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Exchange rate flexibility and credit during capital inflow reversals: Purgatory … not paradise

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ABSTRACT

We identify periods of capital inflows reversals—looking at both gross and net capital flows—and document the behavior of macro and credit variables in economies with different degrees of exchange rate flexibility. We find that more exchange rate flexibility moderates credit swings during capital flow cycles, mainly because it is associated with milder credit growth during the boom. Flexibility, however, cannot completely shield the economy from a credit reversal. We observe what we dub as a recovery puzzle: credit growth in economies with more flexible exchange rate regimes remains tepid well after the capital flow reversal takes place. This results stress potential complementarity of macro-prudential policies with the exchange rate regime. More flexible regimes could help smoothing the credit cycle through capital surcharges and dynamic provisioning that build buffers to counteract the credit recovery puzzle. In contrast, more rigid exchange rate regimes would benefit the most from measures to contain excessive credit growth during booms, such as reserve requirements, loan-to-income ratios, and debt-to-income and debt-service-to-income limits.

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1. Introduction

Large capital inflows usually have an important impact on macroeconomic conditions—and in particular, on fluctuations in domestic credit. Capital inflows booms can finance investment and economic growth, and can also bolster the deepening of oftentimes shallow financial sectors. Banking sector credit usually expands and stimulates consumption. The volatility associated to these cycles, however, may pose significant macroeconomic challenges. Reversals in capital inflows could potentially result in credit busts and asset price deflation. Notably, the recent fluctuations in global risk aversion triggered by the Federal Reserve 'tapering' talk in 2013 are a reminder of the likelihood for reversals of large capital inflows. Consequently, these events strengthen the need for a proper debate about the policy framework and the corresponding policy mix needed to deal with large fluctuations in international capital flows. We tackle some of these issues here.

The impact of capital inflows bonanzas into the domestic credit cycle in emerging economies has prompted a renewed interest in academic and policy circles over recent years. This literature has shown that large capital inflows are associated with a deterioration in the current account, an appreciation of the real exchange rate, and oftentimes a rapid expansion in credit. The literature has also documented that large capital flows—especially those related to 'other non-portfolio investment' flows in the capital account—are good predictors of credit booms, and that these booms are more likely to end in credit crunches. More recently, Mendoza and Terrones (2008, 2012) and Magud et al. (2014) looked at the role played by exchange rate flexibility in credit booms fueled by large capital inflows. The latter find that rapid expansions in domestic credit driven by large capital flows are particularly acute in less flexible exchange rate regimes; moreover, these regimes tilt the composition of domestic credit toward credit in foreign currency.

This paper contributes to the existing literature by looking at how economies with different degrees of exchange rate flexibility behave during capital inflows *reversals*. To this end, we construct a large data set comprising 179 countries for the period 1969–2012. Then, we use standard algorithms to identify reversals that are *conditional on following a bonanza in capital inflows*. This identification is the first contribution of the paper. In order to focus the analysis on (a more homogeneous group of) countries with relatively open capital accounts and access to international private capital flows, we then narrow our sample to emerging economies during the last 25 years, identifying about 130 reversal events. Second, we document stylized facts during +5/−5-year windows centered in the reversals, and focus on differences between economies with relatively fixed and flexible exchange rate regimes. Based on the events identified, we run panel regressions to assess the specific role played by the flexibility of the exchange rate during capital inflows booms and reversals—which are identified based on both total and non-FDI capital flows, either defined in net or gross terms—controlling for a number of macroeconomic factors. The findings are then used to discuss potential policies to mitigate the effects of credit fluctuations that are driven by capital flows cycles.

All in all, the buffering role played by exchange rate flexibility during credit cycles looks like a ticket to purgatory, but no entrance to paradise. In effect, our results suggest that exchange rate flexibility helps containing banking credit growth compared to more rigid exchange rates during capital inflows booms. Yet, the fall in credit growth in economies with more flexible exchange regimes suggests that flexibility cannot fully shield the economy during the reversal, even though it is more modest than in fix regimes. Furthermore, we observe what we dub as a recovery puzzle: credit growth in more flexible exchange rate regimes remains tepid well after the capital flow reversal takes place.

Our findings suggest that flexible exchange rate regimes could be complemented by macro-prudential policies to smooth credit cycles—which could potentially raise systemic financial risks—during capital flow booms and reversals. Given the magnitude of capital flows during booms in emerging economies, curbing credit growth through macro-prudential may be challenging. However, these policies seem to be more effective in building buffers to help the economy avoid a crunch in banking sector credit when—for whatever reason—the credit cycle reverses after the boom. Exchange rate flexibility can keep credit growth relatively at bay during bonanzas, and it could be complemented by measures like capital surcharges or countercyclical provisions during the credit expansion phase. By building buffers, these macro-prudential instruments can help deal with the recovery puzzle experienced by flexible exchange rate regimes during reversals. On the other hand, measures aimed at