation' of monetary policy as emerging markets recovered from the crisis from mid-2009 onwards.

In each stage, the focus will be on how the international investment position and external balances affected the ability of central banks to adopt stabilizing monetary policies. After the crises of the 1990s, the general trend in emerging markets was towards a much stronger international balance sheet, with a marked reduction in net foreign liabilities and much lower dependence on foreign-currency debt (Lane and Milesi-Ferretti 2007). In part, the reduced dependence on foreign-currency debt was attained by the promotion of equity-type liabilities, while the accumulation of large foreign-currency reserve positions further insulated emerging markets from the traditional financial risks associated with rapid currency depreciation. Indeed, a number of emerging market economies established "long" net foreign currency positions (Lane and Shambaugh 2010).

We will ask whether those countries with the strongest external positions were most

able to deploy counter-cyclical monetary policies during the three stages of the post-2003 period. In so doing, we will examine both stock and flow dimensions. In relation to the former, the stock of external debt liabilities is strongly correlated with vulnerability to crises (Blanchard et al 2010, Catao and Milesi-Ferretti 2013). Furthermore, we will address the valuation impact of interest rate and currency movements on net external positions, since the adverse balance sheet impact of currency devaluation was an important complicating factor in the conduct of monetary policy in emerging markets during earlier periods.

In relation to the latter, we will investigate whether it is aggregate net balance (current account) that matters or whether flow risks relate to net debt flows more than to net equity flows. One example of the latter distinction is the empirical pattern that domestic credit growth is strongly correlated with net debt inflows but not with net equity inflows (Lane and McQuade 2013).

This proposal will build on a strong empirical platform. This includes the just-completed updating of the External Wealth of Nations database and the in-progress updating and extension of the Lane-Shambaugh dataset on international currency exposures. It will also draw on a large-scale dataset that I have constructed for the period 1995.1 to 2012.4 with many capital flows measures and measures of the domestic policy environment in emerging markets (policy interest rates, government bond yields, exchange rates, official reserves, fiscal positions, institutional variables).

Related Literature

Blanchard, Olivier, Mitali Das and Hamid Faruqee (2010), "The Initial Impact of the Crisis on Emerging Market Economies," *Brookings Papers on Economic Activity* 41(1), 263-323.

Broner, Fernando, Tatiana Didier, Aitor Erce and Sergio Schmukler (2013), "Gross Capital Flows: Dynamics and Crises," *Journal of Monetary Economics* 60(1), 113-133.

Bruno, Valentina and Hyun Song Shin (2013), "Capital Flows, Cross-Border Banking and Global Liquidity," *NBER Working Paper No. 18942*.

Calderon, Cesar and Megumi Kubota (2012), "Gross Inflows Gone Wild: Gross Capital Inflows, Credit Booms and Crises," *World Bank Policy Research Working Paper No. 6270*.

Catao, Luis and Gian Maria Milesi-Ferretti (2013), "External Liabilities and Crises," *IMF Working Paper No. 13/113*.

Chen, Sally, Philip Liu, Andrea Maechler, Chris March, Sergejs Saksonovs and Hyun Song Shin (2012), "Exploring the Dynamics of Global Liquidity," *IMF Working Paper No. 12/246*.

Committee on International Economic Policy and Reform (2012), *Banks and Cross-Border Capital Flows: Policy Challenges and Regulatory Responses*, Brookings Institution / Sloan Foundation.

Coulibaly, Brahima (2012), "Monetary Policy in Emerging Market Economies: What Lessons from the Global Financial Crisis?," *International Finance Discussion Paper No. 1042*, Board of Governors of the Federal Reserve System.

Forbes, Kristin and Francis E. Warnock (2012a), "Capital Flow Waves: Surges, Stops, Flight and Retrenchment," *Journal of International Economics* 88(2), 235-251.

Forbes, Kristin and Francis E. Warnock (2012b), "Debt- and Equity-Led Capital Flow Episodes," *NBER Working Paper No. 18329*.

Gourinchas, Pierre-Olivier, Helene Rey and Kai Truempler (2012), "The Financial Crisis and The Geography of Wealth Transfers," *Journal of International Economics* 88(2), 266-285.

Hoggarth, Glenn, Lanvan Mahadevaand and Jeremy Martin (2010), "Understanding International Bank Capital Flows During the Recent Financial Crisis," *Bank of England Financial Stability Paper No.08.*

Hnatskova, Viktoria, Amartya Lahiri and Carlos Vegh (2012), "The Exchange Rate Response Puzzle," *mimeo*, University of British Columbia.

Lane, Philip R. (2013a), "Financial Globalisation and the Crisis," *Open Economies Review* 24(3), 555-580.

Lane, Philip R. (2013b), "Capital Flows in the Euro Area," *European Economy Economic Paper No. 497.*

Lane, Philip R. and Gian Maria Milesi-Ferretti (2007), "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004," *Journal of International Economics* 73, 223-250.

Lane, Philip R. and Gian Maria Milesi-Ferretti (2011), "The Cross-Country Incidence of the Global Crisis," *IMF Economic Review* 59(1), 77-110.

Lane, Philip R. and Gian Maria Milesi-Ferretti (2012), "External Adjustment and the Global Crisis," *Journal of International Economics* 88(2), 252-265.

Lane, Philip R. and Peter McQuade (2013), "Domestic Credit Growth and International Capital Flows," *Scandinavian Journal of Economics*, forthcoming.

Lane, Philip R. and Jay C. Shambaugh (2010), "Financial Exchange Rates and International Currency Exposures," *American Economic Review* 100(1), 518–540.

Milesi-Ferretti, Gian-Maria and Cédric Tille (2011), "The Great Retrenchment: International Capital Flows during the Global Financial Crisis," *Economic Policy* 26(66), 285-342.