The International Financial System after COVID-19

Maurice Obstfeld
University of California, Berkeley
Peterson Institute for International Economics
NBER
CEPR

EGROW Foundation Webinar

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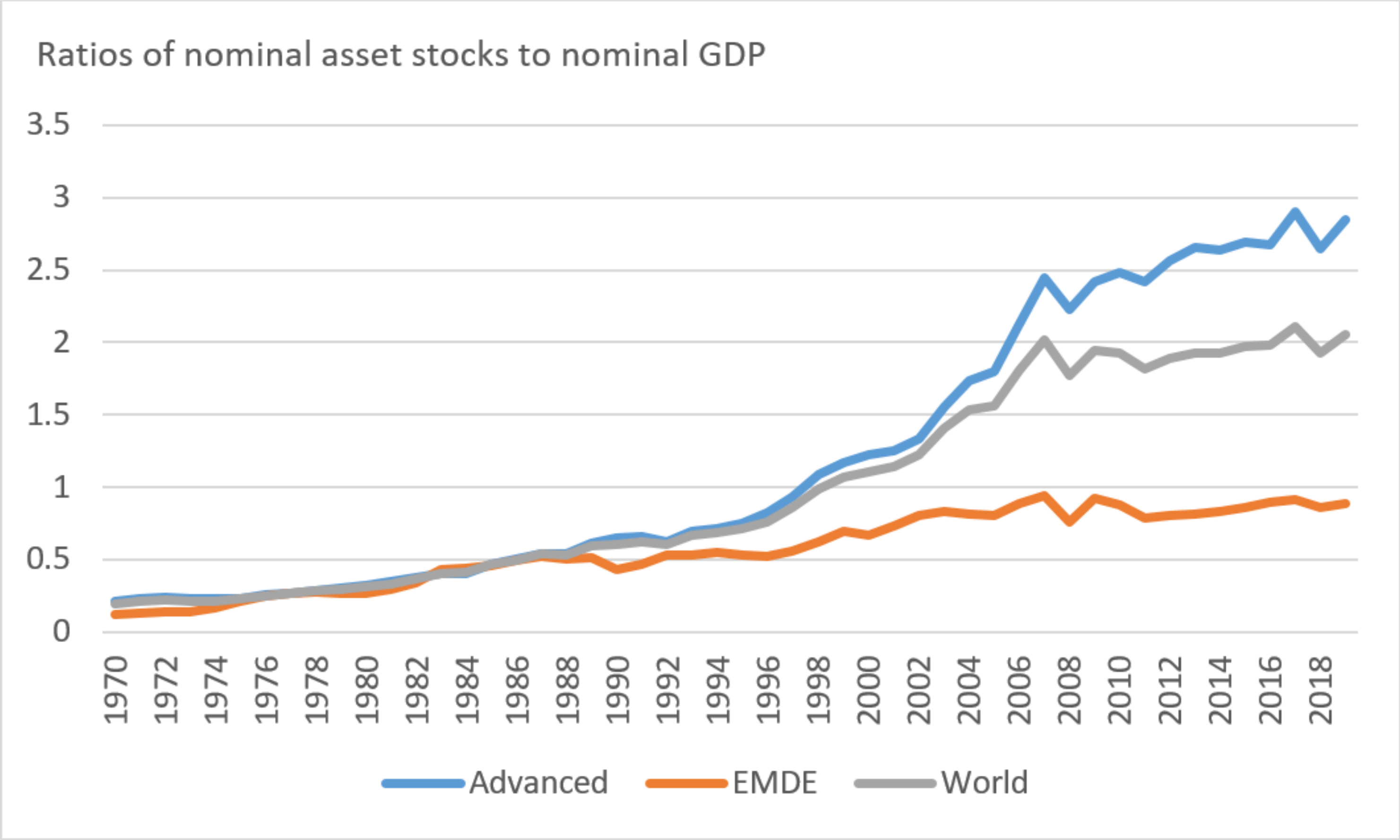
Outline

- The COVID-19 crisis began with a historic, global financial market convulsion
- Capital account volumes exploded to unprecedented levels
- Strong policy actions by advanced economies and countercyclical responses by EMDEs pulled the world back from the brink
- The global financial cycle is in an expansive phase, but it may turn when major central banks tighten
- EMDEs will be especially vulnerable to an uneven global rebound
- The world economy cannot remain reliant on exceptional policy action – financial market resilience badly needs strengthening

External positions: Slower growth since the GFC

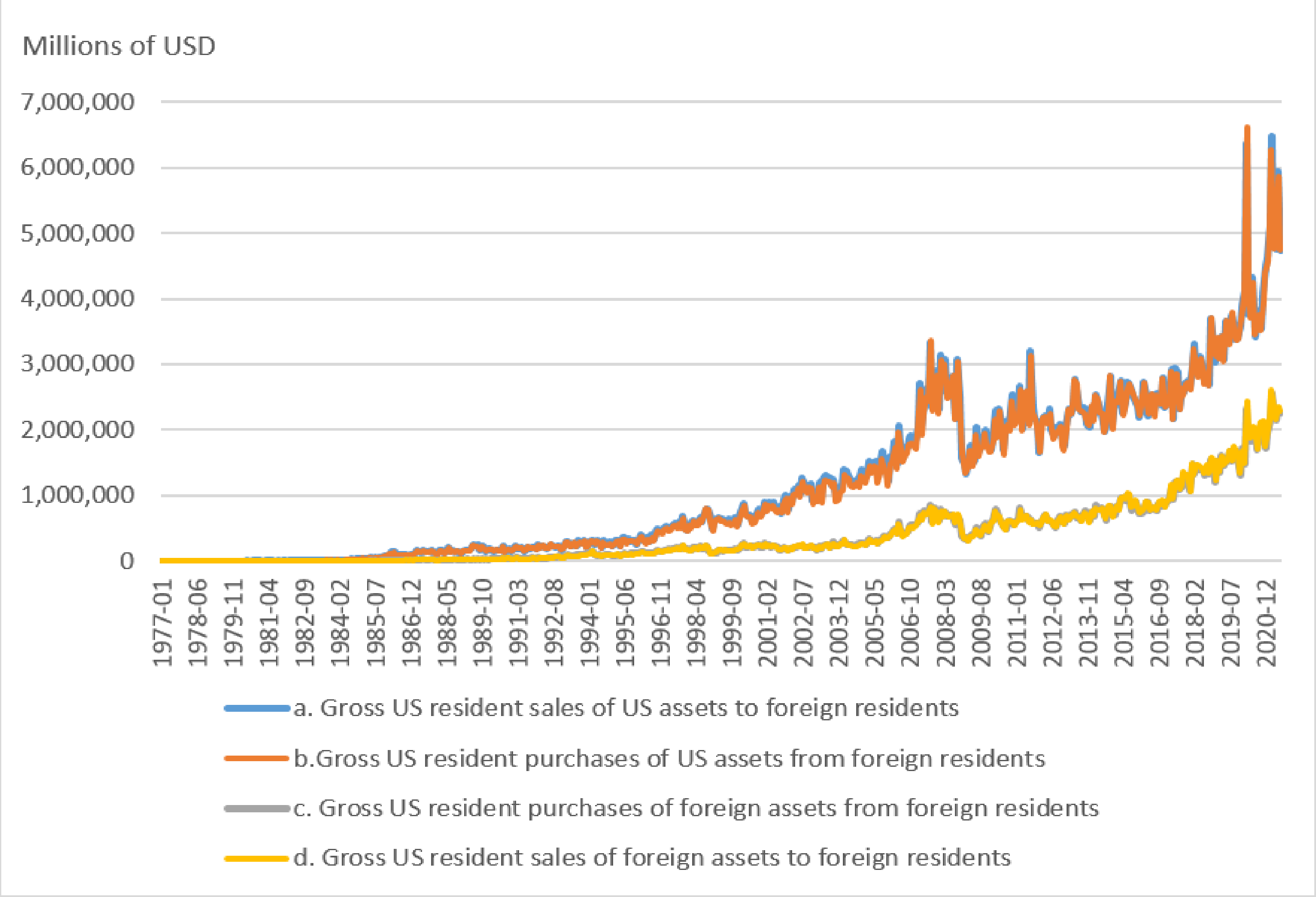
Ratios of external financial exposure to GDP for advanced economies and EMDEs, 1970-2019 (average of gross external assets and liabilities)



Source: Lane and Milesi-Ferretti data, updated by authors through 2019.

U.S. portfolio capital account transactions spiked

Gross U.S. resident monthly asset sales to and purchases from foreign residents



Source: U.S Treasury TIC data.

Key BoP concepts

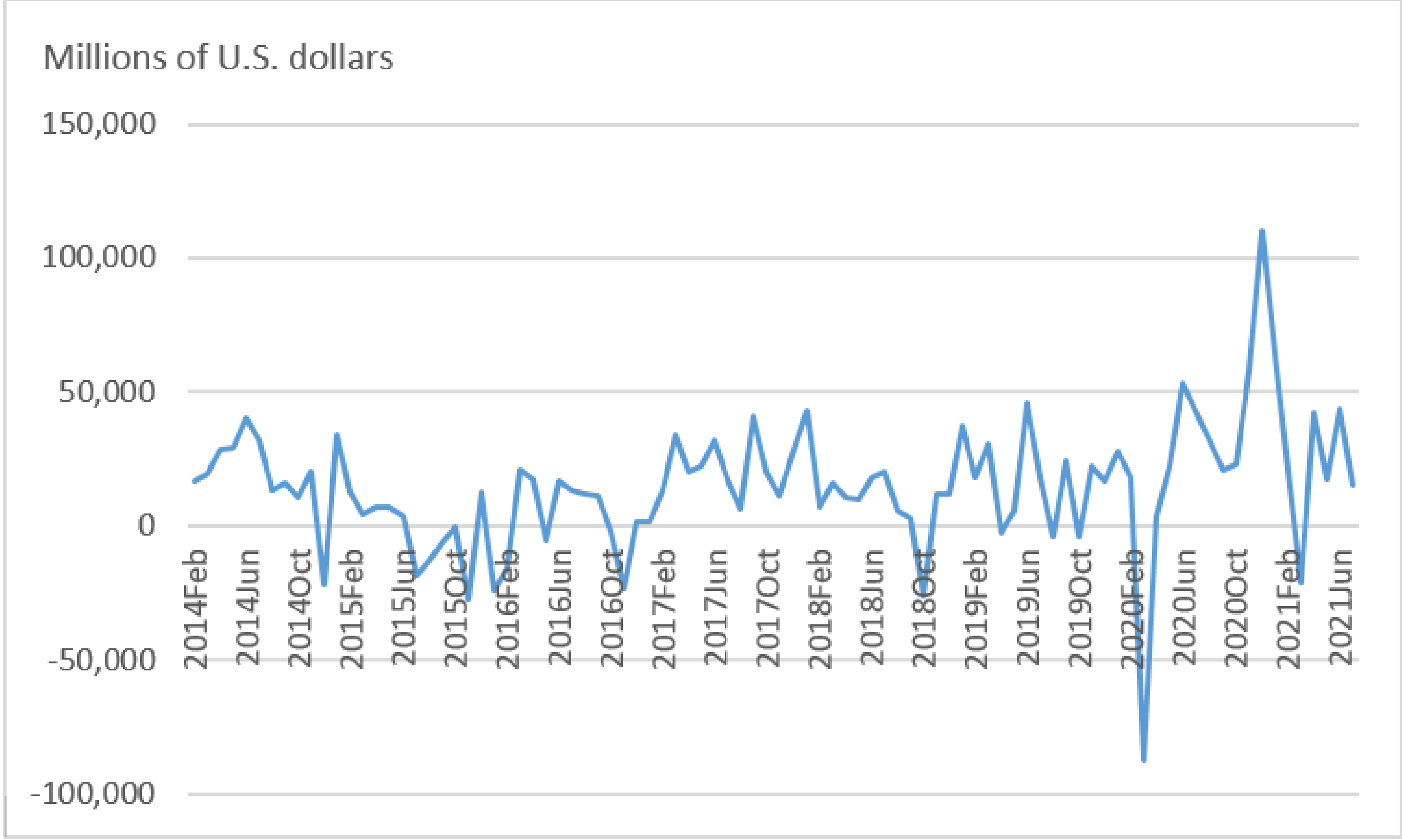
a – b = capital inflow

c – d = capital outflow

a – b – (c – d)
= a + d – (b + c)
= current account deficit

Flows to EMDEs reversed sharply in March 2020

Capital inflows to 26 emerging market economies, 2014-2021



Source: Data for a group of mostly middle-income countries assembled by Koepke and Paetzold (2020).

EMDE countries mounted unprecedented countercyclical policy responses

- Interest-rate cuts.
- QE purchases, mostly of sovereign debt, sometimes in close coordination with fiscal authorities – though not as extensive as in developed markets
- FX intervention
- Looser reserve requirements (including those discouraging capital inflows)
- Liquidity enhancing operations, encouraging bank loans to businesses
- Macro-prudential easing (e.g., relaxed capital requirements)
- Market function enhancements
- There were also fiscal responses – aided by low interest rates → fiscal space
- Some US measures helped (e.g., Fed FX swaps for a selected countries)

A pivot point for counties exposed to capital flows?

- The macro response to the COVID-19 represented a welcome countercyclical response – unlike often in the past
- Interest rates could be cut even as currencies depreciated – showing the value of exchange rate flexibility
- Aguilar and Cantú (2020), English et al. (2021), Céspedes and De Gregorio (2021) discuss – brave new world?
- But EMs started in a relatively strong cyclical position
- They were able to build on a recent track record of inflation credibility – as well as impressive growth in policymaker skill
- And they surfed on the wave of incredibly aggressive monetary and fiscal actions in advanced economies – with the former driving interest rates to very low levels, expected to persist

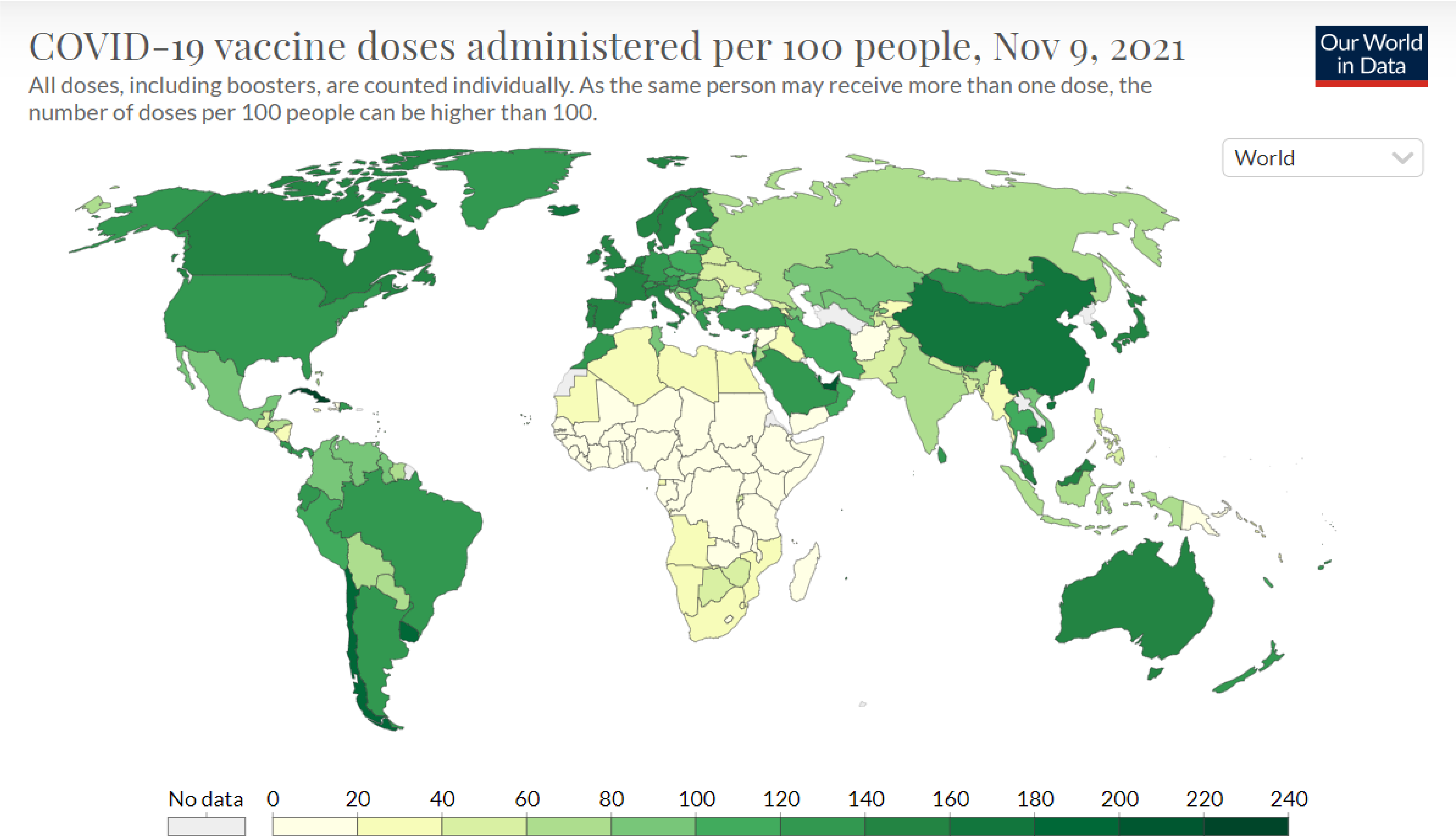
The pandemic has already stretched EMDE finances – scarring could worsen this over time

- Fiscal support of economies
- Health expenditures
- Revenues have fallen even as a share of GDP
- There will be more supply-chain driven inflation pressures

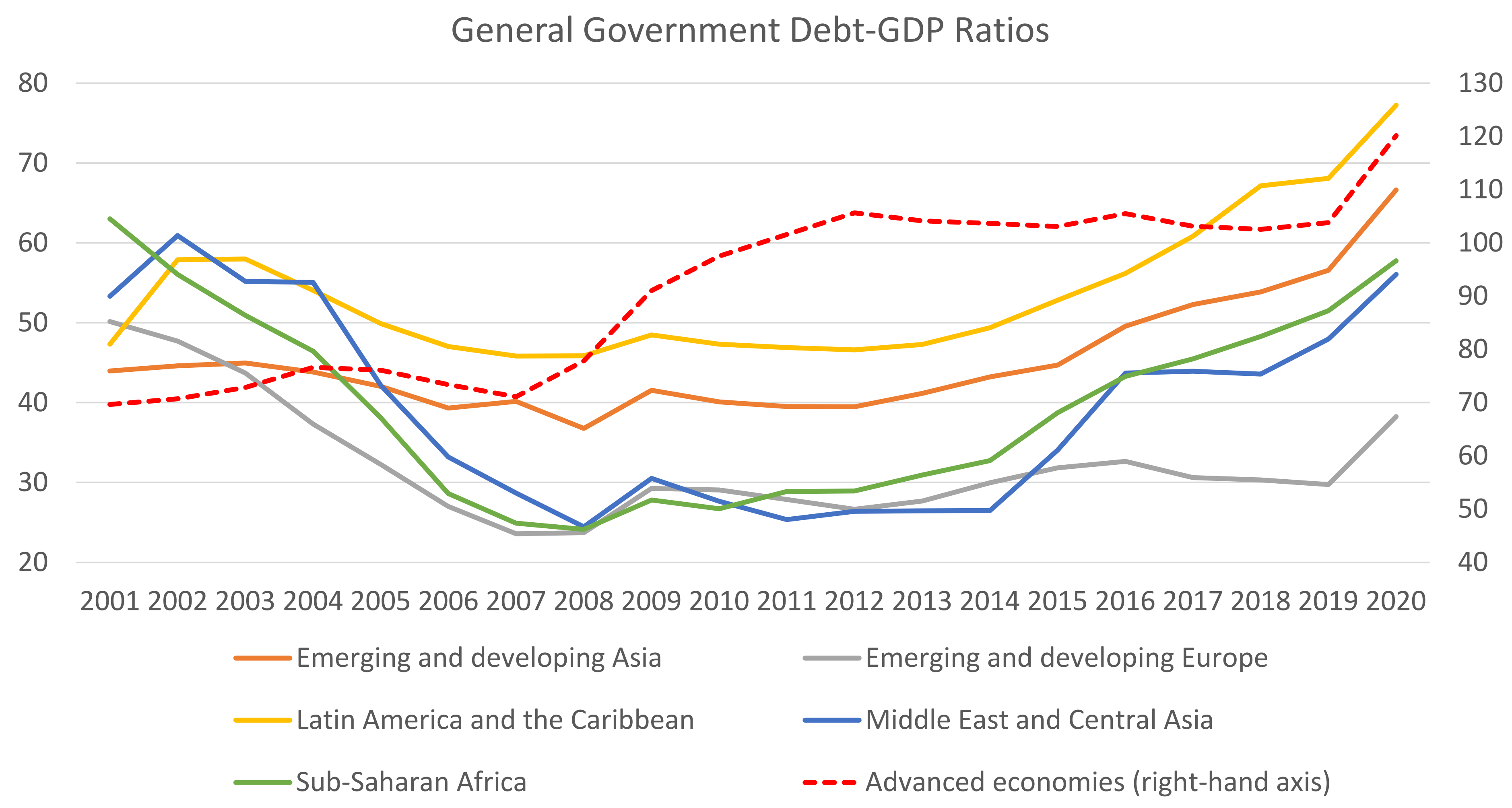
Latent financial stability risks may be higher

- Much government debt resides in EM banking systems (IMF, *GFSR*, April 2021)
- Credit easing measures during the crisis may confront EM authorities with harsher tradeoffs later if/when interest rates rise (IMF, *GFSR*, April 2021)
- The same could apply to macroprudential easing measures (Bergant and Forbes 2021)

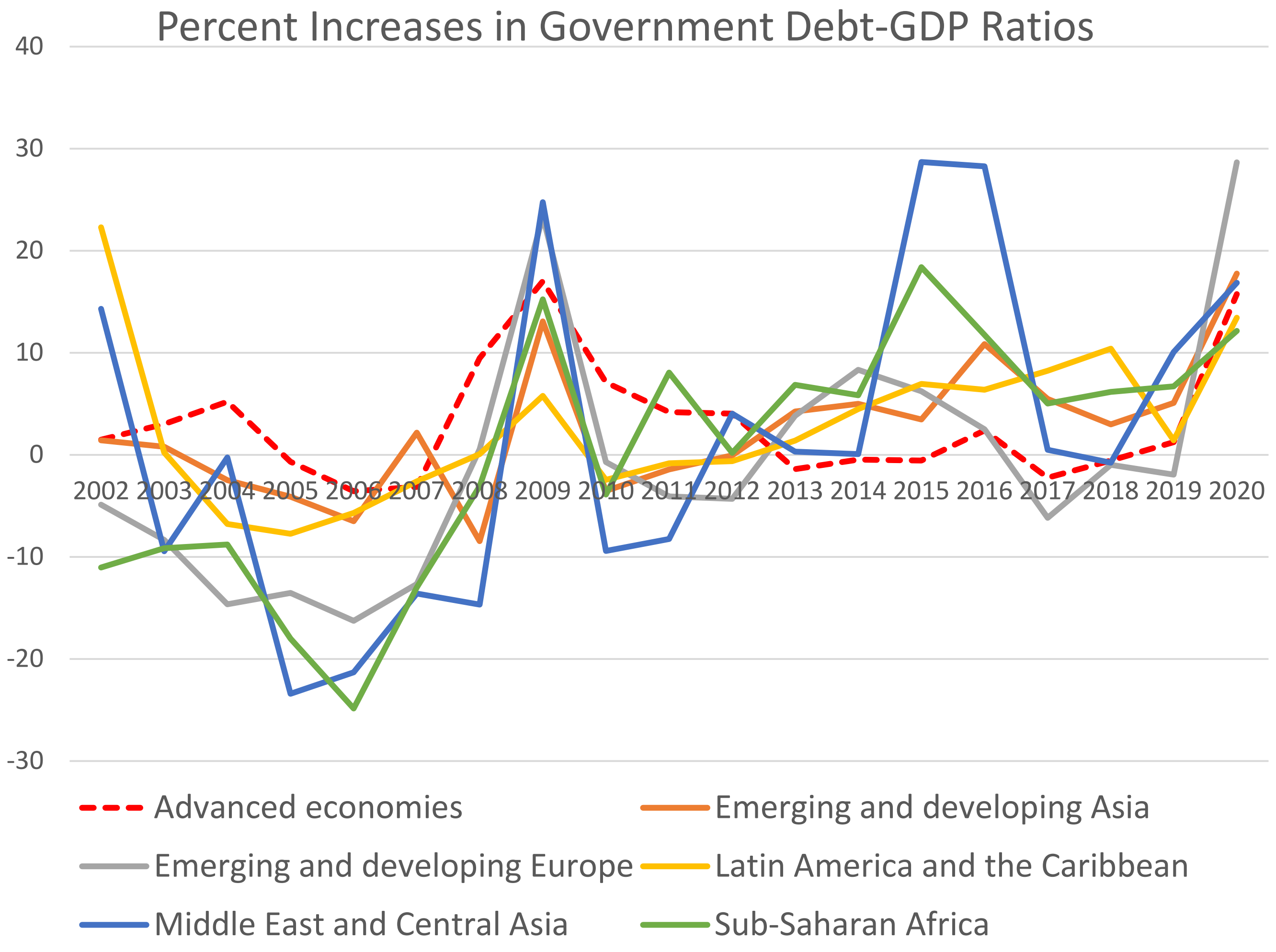
Uneven vaccine access and low fiscal space will magnify the unevenness of the global rebound



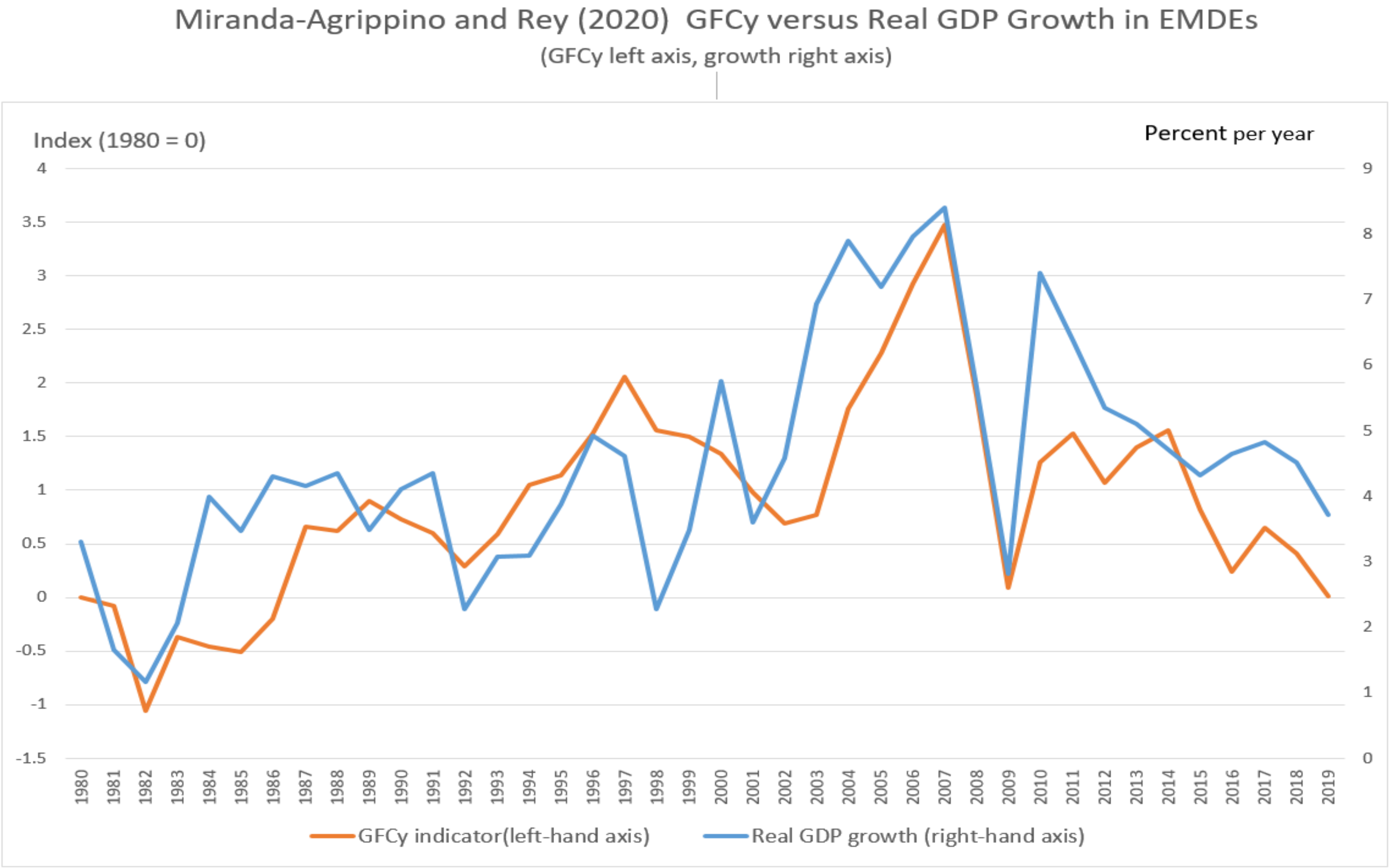
Public debt-GDP ratios rose everywhere in 2020 and for EMDEs, to unprecedented levels



Percent increases in EMDE debt-GDP ratios were comparable to those of advanced economies



The global financial cycle is a potent factor, linked to capital flow surges and stops

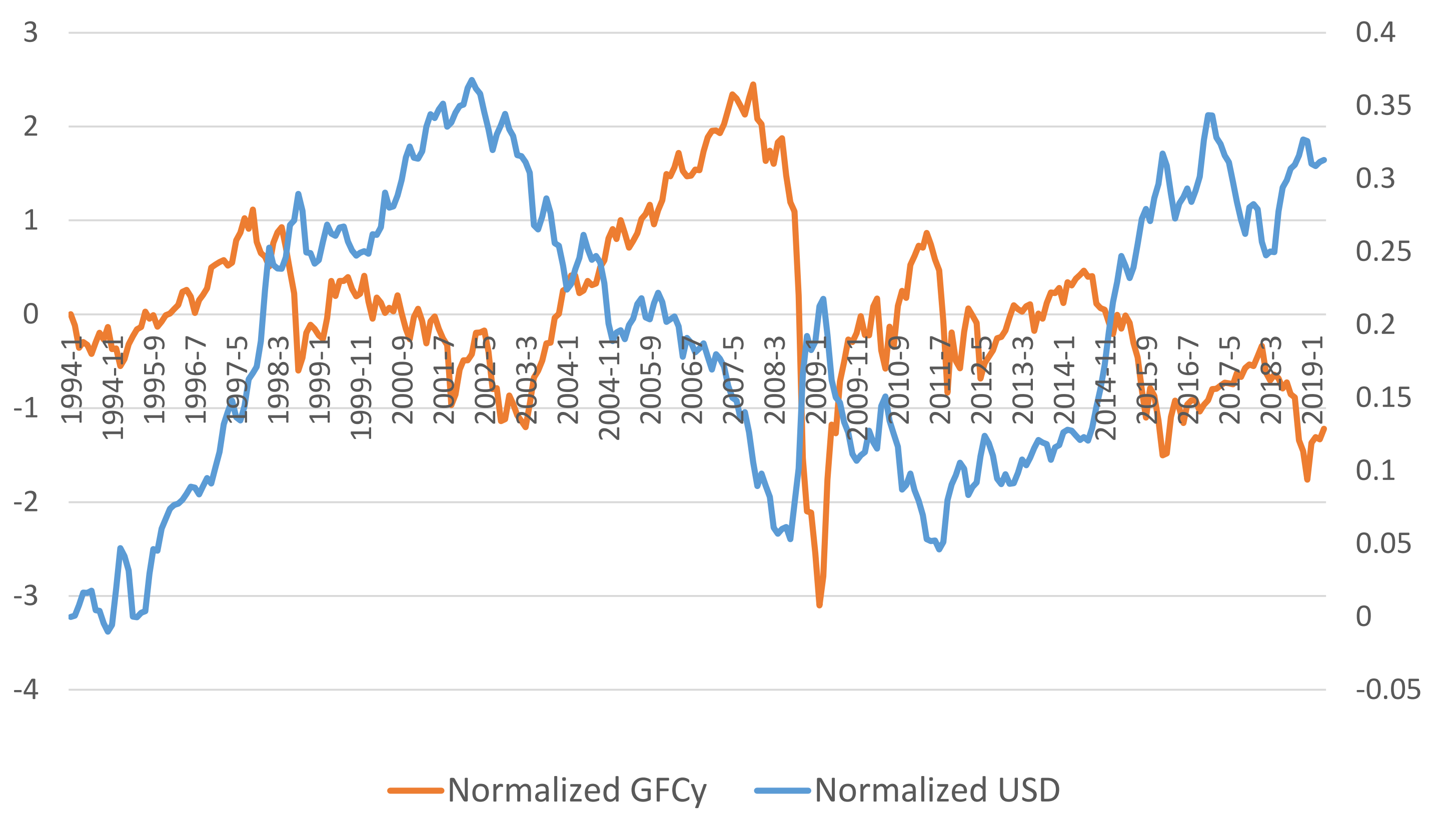


Measuring the Global Financial Cycle

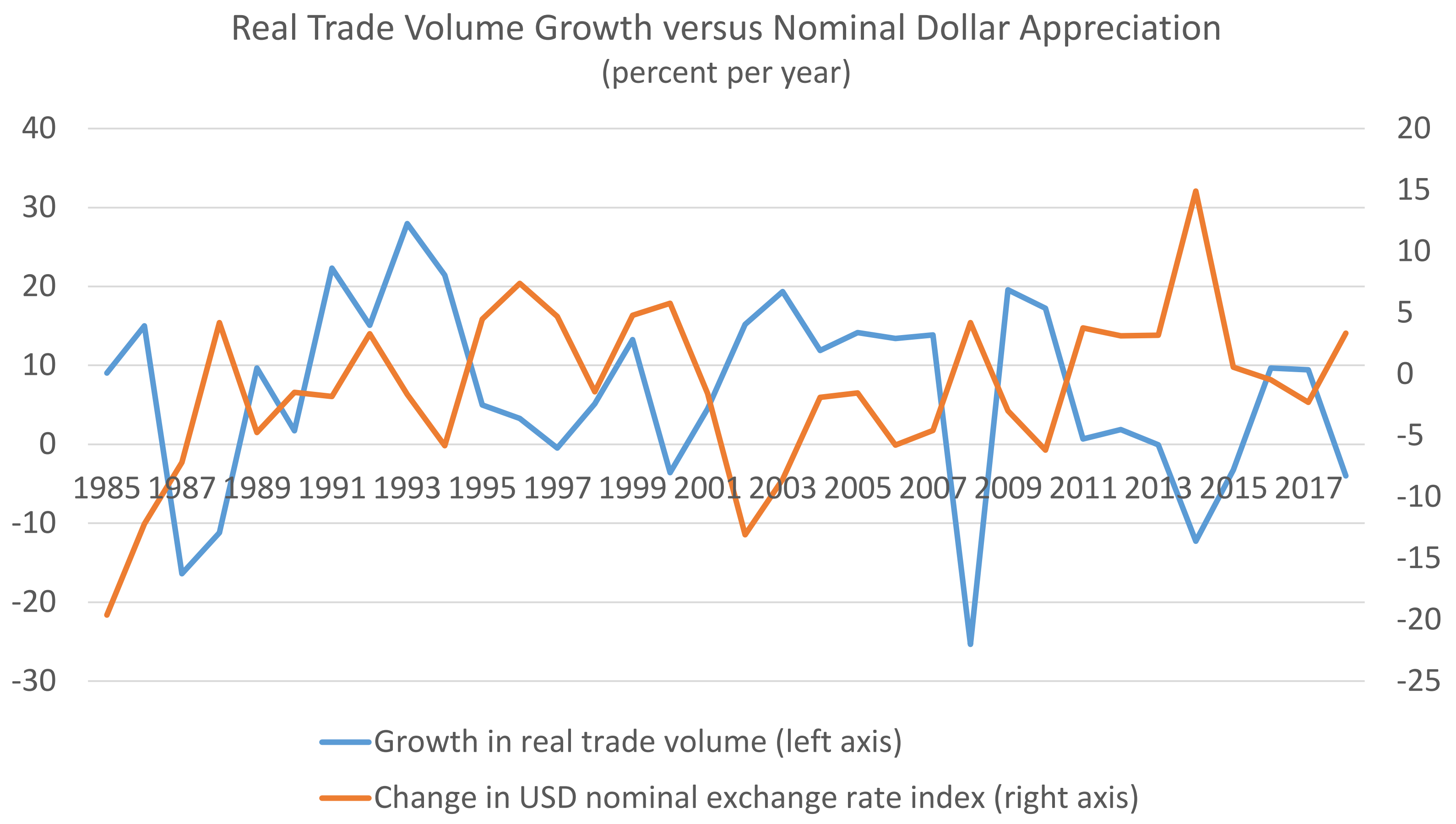
- Miranda-Agrippino and Rey (2020) calculated the measure reported earlier – it is based on asset and commodity prices
- Scheubel, Stracca, and Tille (ECB w.p., December 2019) construct separate price- and quantity-based measures of GFCy
- They are correlated with the M-A and Rey measure, not with VIX
- Positively effect on probability of currency crises and large capital-flow episodes – *downturns* in GFCy may be extra powerful drivers
- Davis, Valente, and van Wincoop (*JIE*, 2021) compute two global factors: one for GFC, one for energy prices
- The two factors together account for large fractions of variance of gross capital flows in AE (50%) and EM (40%)

The cycle is tightly linked to the dollar's exchange rate (Bruno and Shin 2015; Shin 2019)

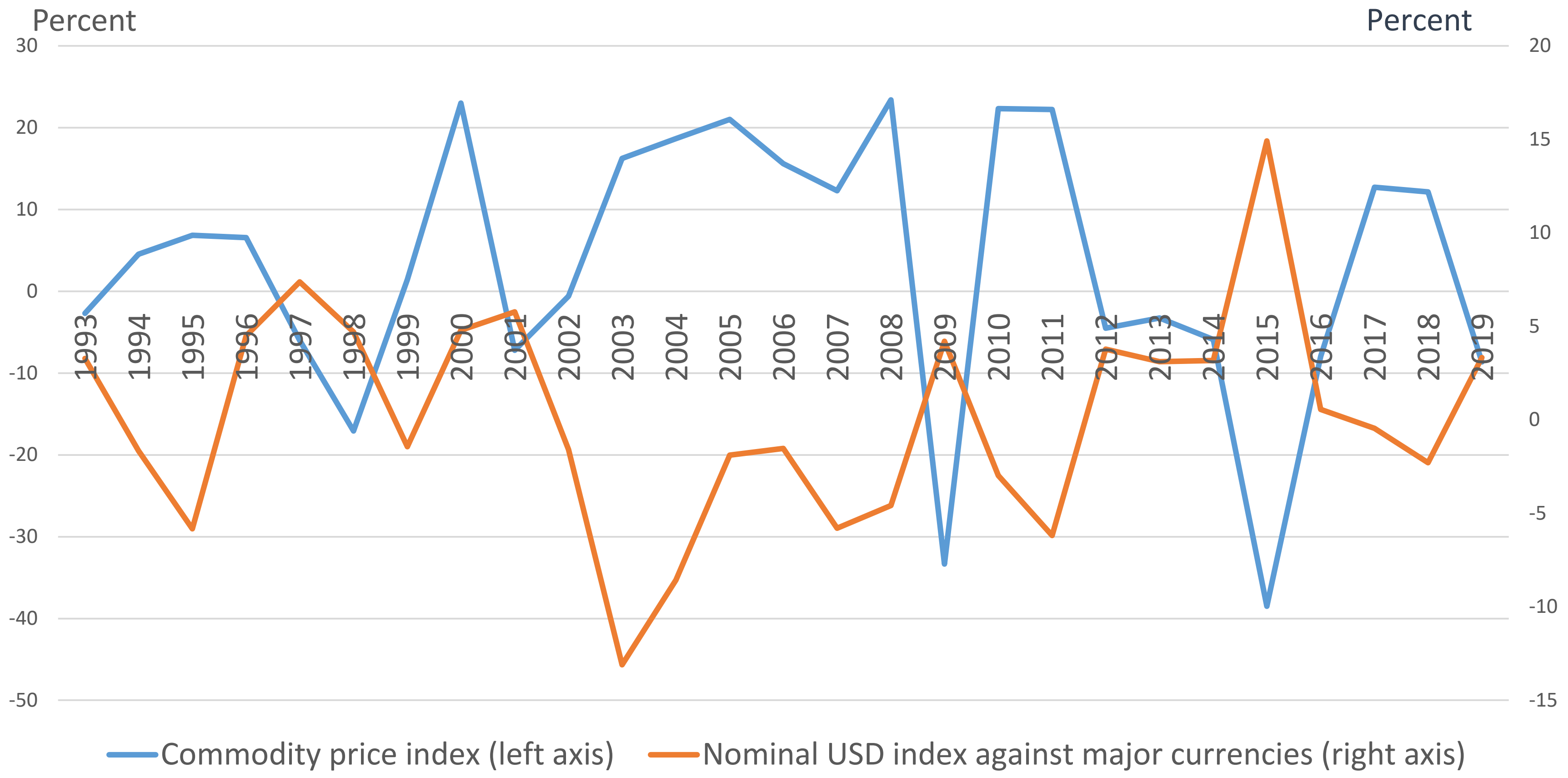
GFCy versus BIS Broad Nominal USD Index
(GFCy left axis, USD right axis)



And the dollar's exchange rate is strongly negatively correlated with global trade



And with commodity prices



What do we fear?

- Rises in AE (especially US) inflation and (consequently) interest rates will stress EMDE public finances, possibly lead to crises
- Dollar appreciation will be a potent transmission channel
- Currently, the global economy is in an expansive stage of the global financial cycle
- That is ending as advanced central banks tighten, especially if they fall “behind the curve” on inflation and tighten abruptly
- Kalemli-Özcan (2019) documents how US tightening raises EM risk premia
- The supply-chain driven inflation pressures that all countries face will be an additional challenging factor for EMDE as well – esp. food prices
- Failing to tighten monetary policy could erode hard-won credibility

Enhancing the financial system's resilience

- Regulation of nonbank financial institutions, big drivers of capital flows
- Reforming the market for US Treasurys – the world's safe asset
- Enhancing the Global Financial Safety Net (GFSN)
- Rethinking the use of capital flow measures together with monetary and macroprudential policies
- Liquidity problems → solvency problems? Rethinking sovereign debt restructuring
- Exchange rate flexibility remains essential
- Macro policy success has required luck
- The more we prepare, the luckier we will be