



External Shocks, Spillovers, and Emerging Markets' Policy Reactions

SEPTEMBER 26, 2019

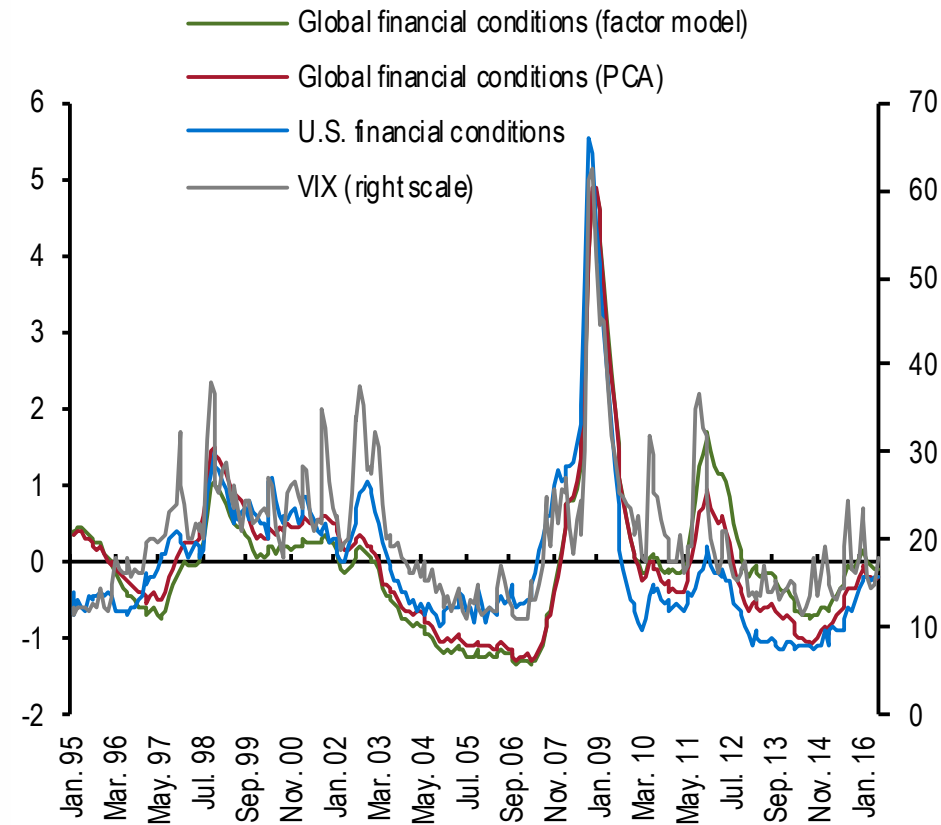
Gaston Gelos

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Global Financial Conditions

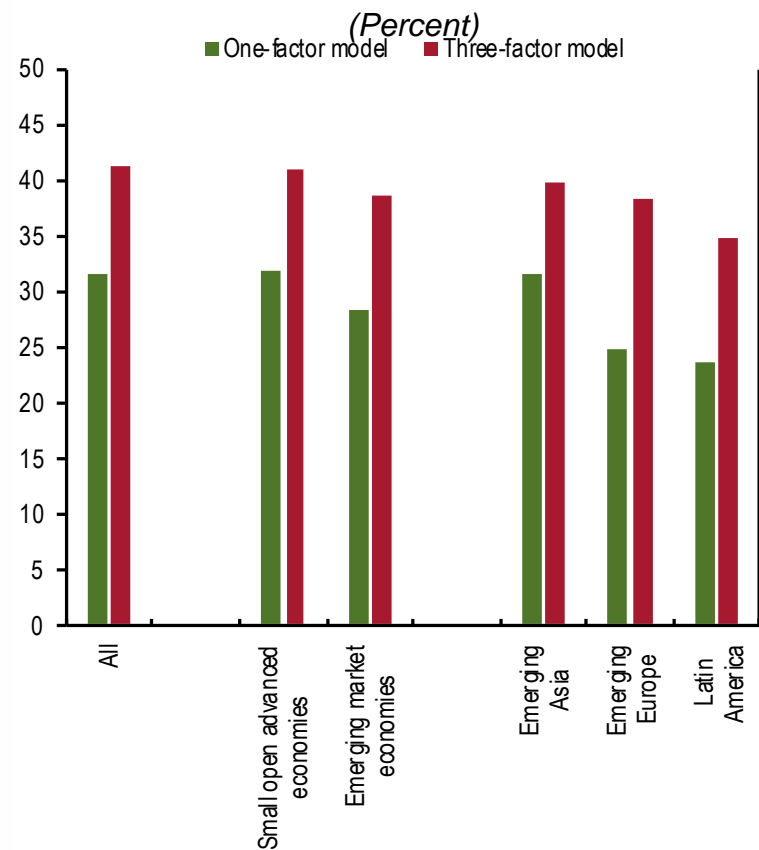
Single Global Factor, U.S. FCI, and the VIX



Sources: GFSR April 2017.

Importance of Global Financial Conditions: Share of FCI Fluctuations Explained

Variance Accounted for by One- and Three-Factor Models

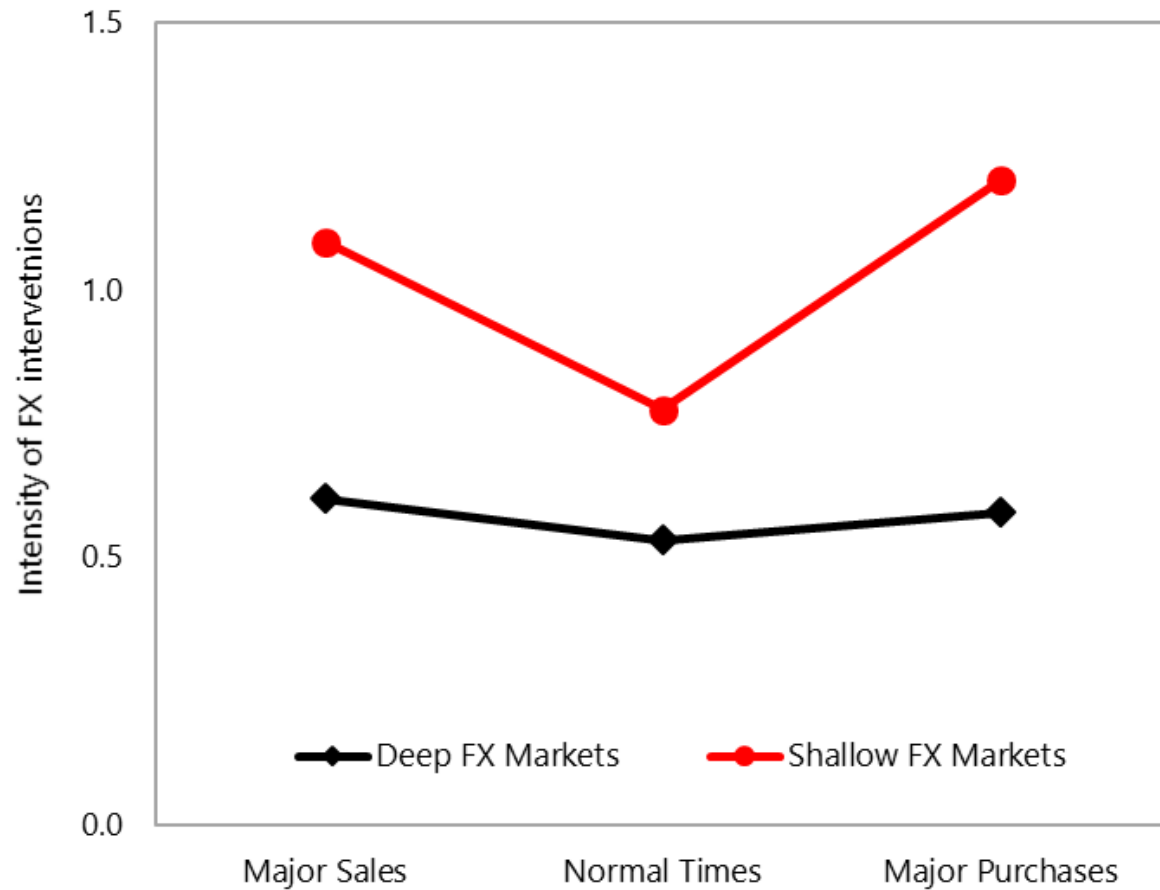


Source: GFSR April 2017

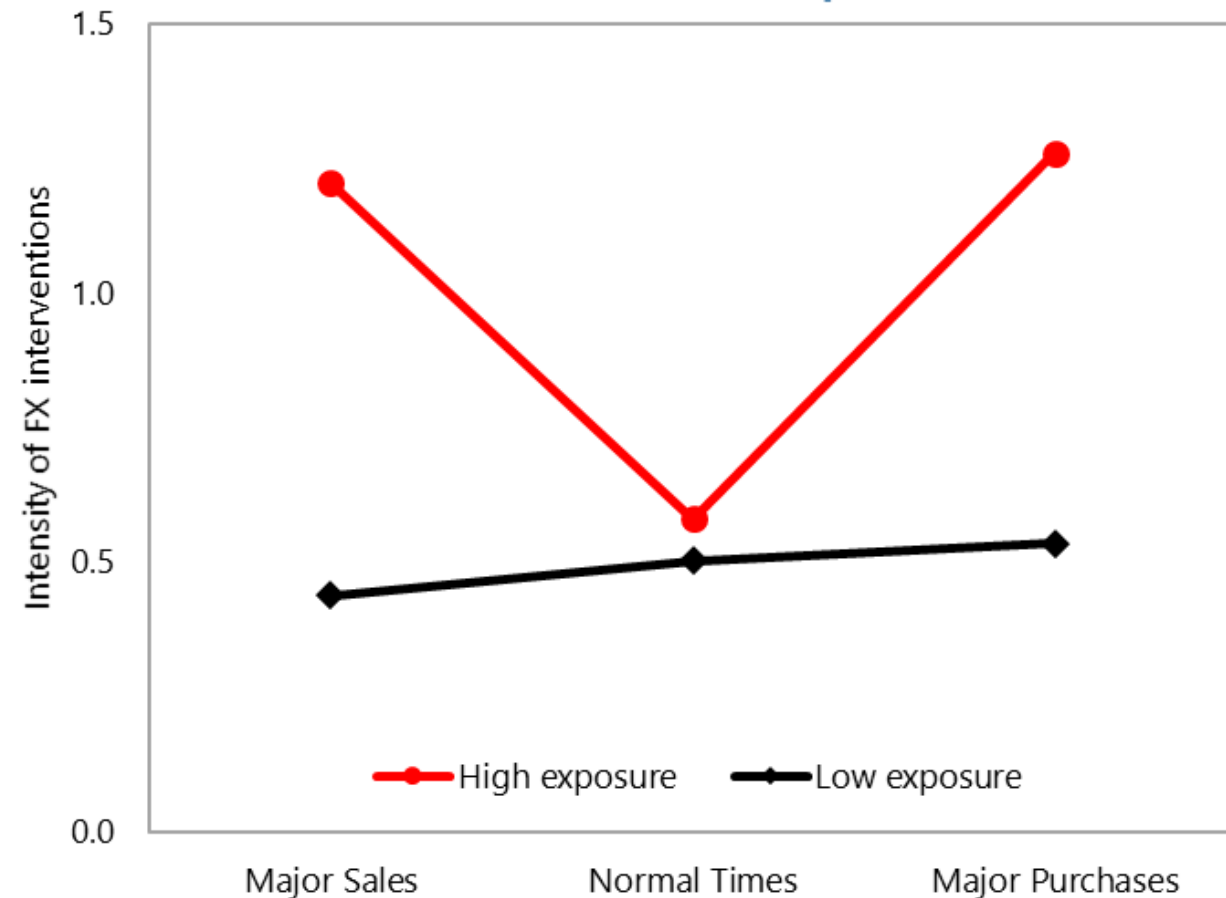
Policy responses vary across countries

Example: Intensity of FX intervention (FXI) depends on market depth and balance sheet mismatches

FXI depends on FX market depth...



... and on FX balance sheet exposures



Source: Mano and Sgherri (forthcoming)

Toward an Integrated Policy Framework

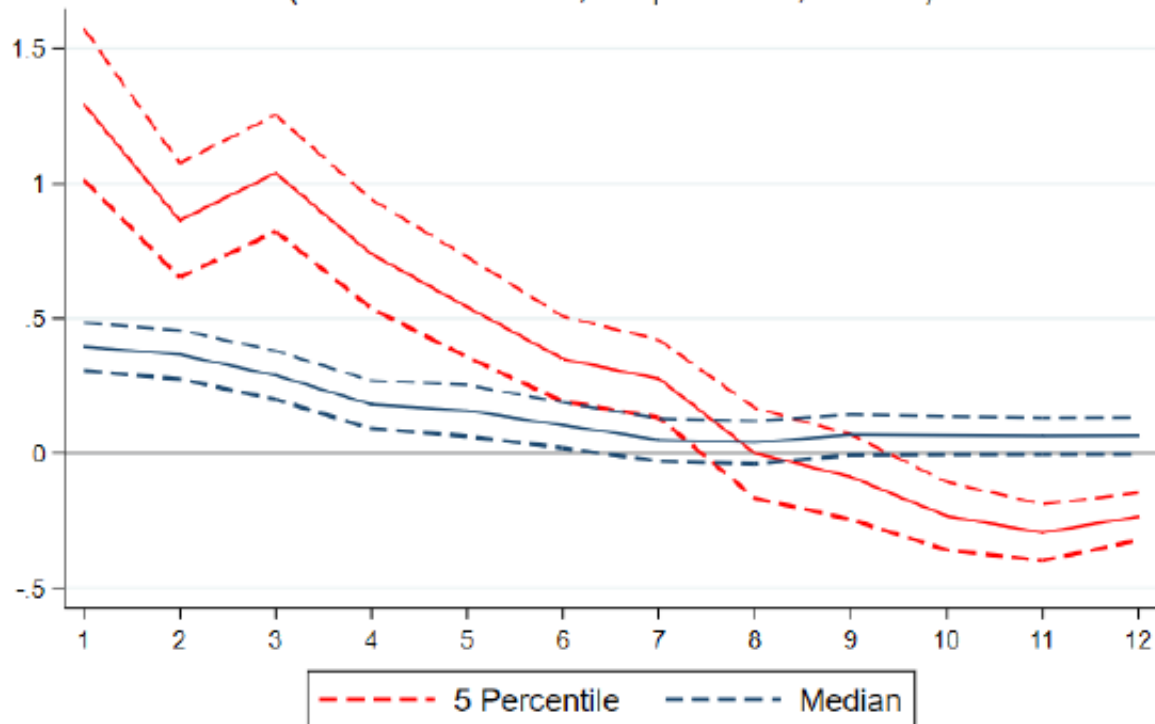
More systematic assessment of effective policy mix to help countries pursue growth and stability objectives. Considers:

- ▶ rising spillovers and deepening macro-financial and external links and role of financial conditions (FC)
- ▶ joint role and interactions of policies:
 - monetary- (MP)
 - foreign exchange- (FX)
 - macroprudential- (MPM), and
 - capital flow management- (CFM)
- ▶ modeling, empirical work, and review of country experiences

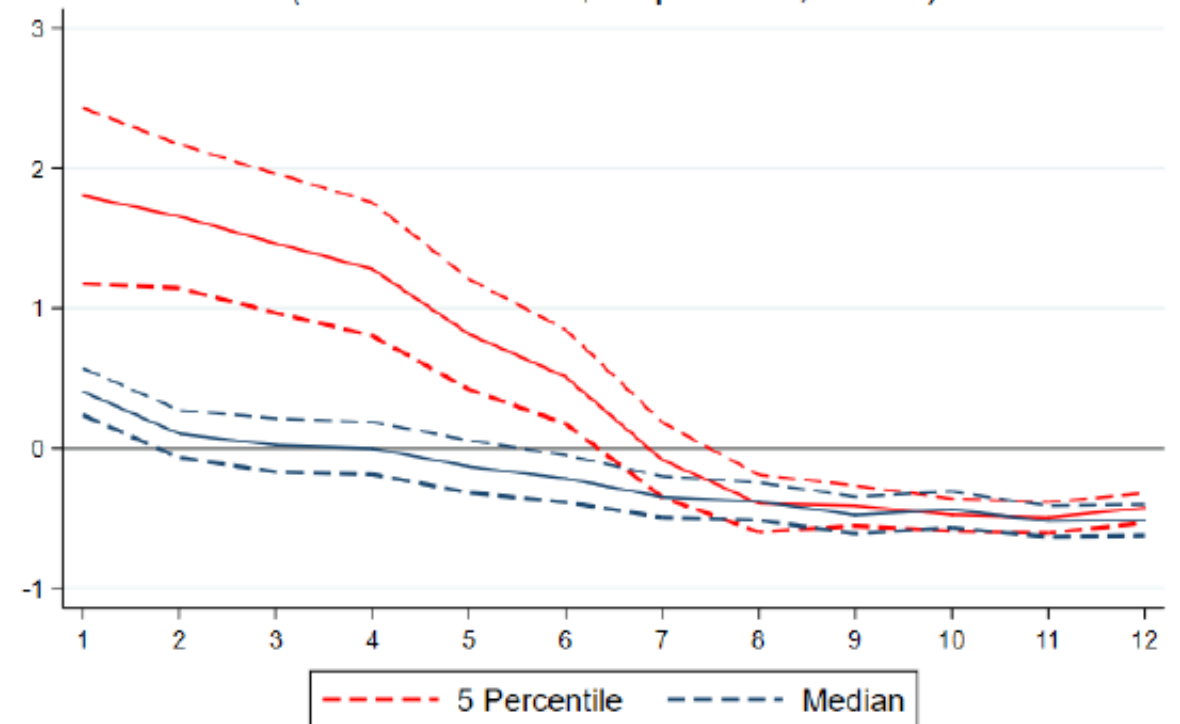
Conceptual framework—intertemporal trade-off between financial conditions and downside risk

Loose FC lead to buildup in financial vulnerabilities (Adrian and others, 2019)

Marginal Effect of FCI on Growth: AE
(With Credit Growth, 5th percentile, median)



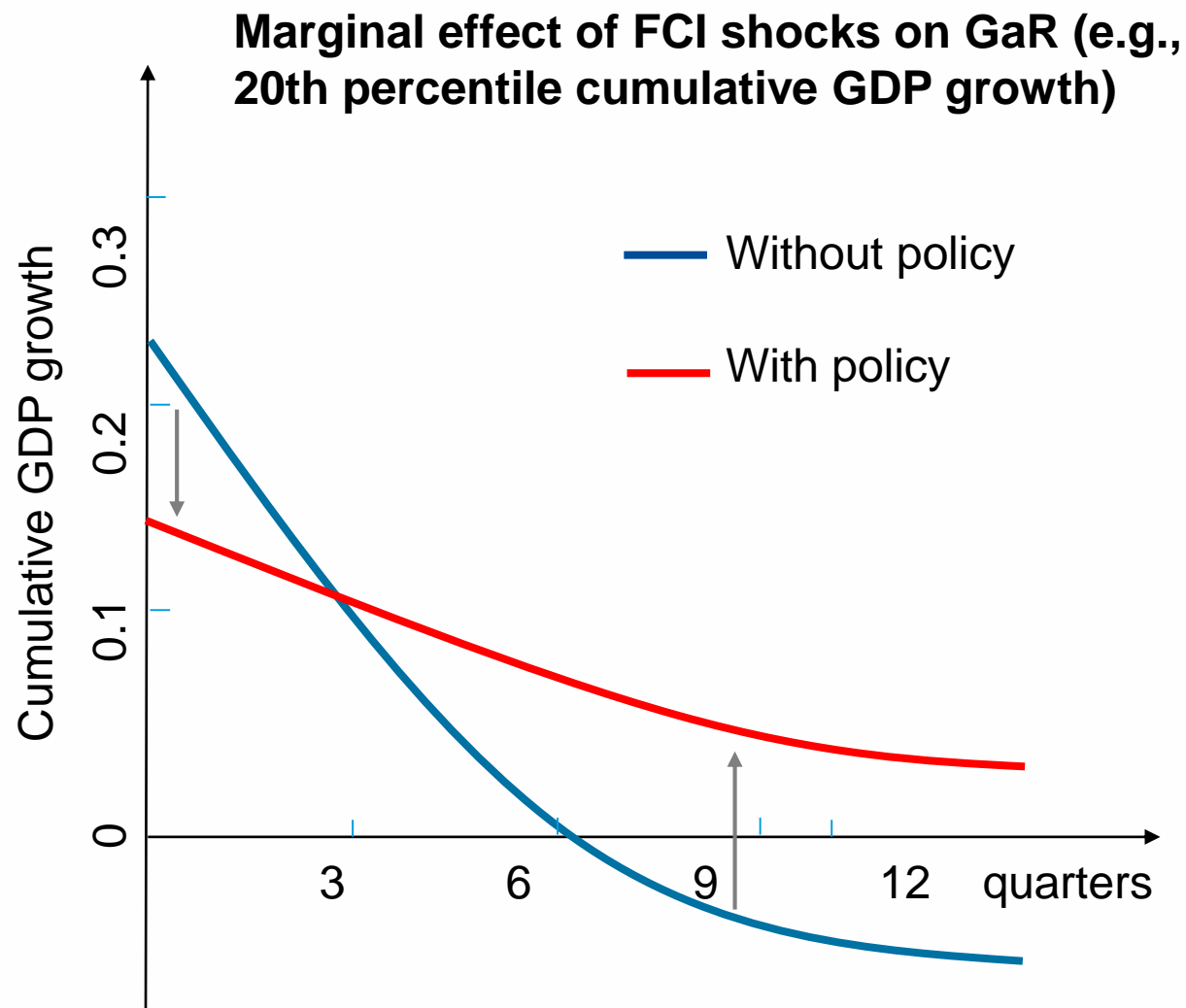
Marginal Effect of FCI on Growth: EME
(With Credit Growth, 5th percentile, median)



Source: Adrian and others (2018)

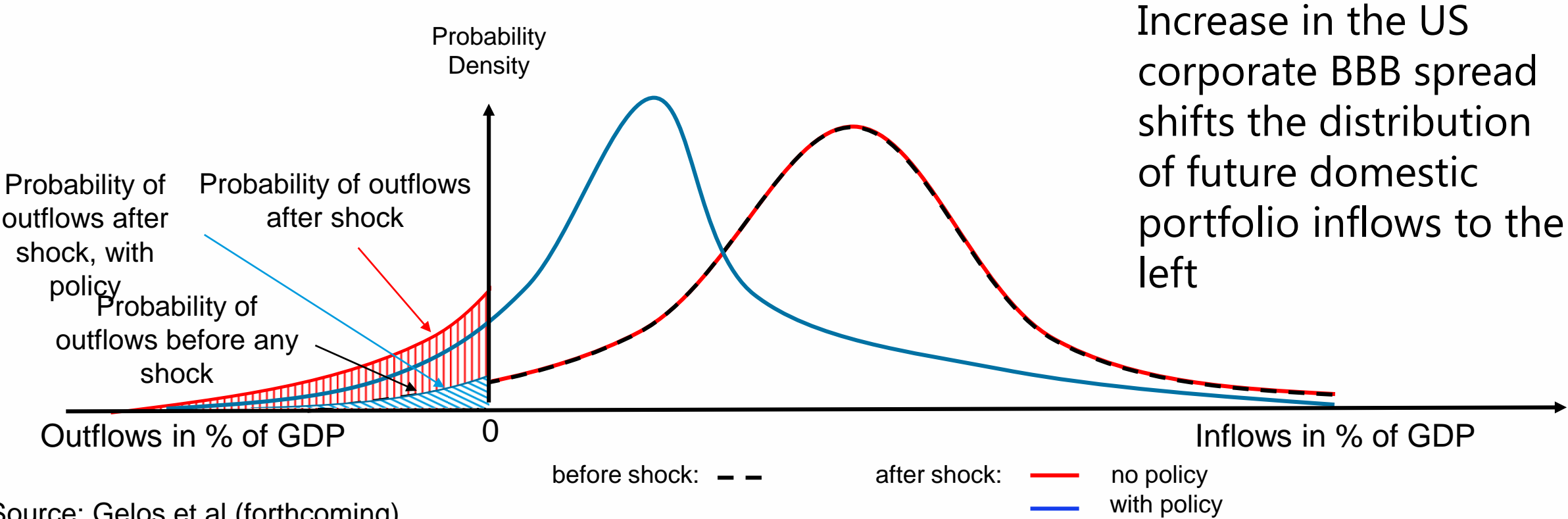
Example 1: Can macroprudential and other policies improve trade offs in response to financial shocks?

- Tightening MPM (red line) when financial conditions loosen (blue line) mitigates negative GaR (20th percentile).
- Need to look at entire distribution of future outcomes
- Examine different policies and compare
- Macroprudential policies appear to be effective



Source: Brandao-Marques, Gelos, Narita, and Nier (forthcoming).

Example 2: Capital flows at Risk - How can policies affect the future distribution of capital flows in response to external shocks?

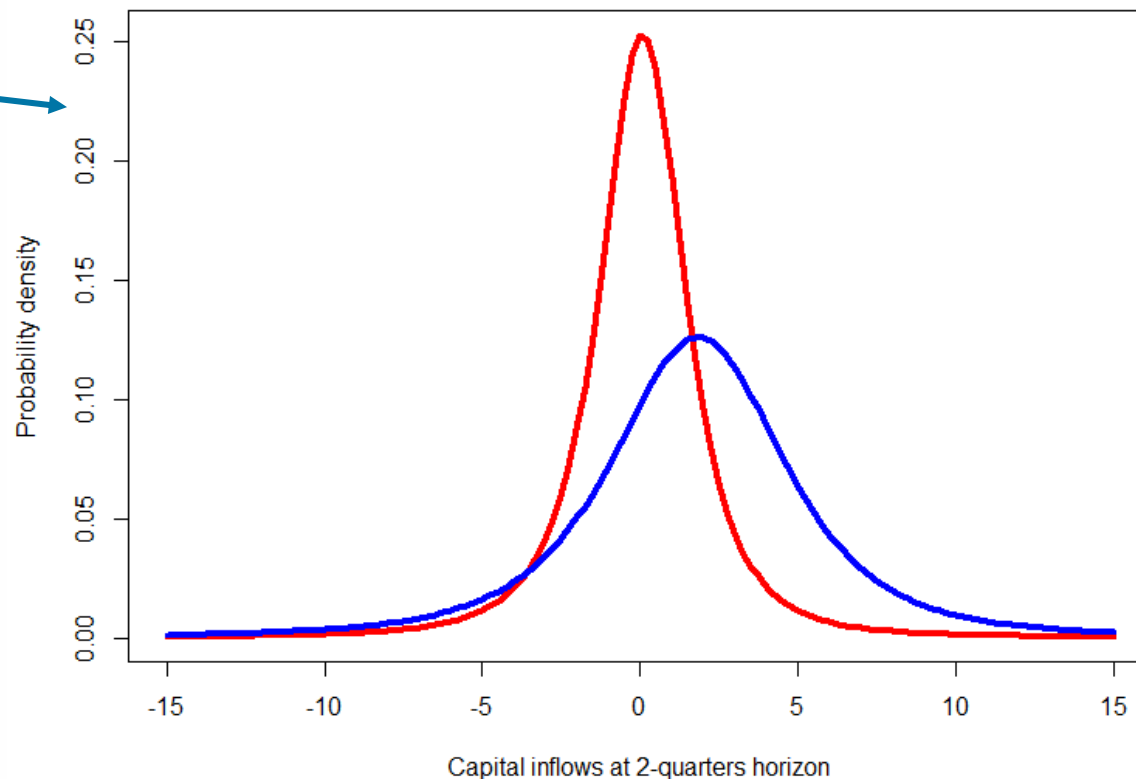


Source: Gelos et al (forthcoming)

Example 2: Which factors matter more for affecting average outcomes and tail risks?

- **Financial development**
- Monetary policy framework
- Financial dollarization
- Indebtedness
- Dominant currency invoicing
- ...other?
- Policy response (MPM, monetary, FXI and CFM) – endogeneity is a challenge

Financial market development and shock to US corporate yield: short term



Distribution of near-term portfolio inflows after a global shock when: **financial markets are shallow** vs **financial markets are well developed**

Source: Gelos et al (forthcoming)

Modeling work

- Empirical work helps inform modeling
- Develop simple but flexible open economy models to elucidate policy tradeoffs
- Should monetary policy (MP) lean against the build up of vulnerabilities?
 - Is there a trade-off between financial stability and inflation stabilization?
- Can FXI/CFM be appropriate tools to manage volatile capital flows?
 - Under which conditions?
 - What are the costs and benefits?

Concluding remarks

- Global financial conditions explain about a third of domestic financial conditions in EMs
- How to best react? Ongoing country case studies, empirical analysis, and modeling work in multiple dimensions.
- Continued engagement with IMF Membership
- No predetermined outcome
- Existing policy framework, including the Institutional View, continues to guide the Fund's policy recommendations