Increasing Resilience to Large and Volatile Capital Flows: The Role of Macroprudential Policies

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Capital flows can bring substantial benefits, but can also pose macroeconomic and systemic risks for the Fund’s membership. Following a request from the IMFC, an upcoming IMF Board paper, scheduled for discussion in June 2017, will flesh out the relationship between large and volatile capital flows and systemic risk, and highlight how macroprudential policies can contribute to the policy response, consistently with the Fund’s Institutional View (IV) and macroprudential policy (MPP) framework. It will build on an ongoing review of the experience with the IV and draw on country experiences. The paper could further help the Fund provide advice using the existing IV and MPP frameworks that is consistent, well-tailored to country circumstances, and adapts with changing conditions in order to help members benefit safely from capital flows.

Principle

Draw on existing IMF frameworks, including on macroprudential measures and the Institutional View on liberalization and management of capital flows, to help countries take advantage of the benefits of capital flows while containing the financial stability and therefore macro risks that they may pose.

I. Context

Capital flows are a key feature of the international monetary system providing significant benefits for countries. Direct benefits arise from the transfer of new technology and management practices that often accompany FDI, increased room for facilitating investment and smoothing consumption, and there are also “collateral benefits” such as financial sector development, macroeconomic policy discipline, trade, and economic efficiency.

Large and volatile capital flows can also have an impact on systemic financial risk in many member countries, operating through multiple, complex channels.¹ The consequences in terms of macroeconomic and financial risks can be difficult to disentangle—depending on the nature of the country’s financial system—and evolve with fluctuations in capital flows. They reflect both direct channels, such as cross-border lending to domestic households, corporate and banks (which in turn onlend to the private sector), and indirect channels including asset price

¹ This note uses systemic financial risk and systemic risk interchangeably to refer to the risk of large sections of the financial sector becoming impaired and therefore unable to provide financial services—an eventuality that would have severe macroeconomic consequences.
effects or second-round effects from cross-border borrowing. Upswings may be associated with a build-up of systemic risk, often manifested through credit booms (with asset bubbles) funded by non-core liquidity and heavy external borrowing by the financial or corporate sector. Downswings can lead to the crystallization of systemic risk as the external liquidity environment becomes more strained.

The key question for countries seeking to benefit from more open capital flows is how to do so safely. In turn, the challenge for the Fund is to provide advice to members in such conditions that is consistent, well-tailored to country circumstances—including institutional conditions—but also adapts as global and country circumstances change, notably when the systemic risk arising from capital flows dissipates or is realized. This raises two questions: (i) how to articulate more explicitly in the guidance the role of countries’ MPP frameworks within the existing IV’s macroeconomic framework; and (ii) how to apply the Fund’s MPP framework more systematically when systemic financial risks stem from capital flows, taking into account country circumstances.

II. The IMF’s IV and Macroprudential Policy Frameworks

The IV and MPP frameworks were developed separately, with different goals and operational implications. This has created the scope for potential overlap and complementarities, some of which are explicitly addressed in the IV and the MPP framework. It also creates scope for tensions given the different underlying perspectives, such as the precautionary emphasis on building resiliency in the MPP framework. As capital flows can pose macroeconomic and systemic financial risks, further integrating the two frameworks would strengthen the Fund’s policy advice.

The range of policy responses to large and volatile capital flows can potentially include macroprudential measures (MPMs) as well as capital flow management measures (CFMs). This reflects the scope for MPMs to mitigate the build-up of systemic financial risks, and thus diminish the macroeconomic risks associated with the disruption to the financial system that would ensue if systemic risk materializes. The presence of strong MPP frameworks provides degrees of freedom in responding to the impact of large and volatile capital flows. However, some members may not be able to implement MPMs effectively due to institutional constraints, such as the risk of leakages, or weaknesses in capacity.

The goal of the IMF’s MPP framework is to contain systemic risks to the financial sector—from all sources, not just those from capital flows. The MPP framework distinguishes between structural risks within the financial sector (e.g., due to interconnectedness) and the time dimension (e.g., the procyclical build-up of risk during credit booms). Precautionary measures intended to deter excessive build-up of risk are by their nature greater than proportional to the observed risk. The toolkit potentially includes instruments that are MPMs and also restrict capital flows (known as MPM/CFMs), along with measures that are pure MPMs that aim to limit the
build-up of risk, notably by building resilience, without necessarily aiming to restrict capital flows. MPMs can therefore help members derive benefits from capital flows while limiting systemic risk.

The advent of capital flows may influence members’ choice on which MPMs would be most suitable relative to domestically induced financial cycles. Based on country experience, options have included MPM/CFMs, Basel III measures (LCR, NSFR) differentiated by currency, other liquidity tools (such as reserve requirements, liquidity charges or constraints on FX funding), and broad-based macroprudential tools such as countercyclical capital buffers and leverage ratios, which do not specifically differentiate by currency or residency of borrower. But this list is not exhaustive, and other MPMs might at times be appropriate.

The key purpose of the IMF’s IV is to provide a framework to help take advantage of the benefits of capital flows while containing the macroeconomic and financial stability risks that they may pose. Capital flows should be primarily handled within a broad package of macroeconomic policies, including exchange rate flexibility, FX intervention, and monetary and fiscal policy adjustment, supported by sound financial supervision and regulation and strong institutions. In certain circumstances, CFMs can also be useful, but should not substitute for warranted macroeconomic adjustment and should be scaled back when pressures abate in order to minimize their distortions. CFMs on outflows should only be used in crisis or imminent crisis circumstances and although temporary, they may need to be broad-based, while CFMs on inflows should be targeted, transparent and temporary. MPMs that also restrict capital flows (MPM/CFMs), including residency or nationality-based measures, may continue to be useful for managing systemic financial risks after capital flow surges abate, but less distortive alternatives should be considered.

III. Upcoming Work

The upcoming Board paper, scheduled for discussion in June 2017, builds on ongoing work at the Fund on capital flows, and follows an IMFC request. A review of experience with the IV will be discussed by the IMF Executive Board in December 2016, and will identify emerging issues requiring follow-up work. The IMFC considers that the review as well as next year’s paper on the interplay of MPP and IV frameworks would together help the Fund provide tailored and consistent advice in addressing macroeconomic and financial stability risks.2

The upcoming paper will explore the relationship between capital flows and systemic risk, including the financial cycle. Drawing on the experience of a range of countries—that are diverse in terms of income groups, financial development and institutional circumstances—and empirical analysis, it will lay out the impact of large and volatile capital flows on financial stability, including the channels of transmission.

Drawing on country experiences, the upcoming paper will consider the scope for members to use MPMs to address systemic risks arising from capital flows, thereby benefiting safely from capital flows. It will take into account the structure of the economy such as the dominance of banks and the development of capital markets, including shadow banking and corporates with direct access to foreign financing. It will also take note of the various roles of MPMs, including building resilience to address financial risks as well as containing financial accelerator effects, and consider both inflow and outflow episodes. It will examine the effectiveness of macroprudential tools in such cases, and their limits.

The upcoming paper will also consider the potential for a more detailed articulation of the role of MPMs in the application of the IV. The IV’s guidance could take more explicit account of how MPMs can address systemic financial risks from capital flows, and therefore may more generally lower macroeconomic risks, even if that is not their primary intent. The paper will also consider how, consistent with the MPP and IV frameworks, the Fund can be more systematic in assessing how capital flows affect systemic risk, and therefore the scope for effective use of MPMs across financial cycles with primarily domestic versus capital flow-induced drivers. Finally, the paper will take note of how international legal frameworks (EU and OECD membership) might affect members’ policy considerations and choices.