An Alternative Policy Tool to Cope with Capital Flow Volatility

A. Hakan Kara, Central Bank of Turkey

(Presented at the OECD-Economic Policy Committee Meeting, May 9-10, 2012)

I will talk about the main question raised by the secretariat for this session: "How can emerging-market economies best adjust to the very accommodative monetary conditions warranted in major advanced economies?"

One of yesterday's sessions discussed why monetary policy is not effective (or less effective than expected) in advanced economies. I will put the question the other way around. "Why monetary policies pursued by advanced economies are too effective on emerging market economies. How can we make them less effective?"

Defining the Problem

Emerging market economies are facing a quite different challenge than many advanced economies. Accommodative monetary policies pursued by leading central banks increase the search for yield, boosting short term capital flows towards emerging markets (especially towards those with sound fundamentals). These capital flows, in turn, lead to excessive currency appreciation and rapid credit growth. Coupled with the weak external demand due to depressed economies in advanced economies, this means growing macro imbalances, inefficient allocation of resources and mounting macro financial risks for emerging economies. More importantly, if the country is running a structural current account deficit (as in Turkey), accelerating credit growth and appreciation of the domestic currency further exacerbate the problem, increasing the risk of a sudden-stop.

How should emerging economies respond to such a challenge? One of the main lessons we learned from the global crisis is that central banks should pay more attention to financial stability issues, macro imbalances and asset prices. From an emerging market perspective, this means existing policy frameworks should be modified to respond to the challenges I just mentioned.

From "Boring" to "Exciting" Monetary Policy

During the pre-crisis period, the conventional wisdom for the practice of central banking—embraced by international capital markets—was to be predictable, simple and boring (rule based). This was also the way how typical inflation targeters of emerging economies like Brazil, Chile, Mexico and Turkey implemented monetary policy. There was one instrument and one goal. Conventional inflation targeting regimes only focused on inflation and used short term interest rate as the single policy instrument. High level of predictability through the communication of the future path of the policy rate was seen as an essential element of monetary transmission mechanism, as it increased the central bank's control over the short- to medium-end of the yield curve.

But does full predictability lead to the best desirable outcomes under all circumstances? The literature is rather silent on this issue for emerging market economies. Still, a large fraction of emerging market central banks (perhaps surprisingly) has adopted full transparency during the decade preceding the global crisis.

However, things have changed after the collapse of Lehman Brothers. The crisis was a wake-up call for many policy-makers. It was also an excuse (or opportunity) to implement some of the long-held views against conventional wisdom. Monetary policy has never been more exciting. Central Banks had to become more and more innovative in dealing with the consequences of the crisis. This episode has also encouraged the policymakers to think out of the box and search for alternative approaches. There seems to be no going back to plain, old boring days soon.

An Alternative Approach

Now, let me turn to the main theme of this session. Given the changing view of central banking across the globe, what are the options for the central banks of emerging economies to deal with adverse consequences of excessive volatility in capital flows?

Emerging markets have adopted many different tools to deal with adverse consequences of capital flow volatility such as capital controls, macroprudential tools etc… The content and effectiveness of these tools were discussed extensively in many studies. For example, IMF published comprehensive surveys on this topic. I will not repeat these arguments here. Instead, I will be rather controversial (and perhaps provoking) to propose an alternative tool to deal with the adverse consequences of the volatile capital flows. Why not use the degree of policy predictability as an additional tool? The prescription is quite simple: Lean against the wind; counterbalance the flow of capital by changing the degree of predictability of the short term policy rates. During times of strong capital inflows, lower policy predictability. During periods of low risk appetite and weak capital inflows, increase policy predictability. This setup introduces an additional channel to cope with capital flows, which we sometimes call as “Risk Channel of Monetary Policy”.

Central Bank of Turkey has been implementing such a policy during the past 1.5 years. We have created more volatility (and less predictability) in interest rates when capital inflows accelerated and vice versa. The degree of predictability is mainly controlled via an interest rate corridor. The width of the corridor is used to control the degree of policy predictability. In this system, the effective central bank funding rate can be set anywhere within the corridor by using daily liquidity management tools. The policy stance can be adjusted even on a daily basis, without waiting for the next formal monetary policy committee meeting. Moreover, central bank communication is also used as a supplementary tool to change the degree of predictability.

Risk Channel of Monetary Policy: An Example

Let me provide an example in order to help better understand how this mechanism can ease some of the policy tradeoffs. Suppose capital inflows towards emerging markets surge due to heightened risk appetite (“risk on” mode) fueled by quantitative easing in advanced economies. Under a fully predictable policy framework (such as conventional inflation targeting) this will possibly lead to rapid credit growth and excessive appreciation of the local currency, feeding into macroeconomic imbalances.

On the other hand, these trade-offs may be relaxed considerably when the central bank uses the degree of predictability in short term rates as an additional tool. For example, during periods of accelerating capital inflows, introducing some interest rate volatility may help through two channels: First, financial intermediaries price interest rate risk in setting their loan rates, which creates an additional spread on lending-deposit rates, dampening the credit growth. Second, higher policy uncertainty, *ceteris paribus*, discourages short term capital inflows, containing the extent of exchange rate appreciation. Therefore, by decreasing the degree of policy predictability, central bank is able to avoid the build-up of some of the macro imbalances.

Of course, this strategy may not be the first best solution. The first best would be removing all the frictions in the global financial system and implementing full coordination among all relevant parties within and across countries. However, this does not seem to be possible under the current structure of the international monetary system. Imperfections and externalities will always be with us. Therefore, introducing some form of intermediation cost might be welfare improving. In fact, introducing policy uncertainty is very similar to implementing a time varying cost on the return to capital, which varies due to the degree of policy predictability. In that sense, changing the degree of policy predictability can be interpreted as some sort of a capital flow management tool, but a much more flexible one. Given the prevailing uncertainties regarding global economy, we believe having this flexibility is incredibly valuable. Moreover, imperfect predictability may mitigate the adverse consequences of the risk taking channel and hence may contribute to financial stability.

Concluding Remarks

Needless to say, it is too early to assess the full impact of these innovative policies. The theory is still way behind to offer us satisfactory guidance in dealing with the new policy challenges we face. Therefore we should not shy away from redesigning our own policy frameworks; but at the same time we should be very careful in not deviating from first principles, also taking into account country-specific conditions.

Last but not least: I would like to underscore that central bank actions (even the most creative ones) can only save us some time; they cannot be substitutes for sound structural policies that would increase the resilience of the economies against global imbalances.