ROUNDTABLE COMMENTS ON MONETARY AND REGULATORY POLICY IN AN ERA OF GLOBAL MARKETS

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The topic of this conference—domestic finance and global capital in Latin America—could not be more timely. Let me start with the issue of global capital. I will respond to most of the orienting questions that we have in the middle of my presentation.

What are the benefits of global capital? Given that these are all well known, I do not need to enter into the benefists of diversification, funding supplies, or funding good projects with capital from all over the world. But global capital also has its costs. What are these costs? I think that we have not yet begun to fully understand the cost side of the equation. Most of the arguments about the cost of global capital are based on what we call the volatility of global capital flows. Personally, I do not think that it is the volatility that hurts us. I say that because if it were just volatiliy, then we have market mechanisms to deal with the volatility problem of capital going up and down. You can hedge in the market and reduce some of the volatility with a floating exchange regime. Or if the problem is that you have just a bit too much capital coming in and you need a slightly lower flow, you can acumulate reserves.

But the real problem is what I call, and what has been called in the literature, the famous "sudden stops." What does sudden stop mean exactly? I define sudden stops as a very large change in the supply of capital. Of course, this sudden stop is always in the negative direction. These are also problems with big booms of capital inflows in the sense that you need to know what you are doing with the big influx. But the real problem is when you get billions of dollars less from one year to the other—on the order of 10 percent of gross domestic product (GDP) or so. And most of the countries that had crises faced this challenge: Mexico, Asia, Turkey, Brazil, all of them.

Of course, the sudden stops may be the result of bad policies or bad luck—which was the topic of the last session—or they may be the result of both or neither. But the question is how to deal with them, because they generate the need for a very large adjustment somewhere. Usually, as was the case in Asia and Mexico, they generally produce a very large decline in output. We are talking about output falls around 6 or 8 percent of GDP faults, depending upon whether it's a country like Mexico or in Asia. In floating exchange regimes, this also means very large depreciation. For cases like Turkey and Brazil, these big sudden stops also required compensatory capital flows. We are talking about official money—which usually requires some sort of an adjustment. But this is often not enough and you need to coordinate private-sector involvement in order to get the amount of capital required.

This is basically what I call the sudden stop. Big, large drops in financing from one day to the next. So what are the "economics of these sudden stops"? The first question is what are the policy recommendations? What do you do? As López-Murphy mentioned yesterday, the first thing is not to panic. Second, you make a calculation of how much foreign direct investiment and short-term debt you have, to see how much adjustment you need. The third thing is to look at what you have done in the past and see whether your financial system is prepared. Check your banking system. If the banking system was well regulated, it will help you because it will not magnify the external shocks. And as the paper by Eduardo Walker and Fernando LeFort mentioned this afternoon, this also means that the banking sector will help you find substitutes for external financing. The banking sector cannot help you with the external balance, but it will help you in terms of corporate financing.

The fourth thing is to evaluate your instruments. I can identify five instruments that can deal with this large shock to the capital stock. What are the five? First, interest rates and monetary policy. It could be either the interest rate or another monetary policy intruments. Second, fiscal policy—you need to implement some fiscal adjustment. Both of these will have a positive impact. Third, if you have a floating exchange regime, you can use that to your advantage. The fourth instrument is intervention in the exchange market—you can use the reserves that you have. And, finally, there is compensatory money from the multilateral organizations. You have five instruments, not all of them under your control, and certainly all of them are limited in some way.

I will touch on these limitations one by one. What are the limits and what can you use to help you? First, big shocks in capital flows mean that you need to make an adjustment to produce a current account surplus or lower the current account deficit. This is why you need a firm monetary policy and that means procyclical behavior. Treat fiscal policy in effectively the same way: you need to find a way to generate reserves.

What about the exchange rate regime? This is a big challenge. Most countries have gone to some sort of fixed exchange regime over the last twenty years. Some of them went to currency boards and some of them are now going to dollarization. Why is this? I think the reason has to do with the need for credibility. You build credibility by tying your hands. However, the economics of sudden stops demand precisely the opposite. They necessitate flexibility and they demand that you use all the instruments you have available. And in the case of fixed exchange rate regimes, one important instrument is not available.

Because during the sudden stops when 10 percent of GDP disappears, you must adjust, you have a falling GDP, you have recession, you try to implemet a fiscal adjustment, but you also need flexibility in the exchange regime. Maybe the case of Argentina will tell us something about the currency board, but that is yet to be seen. And, in my opinion, it will also tell us about dollarization, which was one of the questions here. I think dollarization is a very good device in terms of credibility. However, in this case, you have completely lost one of the five instruments, and, unfortunately, sudden stops require flexibility as well as all the instruments that you have at your disposal. So where are we probably headed? I believe we are moving to a credibility that is related to rules of reaction fuction. You do not tie your hands but rather inform people about how you are going to move. This is the essence of inflation- targeting regimes: playing the game by rules. The fourth instrument is intervention. You use intervention, even in floating regimes. There is no other way. You can be dogmatic about it and say that you only like pure floating, but, in my opinion, that does not exist, especially when 10 percent of GDP is disappearing from one day to the next.

But these instruments by themselves are not enough. It is not enough to have the exchange rate depreciate, because there are limits in terms of the inflation that it will produce. There are other limits too. Depreciation generates a higher debt-to-GDP ratio because most of emerging markets have debts denominated in dollars. There are also limits in intervention. You are limited to the amount of reserves you have.

This leaves us with compensatory or official money. How can a multilateral help in this regard? A question that was raised here was, are the multilateral programs failing, and what reforms are needed? Do they generate moral hazards? Is it an issue of globalization? Those are the questions that were raised. I will put this in the context of the economics of sudden stops. Have they failed? In my opinion, they have not failed, because the multilateral banks are still an available instrument. Certainly they have some problems. Sometimes the multilateral institutions, for example the International Monetary Fund (IMF), provide money, but they tell that you cannot use it. This is basically the NIR or the net international reserves floor. But I think things are changing now, and now you can have a package where you can actually use the money. I think it is surprising that in the last fifty years you got packages of money that could not be used.

And is moral hazard a problem? If moral hazard is understood as coutries taking the money, spending it, and then happily defaulting—then the answer is no. I think the case of Argentina shows that coutries do not happily default. This is the very last option even when everybody is telling you to default. You still do not want to default. And the reason is what Leonardo Villar just mentioned regarding Colombia. The reason is that when you pay your debt and do not default, you can get twenty years of lower spreads. So I do not think there is moral hazard in this sense.

However, there is another type of moral hazard. This concern arises when a country can obtain financing packages easily from the multilateral institutions. The incentive is to use more money from the international organization than is optimal. This means that your exchange rate will be less pressured and you would not have to raise your interest rate very much. In that regard, there is a small moral hazard that needs to be dealt with in the program and the targets. You need to have targets on the fiscal side and to have a firm monetary policy. This is the most effective way to deal with this concern. So, in that regard, I do not see that there is a problem with the multilateral organizations or the IMF. I just see that you need good programs.

The last question on the "economics of sudden stops" is, what determines these sudden stops? In the beginning of the conference we had a paper about the derminants of capital flows. I do not think the causes are the same. In fact, sudden stops are very different. It could be either bad luck, which was called exogenous shocks in the paper, international interest rates, risk aversion, events like the attacks of September11—these are all exogenous shocks. There is also the policy question, and bad policies will, of course, generate sudden stops. But there is also another aspect which is that suddenly you lose credibility because there is a lack of confidence. Then this lack of confidence calls for more lack of confidence, and, there you are, on a roller coaster. The markets are not usually free of self-fulfilling prophecies, and once you get to that stage, you have a very big problem.

So let me conclude by restating my main concerns. First, I do not think that volatility is the problem for global capital. Rather, the problem is the sudden stops. You cannot have fat tails if you want a good distribution of capital. The problem is that once in a while you have big events. Second, how do you deal with them? Unfortunately, you need a lot of flexibility. This goes against the goal of more credibility. Herein lies the big challenge: how to get more flexibility (in the way you need today) while simultaneously maintaining credibility. Regarding the exchange regime, this may mean you move in the direction of inflation targeting because that's the way you can get more flexibility while still maintaining credibility. Third, sudden stops may come from bad luck or bad policies or neither, but once you're on it, it is very hard to stop it. Multilateral institutions still have an important role to play because they provide the fifth instrument, money, when you do not have 5 to 10 percent of GDP to finance your needs. Moral hazard only occurs if the assistance package is badly designed. These were my basic points.