Credibility of Emerging Markets, Foreign Investors' Risk Perceptions, and Capital Flows: an Overview

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Since the work of economist Carlos F. Diaz-Alejandro in the early 1980s, it is well known that emerging market economies (EMEs) are constantly impacted by shocks that emanate from world capital markets, posing many challenges for policymakers in these economies. Examples range from the debt crisis in the 1980s and the Asian and Russian crises of the late 1990s—both having as epicenter EMEs—, to the Global Financial Crisis (GFC) that originated in the United States and, more recently, the Covid-19 crisis and the inflationary consequences of the recovery amid raising interest rates in advanced economies (AEs).

Throughout these nearly half century of increasing financial and trade integration by EMEs with the rest of the world, several lessons have been learned in terms of the ways in which these shocks propagate as well as the various tradeoffs of the policy responses available. The role of credibility is central when dealing with international capital markets. Most EMEs have been able to gradually improve along these dimensions by enhancing their monetary and fiscal frameworks. The role of unconventional policies has also begun taking a predominant role.

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Initially implemented by EMEs in the 1990s, unconventional policies took center stage at the onset of the GFC. They proved to be very effective also during Covid-19 across both AEs and EMEs.

In parallel to these developments, academic research has helped guide policymakers in navigating these challenges. Such growing body of research has documented how international capital market frictions have become markedly more prominent together with the dollar dominance, despite the larger share of EMEs in the world economy, with sharp implications for the conduct of monetary and exchange rate policies. The legacy of the GFC also led many to study the factors that trigger sovereign default crises and what policymakers can do to prevent them or at least mitigate their macro impact.

Despite the prominence of stabilization policies, it is important not to lose sight of long-term growth and its determinants. There has been much progress in advancing economic and social indicators in EMEs. However, there is still lots of ground to cover, and a possible stagnation or even a reversal of the achievements made thus far—as the data seems to indicate—is something that ought to be in every policymaker's radar, no matter how relevant the short-run stabilization concerns are. Surely, a stable macroeconomic environment is a necessary—but not sufficient—condition for growth. Understanding the long-term determinants of capital flows is a must. Likewise, a good understanding of the process of globalization at the corporate level and its ramifications for the transfer of knowledge is key.

It is with these considerations that the volume is divided into two blocks of papers. A first block gathers works aimed at understanding the array of challenges and policy options for EMEs' policymakers for short-run stabilization purposes. A second block deals with longer term issues that should be in EME's policymakers' radars, along the lines mentioned above.

The first block begins with the chapter **The International Financial System after Covid-19**, by Maurice Obstfeld. The author points out that, once again, the world economy appeared on the brink of collapse—until it was pulled back by monetary and fiscal interventions that outstripped even those of the 2008–2009 GFC. The Covid-19 crisis originated in a totally different type of shock—one coming exogenously from outside the financial system rather than from within—, and it provided a kind of stress test for the amended international financial system. But a collapse in 2020 was averted only thanks to unprecedented policy support, previously unthinkable in magnitude and scope, which would be rash to rely on for the future.

The paper reviews the evolution of global financial markets since the GFC, changes in academic thinking about the domestic impacts of these markets, the strains seen during the Covid-19 crisis, and perils that may lie ahead. A key theme is that stability will be enhanced if the global community embraces reforms that elevate market resilience, rather than depending on skillful policymakers wielding aggressive but ad hoc policy interventions to come to the rescue again.

In the second chapter, titled **Exchange Rate Puzzles and Policies**, Oleg Itskhoki and Dmitry Mukhin zoom in on the problem of designing optimal exchange rate regimes, providing a fresh look at the long-standing debate of benefits and costs of pegged vs managed or free-floating regimes. Indeed, a perennial question in the mind of EMEs' practitioners relates to the extent to which their economies face a trilemma constraint in choosing between inflation and exchange rate stabilization, unlike the divine coincidence observed in closed economies. The authors address these questions by developing a general equilibrium policy analysis framework with nominal rigidities and financial frictions that are both central for equilibrium exchange rate determination and result in an empirically realistic model of exchange rates. Building on their earlier work, the new model is consistent with the exchange rate disconnect properties across floating and fixed regimes allowing for explicit policy analysis, using both monetary policy and foreign exchange (FX) interventions in the financial market. The model features a Balassa-Samuelson mechanism determining the value of the frictionless real exchange rate (departures from purchasing power parity, PPP) and segmented financial markets resulting in endogenous equilibrium, and Uncovered Interest Rate Parity (UIP) deviations. The presence of both endogenous PPP and UIP deviations is essential for the optimal exchange rate policy analysis, as exchange rate variation is at the core of both deviations. A key takeaway is that, within this environment, FX interventions surface as a valuable stabilization tool against the costly UIP deviations.

The third chapter, on **International Risk Spillovers: Implications for Emerging Markets' Monetary Policy Frameworks with an Application to Chile**, by Şebnem Kalemli-Özcan looks closely at international risk spillovers to EMEs and their implications for the design of their monetary policy frameworks. Among the factors behind international spillovers, U.S. monetary policy developments retain a major influence. Such developments drive the global financial cycle and shape global investors' risk perceptions. Drawing from her earlier work, she shows that the transmission

mechanism for monetary policy spillovers to emerging market economies rests on the effect of U.S. monetary policy on investors' risk sentiments, as those sentiments are more volatile in the case of EMEs, and that capital flows to emerging markets are particularly "risk-sensitive," creating a challenge unique to the EME policymakers and their monetary policy frameworks. A clear policy advise follows: EME policymakers should smooth out this risk sensitivity by deciding not to use monetary policy rates but other policy tools instead. A good barometer of this risk sensitivity is the UIP risk premia and, if EME policymakers use policy rate to respond to U.S. monetary policy changes, the UIP risk premia increase further. The case for flexible exchange rates is stronger under international risk spillovers, since floating exchange rates help to smooth out the UIP risk premia, thus freeing domestic monetary policy's hand to focus on inflation targeting and output stabilization. Countries may want to limit exchange-rate volatility because of the negative effects of excessive volatility on balance sheets due to extensive debt denominated in foreign currency and/or a high degree of passthrough of currency depreciations to inflation. For "fear of floating" linked to foreign-currency debt, countries can limit the extent of foreign-currency debt by using countercyclical prudential policies. Macroprudential and capital-flow management policies can be used countercyclically in a transitory way, to limit unhedged foreign-currency-denominated liabilities not only in the financial sector, as typically done, but also in the nonfinancial corporate sector.

The fourth chapter, on **Global Drivers and Macroeconomic Volatility in EMEs: A Dynamic-Factor, General-Equilibrium Perspective**, by Gent Bajraj, Andrés Fernández, Miguel Fuentes, Benjamín García, Jorge Lorca, Manuel Paillacar, and Juan Marcos Wlasiuk complements this strand of literature by exploring the nature of the global forces that impact EMEs as well as their transmission mechanism. Motivated by various influential works in the literature, they consider a wide array of forces and their interlinkages, from a global financial cycle to fluctuations in commodity prices and a common growth factor. One interesting finding of their work is the preponderance of the financial factor affecting the other two. It is also noteworthy that jointly, the three factors account for more than a third of the variance in GDP in a pool of 12 EMEs. Then, to better understand how these global forces are transmitted into EMEs, they zoom in on Chile and augment a large-scale DSGE regularly used for policy analysis with the estimated global dynamic factor structure.

This allows them to document the general equilibrium channels through which shocks in these global factors are transmitted into the business cycle and, in turn, the policy challenges that they entail. Their findings indicate a preponderant role of global drivers for EMEs' business cycles, with a third of their macro variability being traced back to shocks in global dynamic factors. While the global financial cycle is a relevant force, a factor associated to global prices and commodities appears equally important, with a relatively modest role played by pure growth/productivity forces. Further, although some of the ensuing effects of shocks to the financial cycle offset each other, the opposite occurs when a shock to global prices materializes, calling for a more active monetary policy response.

In extreme cases global forces, combined with domestic factors, may drive EMEs to default on their debt. This is addressed in the fifth and last chapter of the fist block by Mark Aguiar, Manuel Amador, and Ricardo Alves Monteiro in **Sovereign-Debt Crises and Floating-Rate Bonds**, which looks at sovereign-debt crises and the policy options related to them. They argue that the choice of sovereign-debt maturity in countries at risk of default represents a complex set of competing forces. An interesting policy recommendation that the authors stress is that long-term bonds may be a useful tool for a government to hedge shocks to the cost of funds arising from business cycle fluctuations. They show that having a coupon on a long-term bond indexed to one-period-ahead default probabilities provides all the incentive properties of one-period bonds, without the vulnerability to rollover risk. In terms of implementation, the authors argue that such policy can be implemented by indexing the coupon to the auction price of a small amount of one-period bonds.

The second block, which deals with longer term issues, begins with the sixth chapter by John D. Burger, Francis E. Warnock, and Veronica Cacdac Warnock, entitled **KFstar and Portfolio Inflows: A Focus on Latin America**. Their work studies the natural level of capital flows, denoted by KF*, as a useful tool available to policymakers faced with volatile capital flows who may desire a method to identify the level of flows likely to persist in the medium run. KF* is a supply-side measure in that it is derived from the supply of rest-of-the-world savings, and it is computed by using lagged portfolio weights from portfolio liabilities data multiplied by current rest-of-the-world savings. In that sense, KF* is an easy-to-construct, slow-moving supply-side benchmark derived from the supply of rest-of-the-world savings approximating the level of flows to which they should converge over a medium-term horizon.

In an interesting application to Latin American portfolio inflows, the authors show how deviations from KF* help predict sudden stops in the region. Furthermore, they document the ability of KF* to act as an indicator of vulnerability in the face of global shocks. Case studies of the Global Financial Crisis (GFC), the post-GFC surge, and the Covid-19 pandemic each indicate that, for Latin American countries, KF* provides useful real-time information on the vulnerability of flows. Finally, they analyze the drivers of short-run deviations of flows from KF* and document interesting heterogeneity as flows to Brazil, Chile, and Mexico appear closely linked to the commodity prices, while flows to Argentina, Costa Rica, and Peru are linked to global risk tolerance.

Another source of medium-to low-frequency variability for various EMEs is the so-called "commodity supercycle". This is explored in the seventh chapter, entitled **How Important is the Commodity Supercycle?** by Andrés Fernández, Stephanie Schmitt-Grohé, and Martín Uribe, who identify global disturbances that cause regular cycles and supercycles in world commodity prices and estimate their contribution to aggregate fluctuations across many emerging and developed countries. The commodity price supercycle, which has a periodicity of 20 to 30 years, is identified as a common permanent (nonstationary) component in all commodity prices. An important advantage of the method applied in this work is that it allows for the joint estimation of transitory and permanent domestic and world disturbances affecting aggregate activity in individual countries. The authors show that the common permanent component explains on average across commodities between 67 and 91 percent of the forecast error variance of commodity prices at horizons between five and thirty years. Estimates using quarterly and annual data from 1960 to 2018 indicate that world shocks that affect commodity prices and the world interest rate are major drivers of aggregate fluctuations in developed and emerging small open economies, explaining more than half of the variance of output growth on average across countries. However, most of this contribution (i.e., more than two thirds) stems from stationary world shocks, even at forecasting horizons typically associated with the supercycle. These results suggest that world disturbances that are responsible for the commodity price supercycle did not play a dominant role in driving fluctuations in aggregate activity at the country level.

A potentially important driver of growth for most EMEs relates to the ability of firms and corporations to insert themselves into the world economy. This can happen through various channels, one of which is cross-border corporate control. A first step towards a better

understanding of this topic is done in the eighth chapter entitled **Cross-Border Corporate Control: Openness and Tax Havens** by Gur Aminadav, Luís Fonseca, and Elias Papaioannou, documenting some broad patterns, based on ongoing research of the drivers of the internationalization of corporate control. Until now, this has not been well-understood due to the esoteric corporate holding schemes and the complex network of equity holdings. By compiling new ownership data for almost 90 percent of the world market capitalization of listed firms in 2012, the authors provide a mapping of corporate control, zooming into the role of tax havens. Their descriptive analysis reveals considerable cross-country heterogeneity in the openness to foreign control and in the usage of tax-haven intermediate and controlling entities. Foreign control is more frequent in smaller and less developed countries, echoing the international trade and portfolio investment evidence. Residents and entities of richer countries exert a larger portion of their controlling equity stakes in firms abroad. The authors also detect that a sizable portion of controlling equity stakes is held by or via tax-haven-incorporated entities, particularly in lower-income economies. Tax-haven use is the highest in Eastern Europe (Bulgaria, Ukraine, Serbia, Latvia, Russia), Africa (Ghana, Nigeria, Ivory Coast), and some East Asian countries like Indonesia and Pakistan.

Completing the volume, the final chapter **The Reversal Problem: Development Going Backwards** by Eduardo Olaberria and Carmen M. Reinhart, identifies a setback in development for emerging and developing countries that appeared around half a decade earlier than the huge economic downturn triggered by the Covid-19 pandemic, which, on the other hand, deepened and accelerated the process. The authors argue that the turning point occurred around 2015, and it was marked by the sharpest decline in commodity prices since the early 1980s. They document these trends with an encompassing array of indicators, including poverty rates, inequality, human capital, and democratic values. Their analysis shows that the Reversal Problem is widespread in terms of geography, though more acute in Africa and other low-income regions. It is also encompassing in that it not only affects economic and social indicators but also has the potential to cause political instability both domestically and across borders, as these trends appear to coincide with a setback in democratic values. They conclude by arguing that, while the extent of the development Reversal Problem is not yet on the development reversals scale of 40 years ago, there are added new risks posed by climate change that will disproportionally harm emerging and developing economies.