

What Kind of International Financial Architecture for the Next Decade?¹

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The issue we have been called to address in this concluding panel is how we see the unfolding of the international financial architecture over the next decade, and specifically whether we see the global financial system pushing forward into increased interconnectedness, or we are more likely to witness a fragmentation through limits on capital movements. This is a very broad topic, and thus by necessity and in the interest of time I will focus my remarks on a set of specific points. I want to argue that the discussion regarding the direction where the international monetary system will evolve is not separable from the scenarios we deem the most likely for global interest rates.

For this purpose I will first lay out a few aspects that underlie how we can think about global interest rates scenarios going forward, related to saving and investment perspectives and the exit from quantitative easing in the United States. Then, I will move to discuss the implications or spillovers for small open economies and the trade-offs from the choice they may make regarding their degrees of integration with the world economy. I will look into the recent experience of emerging economies facing the tapering volatility, and whether their performance has been affected by their degree of financial integration. These are broad strokes on issues that require careful research and consideration, and as I will state at the end many uncertainties will continue to nag us.

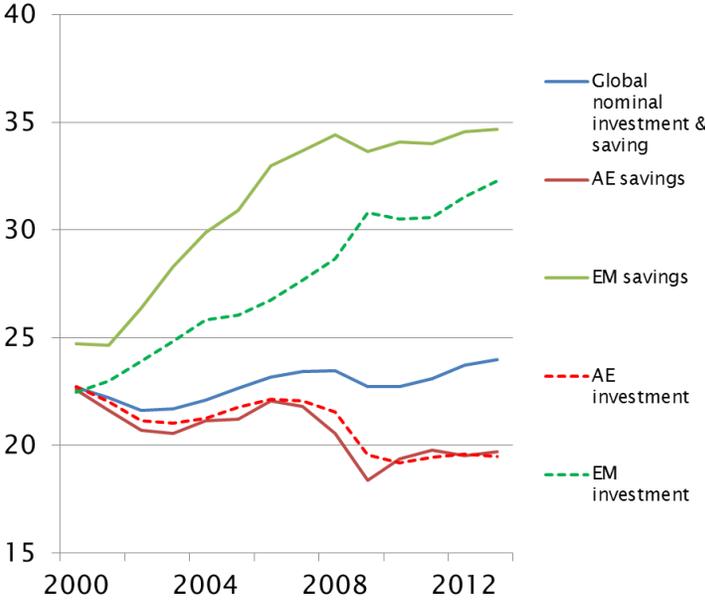
Perspectives for international interest rates

First of all, we need to take stock of recent developments in global interest rates, and assess to the best of our insight what can we expect going forward. The past decade has witnessed a dramatic fall in risk free, short and long term, interest rates of reserve currency financial instruments. Greenspan's conundrum, with an inverted yield curve, was followed by the financial crisis and recession of 2008 and 2009, and policy rates in the major economic zones hit rock bottom. Even though some economic recovery is taking hold, major central banks have been adamant that policy will remain loose until sustained growth can be assured.

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As we have been asked to take a longer-term view, it is necessary to take a fundamentals-based view on the perspectives of real interest rates going forward. This will in the end underpin whatever monetary policy actions are taken. As expected, this implies that we need to take a look at the perspectives for saving and investment. The IMF has done an outstanding job discussing this issue,² and I will use that analysis as reference here. Figure 1 presents the evolution of saving and investment rates in Advanced (AE) and Emerging (EM) economies since 2000. Although they have followed differing trends, overall global savings and investment has trended upwards. The fact that interest rates have also come down over this period is suggestive that the upswing in the global savings rate has been driven by increases in savings, likely in EMs, that have pushed interest rates lower. The IMF's results also support the (expected) finding that savings are less sensitive to interest rates than investment, and this also suggests that shifts in savings rates have been the determinant feature of real interest rate dynamics.

Figure 1 – Global saving and investment trends (as % of nominal GDP)



Source: IMF (2014)

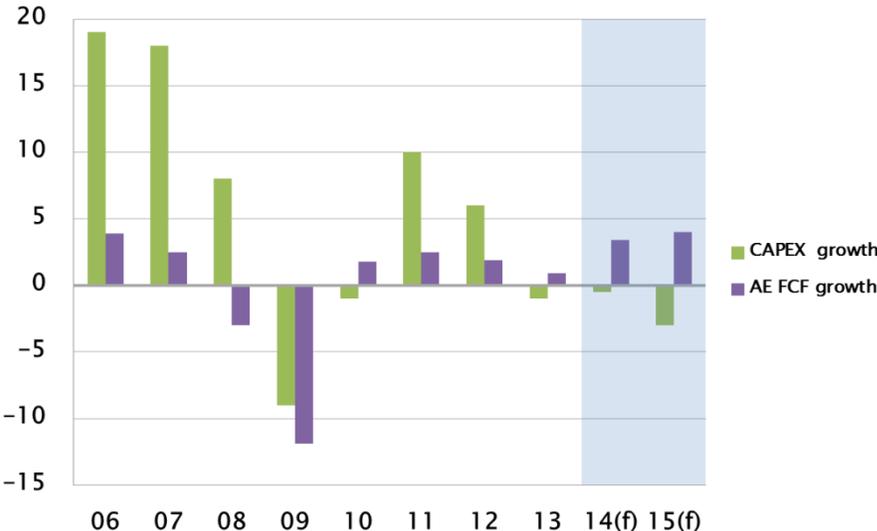
What can we expect for the near future? The IMF concludes that we should see a moderate increase in interest rates, driven mostly by the fact that lower growth will bring down savings rates in EMs. Indeed, not much can be expected in the drivers of investment, as the recovery from the

² See IMF (2014).

slump in AEs is likely to be moderate, whereas the rebalancing towards consumption, mostly in China, should also cap the growth of capital formation there. This scenario is however likely to be optimistic on the scope for higher interest rates. On the one hand, we need to see anyway some degree of autonomous pick up in investment rates that can then foster an underlying shift upwards in real returns. However, corporate capital expenditures do not show a very promising panorama going forward, and they diverge markedly from the IMF's expected fixed capital formation in AEs, as shown in Figure 2. On the other hand, the reliance on slower growth to drive down savings must also take into consideration the impact that lower expected aggregate growth might have on corporate profitability, some of which might be already at play in the CAPEX trends.

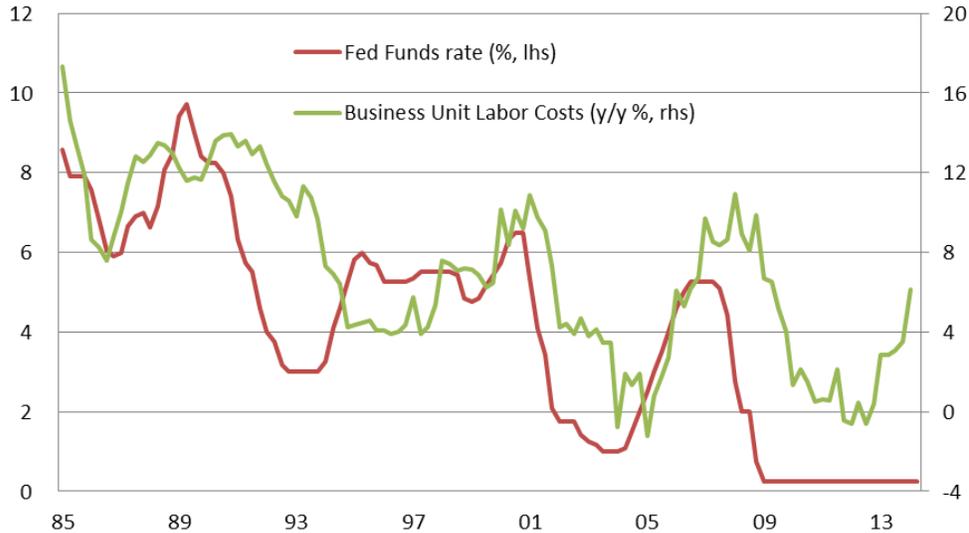
Thus, from a savings and investment perspective, it is not obvious to derive scenarios of much higher real interest rates ahead. This stands somewhat in contrast with the observation that at the current juncture, risks are seemingly tilted upwards, as 2015 approaches and the Federal Reserve is expected to start raising interest rates. The overall macroeconomic context in the U.S. surely supports this scenario, given that slack in the labor market has gradually gone down, disinflationary pressures abate, and growth approaches trend. Some observers have even suggested that the Fed's implicit scenario might be too dovish, because underlying inflationary pressures have built up to a sufficient degree to make a more rapid exit from the zero lower bound the most likely scenario. This view is supported by developments such as the ones presented in Figure 3.

Figure 2 – Growth in non-financial corporate CAPEX and AE fixed capital formation (%)



Source: IMF (2014), Standard & Poor (2014).

Figure 3 – Fed funds rate and unit labor costs



Source: Haver analytics.

Spillovers from interest rate scenarios

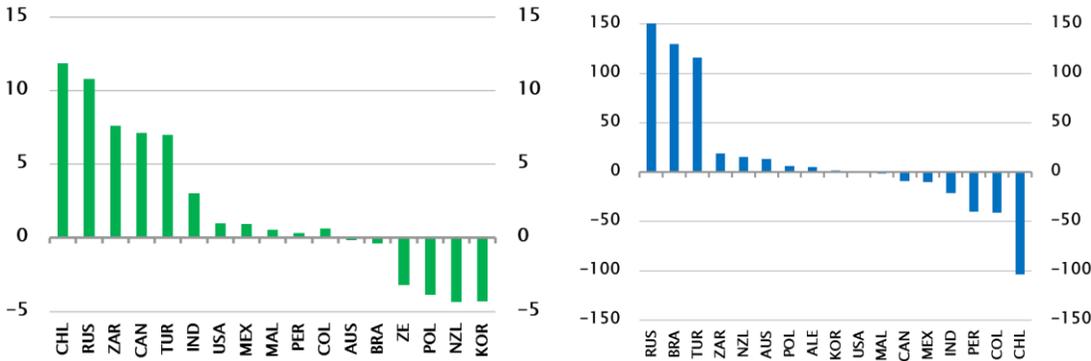
The implications for EMs of a scenario of faster exit by the U.S. will depend, according to standard macroeconomic arguments, on the balance between direct trade linkages with the U.S. and the specific financial exposure to higher interest rates. Thus, as growth in the U.S. should bolster growth globally, and if higher interest rates are required, then this is in the sense of preventing overheating and maintaining both price and financial stability. As the dollar strengthens, thanks to better growth perspectives and tighter monetary policy, EMs can in principle calibrate their monetary policies so as to confront the differing impact of higher international interest rates coupled with higher growth.

Although in principle this can provide a useful benchmark for designing the appropriate policy response, in practice one needs to consider at least two additional dimensions. Firstly, the scope for monetary policy accommodation in EMs might be limited if, for instance, inflationary pressures are already higher than desirable or if balance sheet exposures to foreign exchange risk limit the scope to accept depreciation. Secondly, a faster pace of growth in the U.S. would surely not occur in isolation, but rather in the overall context of global rebalancing of demand, for instance due to structural reforms and/or unconventional monetary policy measures in the Eurozone and Japan, as well as domestic rebalancing in China. The confluence of all these developments presents non-obvious challenges for small open economies that have diversified trade and financial relations.

Although it is not possible to derive specific scenarios for interest rates and exchange rates across economies, we can take a look at the experience so far during the period of volatility associated

with the tapering by the Federal Reserve. Figure 4 shows the evolution between November 2013 and April 2014 of nominal exchange rates and interest rates. It is apparent that economies have not gone through a one-size-fits-all process of adjustment. Whereas some economies experienced significant depreciations of their exchange rates and tighter nominal interest rates, others were able to engage in looser monetary conditions to accommodate the weakening of their currencies. Yet another group of economies actually experienced some appreciations over this period.

Figure 4 - Nominal exchange rate depreciations (left) and long term interest rate changes (right)

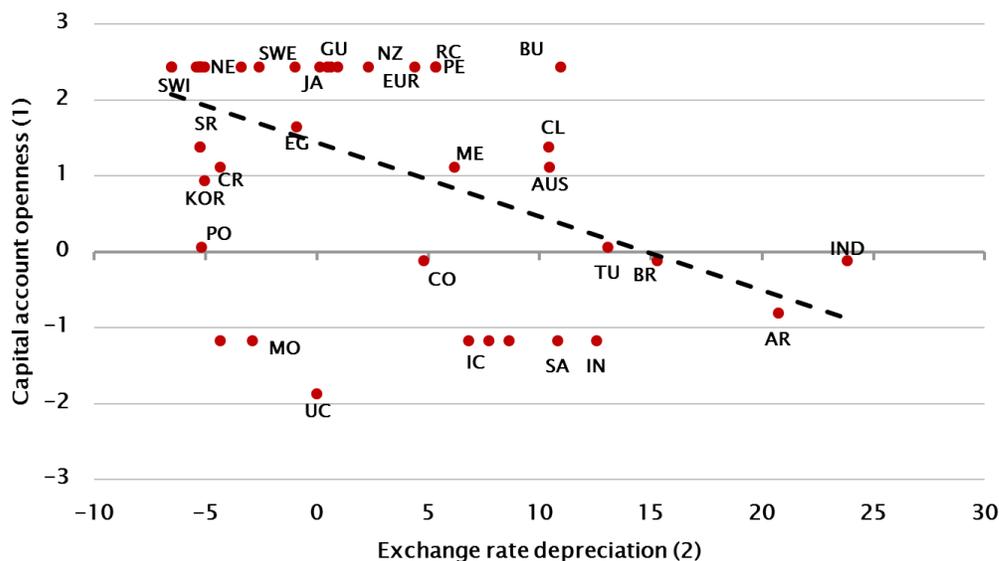


Source: Bloomberg.

The heterogeneity in the way economies have adjusted to the last year or so of financial volatility is suggestive that going forward there is also likely to be significant differences, as the focus will remain on the lingering uncertainty regarding the actual path of international interest rates. Expectations on global interest rate developments will be pushed back and forth between the long-term determinants of saving and investment rates, global rebalancing, and the short-term monetary policy conditions.

Coming back to the original question we were asked to address in this panel, we can also take a look at whether the degree of financial integration has affected the overall responsiveness of exchange rates to the volatility during the tapering period. Figure 5 plots the magnitude of the exchange rate depreciation in selected economies between May and December 2013, with the degree of capital account openness of these economies as of 2011, measured by the Chinn-Ito index. There is a clear negative association, implying that those economies that had a relatively more closed capital account in 2011 did not experience smaller exchange rate depreciations.

Figure 5 – Nominal exchange rate depreciations and capital account openness



(1) Measured by the Chinn–Ito Index as of 2011. A higher value indicates a more open capital account.

(2) Nominal exchange rate depreciation vis-à-vis the US dollar between May and December 2013.

Sources: Bloomberg, Chinn, M. and H. Ito (2006)

The latter unconditional association can hide country-specific characteristics, so Table 1 shows the results of regressing the exchange rate depreciation from May to December 2013 and a number of variables that aim to capture the initial state of each economy. The result that economies with closer capital accounts experienced significantly larger nominal depreciations during 2013 remains valid. This result is also economically significant. The range of variation of the capital account measure and the estimated coefficient imply that a completely closed and a completely open capital account implied around a 7% larger exchange rate depreciation. Moreover, this result does not take away from the effect of higher inflation or expected growth on the exchange rate, which remains highly significant.

A number of hypotheses could be mustered to explain the result apparent in Figure 5. Maybe economies that are more sensitive to external financial volatility are precisely those that attempt to shield themselves by closing their capital account. Maybe closing the capital account is an indirect indicator of higher policy discretion, thus making the economy more exposed to external shocks. Maybe economies that succeed in developing their domestic financial markets are then able to open the capital account, along traditional reform sequencing arguments. One needs also to take into account the counterfactuals, as maybe a more open capital account would have led to even larger depreciations. Whatever the case might be, it is striking that having a more closed

capital account, at least in this simple exercise, does not correlate with enhanced robustness at least in preventing exchange rate depreciations.

Table 1 – Determinants of nominal exchange rate depreciation, May–December 2013

	Δ ER (1)	Δ ER (1)
Curr. account deficit (2)	0.085	0.141
Inflation rate (3)	1.351 ***	1.364 ***
Expected GDP growth (4)	1.877 ***	1.489 **
Sovereign CDS spreads	-0.003	-0.007
Ratio of government debt to GDP (5)	-0.100	-0.008
Chinn - Ito 2011 (6)		-1.249 **
Number of observations	38	38
R2 (%)	46.3	50.5

***/**/* denotes significance at the 1/5/10%.

(1) Dependent variable: percentage change in the nominal exchange rate between May and December 2013 (local currency units per US dollar)

(2) As a percentage of GDP, 2012.

(3) Percentage change year to year in the CPI 2012.

(4) IMF, WEO growth forecast for 2013.

(5) General government gross debt as a percentage of GDP 2012.

(6) Chinn-Ito Index, from Chinn and Ito (2006).

Some concluding thoughts

Whether the global economy evolves in the future towards fragmentation or increased integration will likely depend on how successfully we manage to sail through the period of withdrawal from ultra-low interest rates. On the one hand, I have no illusions that if over 2015 and 2016 we see yet another wave of financial turmoil and instability across the emerging economies the discussion will continue unabated. The relative performance of economies that have chosen different paths will come under careful scrutiny, to assess the relative merits of different degrees of management of the capital account. In any case, it is difficult for me to think that small open economies can benefit significantly from policy frameworks that depend on discretion regarding their degree of financial integration.

A more disturbing scenario would occur if we see, yet again, financial instability in a large scale develop in the main financial centers. This would not only create significant economic and financial damage across the world, and put into question the capacity of policy makers and regulators in the main economic areas, but would create a significant pushback against financial intermediation in general. In this scenario, financial globalization would be one of many casualties, but probably not the most important.

References

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