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Policy Round Table Remarks[1]

For my initial intervention in this policy round table, I would like to concentrate on the (potential) volatility caused by mayor central banks' monetary policy normalization and other related topics.

There has been a **high volatility in capital flows** in both directions, in and out of Emerging Market Economies (EMEs), for many years now. There are several factors and mechanisms that can contribute to explain this phenomenon. Some of these I mentioned yesterday, and many were examined in the presentations from yesterday and today. In particular, the **search for yield** has been one prominent factor. It has had as a key element **the prevailing low levels of interest rates in many Advanced Economies (AEs)**. Such low levels are largely explained by the low levels in real interest rates. Several related hypotheses have been put forward for this, such as the presence of secular stagnation, demographics, low productivity growth, achieving educational plateaus in Advanced Economies, among others.

Just a few years ago, we all expected interest rates in AEs to increase significantly. In particular, we were extremely worried with the normalization of U.S. monetary policy. In effect, the U.S. 10-year interest rate saw its level reach close to 3.3 percent; however, it has come back and presently is around 2.7 percent. On their part, the ECB and BoE's normalization processes have had a slower pace than anticipated.

There are **additional factors above and beyond the U.S. monetary policy normalization**

that have made the present situation significantly more intricate.

1. Consider the presence of **trade wars**, most notably, that of the U.S. and China. In some specific cases, trade policy might involve bona fide strategic rationales. Nonetheless, I think there is a consensus in the profession that, in general, a trade war between the U.S. and China is harmful not only for such economies, but also for the global economy (see Huang et al. 2018).[2]
2. Overall **U.S. economic policy uncertainty**. As a prominent example, consider the tensions between **President Trump** and the **Federal Reserve Board**. In addition, in the last couple of years, **U.S. multilateralism** is in the process of being eroded. More generally, the **economic policy uncertainty index** has notably increased during the

[1] As prepared for delivery.
[2] Huan et al. (2018) "The economic costs of the 2018 US-China 'trade war': A view from the financial markets" VoXEU Post.

past year.[3]

3. **Geopolitical risks**, such as the growing risks of cyber-attacks, the rise of populism across countries, and the erosion of a world order led by the U.S., adds to the potential deterioration of the situation (Euroasia, 2019).[4]
4. These factors add to a **fragile macroeconomic management in several EMEs**. When it comes to EMEs, there are two additional elements worth reemphasizing.
    - **First**, there is a lack of **institutional strength**. The relevance of institutions shaping an economy goes, at least, as far as Hamilton (1919).[5] More contemporary economists such as Rajan (2009), have studied the implications of institutions for economies.
    - **Second**, there is the **degree of financial development** in EMEs. In effect, most EMEs financial markets are not deep and present some serious market microstructure issues. To be clear, the size of EMEs´ financial markets relative to size of the capital flows´ shock they receive can be quite small. This is particularly the case for their bond markets. Some EMEs simply do not have the fiscal capacity to develop a very deep bonds market. In terms of **market microstructure**, for example, several EMEs´ currencies are not part of an international system in which their operational, settlement, and liquidity risks are minimized.
5. There are the innovations in how financial markets operate. Prominently, **algorithmic-trading** has gained importance. In fact, in many financial markets, a significant portion of the operations are performed by algorithms. These not only have changed the dynamics of such financial markets, but have increased operational risks in new dimensions.

There have been **changes in some of the most important actors in financial markets**. For instance, while in the past commercial banks were a major player, nowadays, **Global Asset Management (GAMs)** have gained a central role in EMEs (e.g., see Miyajima and Shim, 2014).[6] This change has led to the exacerbation of **agency problems** in asset management companies (e.g., Morris and Shin, 2014, and Feroli et al. 2014).[7]

From my point of view, in the last few years, a central issue in trying to understand capital flow dynamics is the sheer size of **GAMs**, in the context of their increased presence in EMEs markets. Their size might have some advantages, but it might as well lead to excess co-movements in their positions. The fact that they tend to follow similar indices, share similar risk management tools, and can implement similar trades, can exacerbate such a situation.

Agency problems can lead to herd-like dynamics in capital flows. In fact, agency problems are one of many mechanisms that can lead to such dynamics. Asymmetric information and

[3] http://www.policyuncertainty.com/
[4] https://www.eurasiagroup.net/issues/Top-Risks-for-2019
[5] Hamilton (1919). "The Institutional Approach to Economic Theory," American Economic Review, 9(1), Supplement, pp. 309–18.
[6] Miyajima and Shim (2014). "Asset managers in emerging market economies" BIS Quarterly Review, September.
[7] Morris and Shin (2014). "Risk-Taking Channel of Monetary Policy: A Global Game Approach," Princeton Manuscript, and Feroli, Kashyap, Schoenholtz and Shin (2014). "Market Tantrums and Monetary Policy". Chicago Booth Research Paper No. 14-09.

informational cascades, among others, can also lead to herd-like dynamics in capital flows. Having said that, I think that the agency problems are one of the most relevant mechanisms to explain such dynamics.

In this context, **herd-like dynamics can lead to liquidity issues**. In terms of regulation, a possible way to address the externality imposed by the investor abandoning her position and adversely affecting the asset price, is implementing a redemption fee. As this falls in AEs regulatory perimeter, there is little EMEs can do.

An additional consideration are the **difficulties in gauging the phase of the US and other Advanced Economies business cycles**. In the aftermath of the **Global Financial Crisis (GFC)**, along with the unprecedented monetary policy stance put in place, many questions have arisen. Two cases in point are as follows. The first has to do with whether the Phillips Curve has flattened considerably and, more generally, whether Phillips Curve type of analyses are still relevant for central banks. The second has to do with whether the GFC affected potential GDP growth. These add to the challenges of **measuring the U.S. and other AEs' business cycles and, in turn, to the challenge of having a better reading of the expected path of monetary policy in those economies.**

Closely related to the above, we have that the **deep formation price processes** have changed in the past several years. Three elements are worth underscoring.

- **First**, the growing differences between firms that have led to more market power (Van Reenen, 2018).[8]
- **Second**, the growth of online competition and their pricing behavior leading prices to be more sensitive to some macroeconomics shocks (Cavallo, 2018).[9]
- **Third**, the role of intangible capital in the rise of industry concentration (Crouzet and Eberly, 2018).[10]

For policy makers and market participants at large, these elements add to the challenges related to the **understanding of the inflationary process** and to their capacity to formulate an inflation forecast and their ability to foresee abrupt changes in inflation.

At this point, as I have mentioned, it seems that the Federal Reserve will not raise its policy rate much more. Moreover, some market participants even expect that there could be a U.S. recession next year. These elements have provided, at the margin, support for further capital flows toward EMEs. These renewed sources of capital flows have implied some sort of 'anesthesia' for the financial stability of EMEs. In effect, it has allowed them to postpone dealing with some *bona fide* economic problems. **In my mind, markets have been perhaps too lenient, and a time might come when they might turn unforgiving.**

All in all, the high **volatility in capital flows** in both directions has prevailed but for somewhat different factors than those that were presented in the immediate years after the GFC. Two key

[8] Van Reenden (2018) "Increasing Differences between firms: Market Power and the Macro- Economy" Paper prepared for the 2018 Jackson Hole conference
[9] Cavello (2018). "More Amazon Effects: Online Competition and Pricing Behaviors" Paper prepared for the 2018 Jackson Hole Economic Policy Symposium.
[10] Crouzet and Eberly, 2018, "Understanding Weak Capital Investment: the Role of Market Concentration and Intangibles" Paper prepared for the 2018 Jackson Hole conference.

factors are, as mentioned,

- ✓ The **low level of interest rates** and,
- ✓ The **unsparing competitive structure of the market for GAMs** services and the consequent active search for yield phenomena.

In this context, we are seeing authorities participating in a global monetary game in which capital flows are quite sensitive to interest rates differentials.

How should policy makers in EMEs respond in this environment?

1. **Macroeconomic fundamentals** should be kept in order. In effect, there is no substitute for solid macro fundamentals.
2. They should procure that **liquidity conditions** in financial markets are adequate. This might involve some further developing of financial markets as well as exchange rate intervention.
3. In goes without saying that authorities should have **a very good understanding of monetary policy** in their respective economies.
4. They should have a solid understanding of **macroprudential policy**.
5. In turn, they should have a very good understanding of the **interaction of monetary and macroprudential policies**.
6. E**xternal conditions** should be assessed and, quite possibly, considered in the monetary policy decisions. For an EME, this could have many aspects to it; for example**, the phase of the Global Financial Cycle and/or the relative monetary policy stance**. Two examples of this were given in a couple of papers presented in this conference.

Martin Tobal argued that in an open economy in which the probability of default is endogenous, given a shock to aggregate demand, the monetary authority that raises the interest rate would end up attracting capital flows, in turn raising the prevalent credit and thus increasing the probability of a crisis. The policy recommendation was in some cases to the *decrease* the interest rate. In a sense, the external conditions were favorable to the implementation of policy.

In our paper, presented by **Santiago Garcia-Verdú**, he explained that for some EMEs, **the VIX might lead to a short-term interest rate shift in the opposite direction from what the inflation dynamics would indicate**. Moreover, he also explained that in several cases, a positive VIX shock not only increased the long-term interest rate, but also seemed to **amplify the response of such an interest rate to an inflationary shock**. In both cases, the external conditions might be unfavorable to the implementation of monetary policy.

Overall, this is a global game, which economies have to face, in particular, those that are small and open (price takers) and that do not have strong currencies. In effect, we are in a very complicated environment in which each economy not only needs to confront its challenges and put its fundamentals in order, but also be vigilant for adverse external market conditions that can translate into adverse externalities for the economy.

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