The challenge of high capital inflows to financial stability: an emerging market perspective

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High liquidity and continued economic weakness in advanced economies have led to a surge in capital flows to emerging markets with strong fundamentals and open financial accounts such as Brazil. While capital inflows have undeniable benefits to emerging economies, they are also potentially destabilising. Past experience has shown that high levels of capital inflows can lead to exchange rate volatility and credit or asset price bubbles. In the context of Brazil's inflation-targeting regime for monetary policy, macroprudential measures have proved to be a useful complement to traditional macroeconomic policies. However, today's imbalanced global economy presents an especially difficult challenge for policymakers. The international financial community needs to work together on two fronts: improving our macroprudential toolkit and building a stronger framework for multilateral macroeconomic cooperation.

Continued economic weakness and the liquidity level in advanced economies have led to a substantial increase in the capital inflows to the emerging markets which have good fundamentals and open financial accounts. While capital inflows have undeniable benefits to emerging economies, they are also potentially destabilising. Historical evidence has shown that excessive levels of capital inflows can bring with them excessive exchange rate volatility, unacceptable credit risk taking and asset price bubbles. The challenge for Brazil and other emerging economies is to adopt policies that, in an environment of imbalanced global economies, allow those countries to keep the benefits of foreign investment while avoiding the problems that might be created by the excesses. The complex negotiations at the level of G20 for a rebalancing of the global economies and better coordination of macroeconomic policies mean that significant progress in this area is not a short term prospect.

In order to provide a better analysis of the challenges faced by emerging economies in this environment let´s take Brazil as an example. It has a floating exchange rate and open capital markets; and the Central Bank is building up foreign exchange reserves, within an inflation targeting framework. The sterilised Central Bank interventions in the foreign exchange (FX) markets aim to increase the resilience to FX outflows and to smooth exchange rate movements, rather than to influence the exchange rate trends. This framework has served the country well in the decade since it was introduced, as we have experienced higher economic growth and low inflation for most of the period, in spite of the international financial crisis of 2007-2008. The current global economic conditions present a challenge to this framework as a result of the surge in capital inflows.

Macroeconomic policy measures such as foreign exchange interventions and taxes on foreign investment are the standard first line of defense against excessive capital inflows. In this context macroprudential measures might become necessary. The first goal should be to protect the financial system from boom and bust cycles in foreign exchange, credit or asset markets. These policies are also instrumental in preventing bubbles in the first place. There is a self-reinforcing dynamic between capital inflows and asset prices distortions, in which foreign capital increases asset prices and the resulting returns attract yet even more capital. Therefore, a well-designed macroprudential policy should limit this feedback loop. Brazil has had a long history of macroeconomic instability, so we have learned not to be complacent about the risks to financial stability stemming from macroeconomic developments. Several aspects of our prudential framework were designed with these risks in mind. First, we set the minimum required level of capital at 11% of risk-weighted assets, instead of the 8% level established in the Basel II accord. Some amount of moral suasion has led the actual average capital level in the system to 17%. This provided our financial system institutions with an extra capital buffer to deal with systemic shocks. Second, the procyclical effect embedded in internal models for credit and market risk is not present, as the use of such models to determine capital requirements has to be approved by the supervisory authority. Additionally, we have in place a prudential rule that limits the cyclical behavior of banks, namely a provisioning rule that takes into account not only incurred losses, but also expected ones. Furthermore, the required bank reserves placed at the Central Bank in Brazil are set at a relatively high level, creating a deep pool of liquidity which is available when international liquidity dries up or in case of any other contingencies. The dual role of the Central Bank as the Monetary Authority and Supervisor of the financial institutions facilitates the timely and targeted use of the banks´ reserves.

Finally, our prudential regulation is in general conservative in its outlook; for example, there are limits for higher exposures in general and for foreign exchange exposures in particular. Over-the-counter derivatives trades must be registered in a clearing house, and only financial institutions can enter into credit derivatives trades. Finally, our on-site and off-site supervisions are a high priority and many features of our regulatory framework are already in line with Basel 3. These features provided an acceptable level of protection during the last financial crisis. They also provided substantial policy ammunition to counteract the main impact of the crisis on the Brazilian banking system: a near collapse of the cross border lines led to a domestic credit and liquidity crisis. This was addressed through a reduction in required bank reserves and the channeling of a portion of the funds to the smaller banks, which had been most affected by the crisis; an increase in the deposit insurance limit to 20 million reais for certain long-term deposits and the purchase of loan portfolios by the privately-financed deposit insurance fund. The recognition of excess provisions as Tier 1 capital was also instrumental. The Monetary Authority acted to restore foreign currency liquidity through the sale of dollars on spot and future markets and the use of the International Reserves to provide credit lines to replace the cross border loans. A strong recovery of the domestic credit markets and the return of ample domestic liquidity have allowed the winding down of almost all of these emergency measures at this point.

As the Brazilian economy has recovered, the Central Bank has raised the benchmark interest rate. As a result, the increased differential between the Brazilian gross domestic product growth and interest rates compared to those of developed economies have attracted the inflows. Not only portfolio and foreign direct investments but also carry trade have surged due to the optimism about the Brazilian economy. It should be noted, though, that the inflow related to direct investment has a relatively lower volatility. Overall, we are once again faced with the challenge of dealing with a wave of potentially volatile capital inflows, an appreciating exchange rate and a current account deficit. In response, the fiscal authorities have increased the tax on capital inflows for fixed-income investments from 2 to 6%. The Central Bank has increased the purchase of foreign exchange in the open market and also taken steps to limit excessive foreign exchange risk taking in derivatives. Finally it has implemented a substantial tightening of the loan-to-value rules.

Moving from our specific case back to the global situation, we believe that one lesson from the financial crisis is that there is a need to develop better policies to prevent global imbalances from threatening the financial stability. In our view, the policies we need to develop fall into two basic categories: first, we need to build a stronger framework for international macroeconomic cooperation. This framework should provide incentives for the avoidance of potential negative spillovers from national macroeconomic policies. When they occur it should be acknowledged that countries with responsible economic policy frameworks must respond to the eventual spillovers. Finally we strongly support the recent initiatives of the international community of financial supervisors to strengthen the prudential rules.