Toward an Integrated Policy Framework

REMARKS BY GIOVANNI DELL'ARICCIA (*IMF RESEARCH DEPARTMENT*)

G-24 VIRTUAL TECHNICAL GROUP MEETING

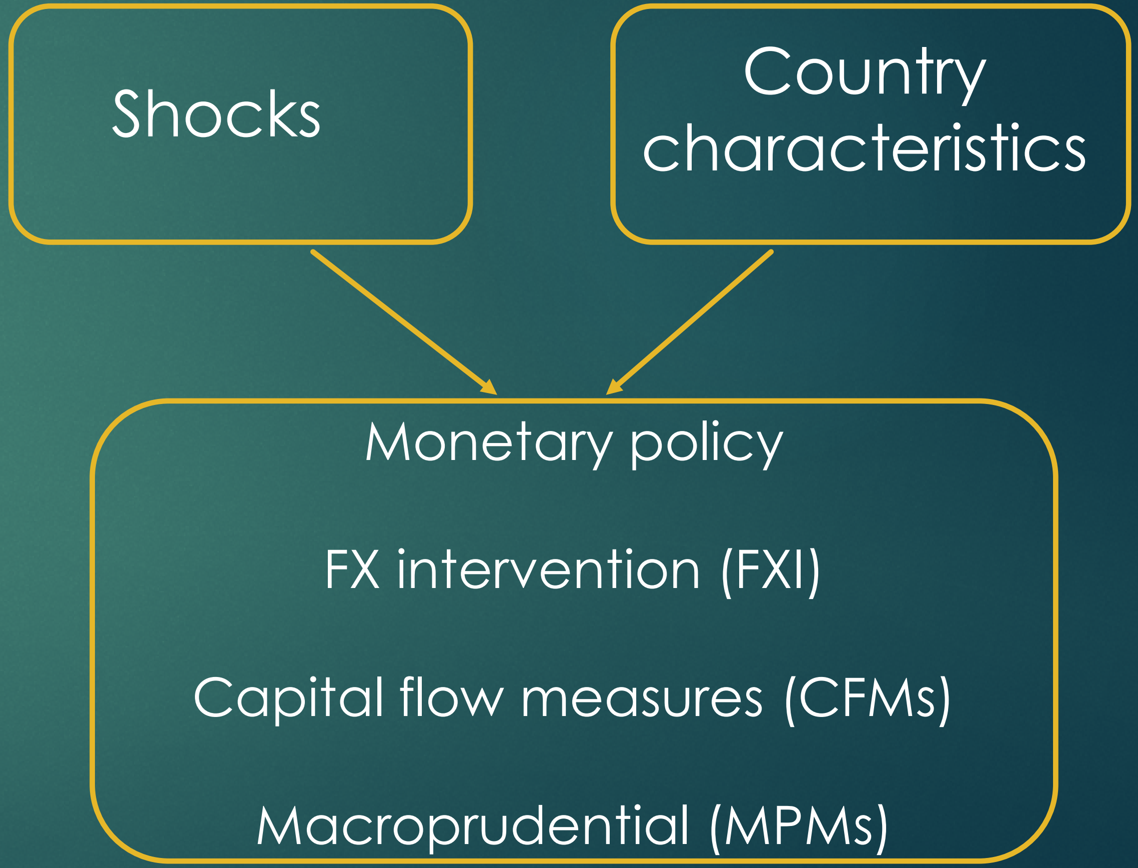
FEBRUARY 2021

Motivation

- Textbook approach to external shocks: Allow ER to move freely
- In practice: Capital flows provide benefits but may generate or amplify shocks
- Many countries use multiple policy tools after domestic and external shocks
- Policymakers cite diverse rationales for their approaches
  - Some rationales may be justified because textbook inflation targeting misses out important real-world imperfections
  - But some rationales may not be justified
- These approaches are generally not guided by a systematic analytical framework

Integrated Policy Framework (IPF)

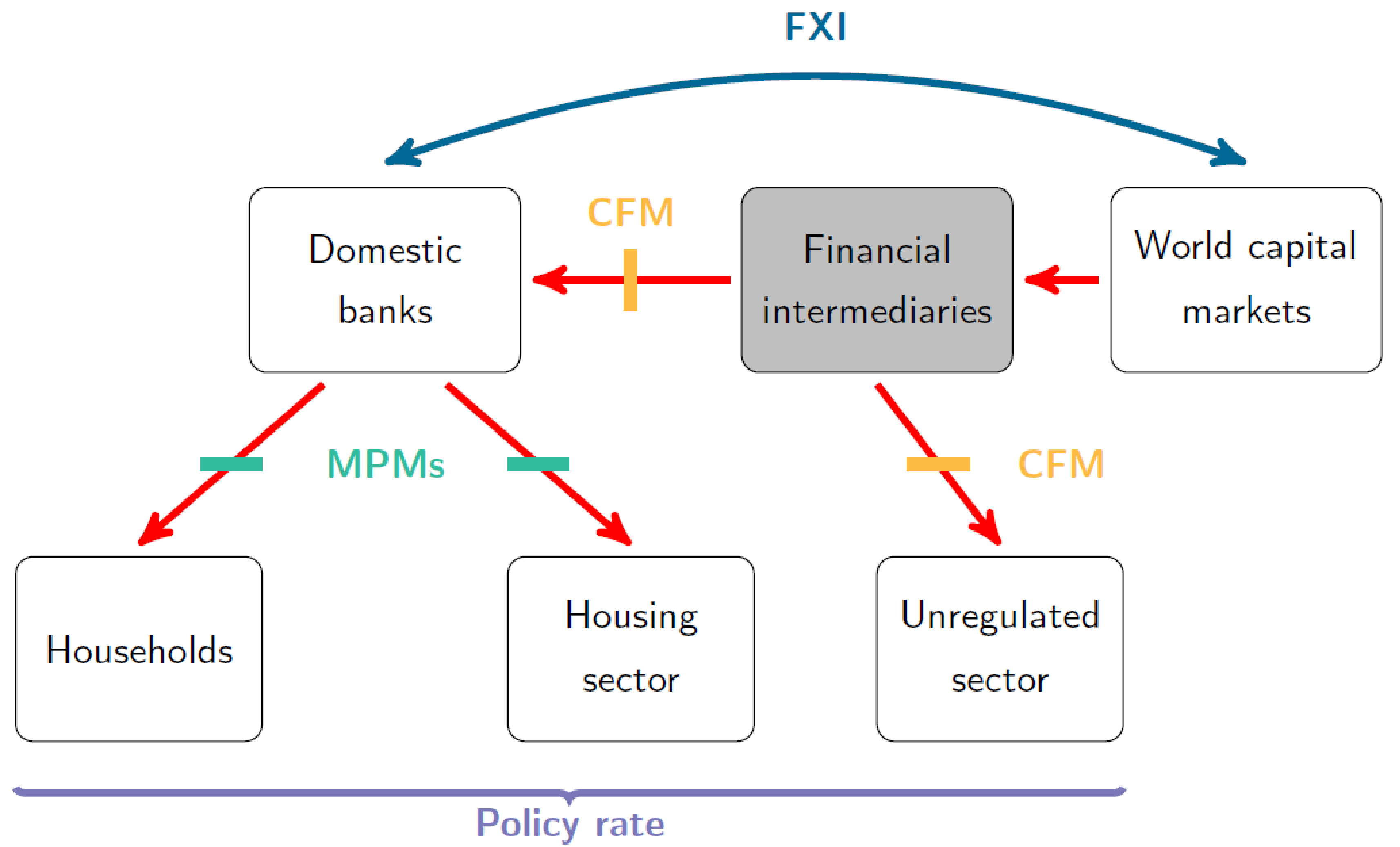
- Framework to map shocks and country characteristics to the optimal policy mix
  - Captures interactions between tools
- Allow for multiple frictions
- Modeling, empirics, case studies



Overview of conclusions

- Optimal policy mix depends on shocks and country characteristics
- For countries with no financial frictions, allowing ER to adjust feely remains optimal
- Elsewhere:
  - FXI/CFM/MPMs enhance monetary autonomy after external financial shocks
  - Precautionary CFMs and MPM/CFMs mitigate financial stability risks
- Challenges: operationalize framework and develop safeguards to prevent misuse

Financial flows and policy measures



Adverse shocks in absence of financial frictions

- In countries with deep FX markets and continuous market access, full exchange rate flexibility stabilizes output and inflation
  - Expenditure switching
- Result holds for all shocks: real and financial, domestic and external
- Result does not depend on pricing paradigm
- No need for FXI/CFMs/MPMs

Countries with currency mismatch and limits on external debt

- Precautionary CFMs on unhedged FX debt inflows reduce sudden stop risk
- CFMs can help plug potential gaps in MPM coverage
- It is not optimal to impose CFMs to:
  - Restrict domestic currency debt
  - Keep the exchange rate persistently undervalued
  - Shield sectors from foreign competition

Empirical analysis

- Evidence on effectiveness of tools, not necessarily their optimality
- Work broadly suggests:
  - FXI affects the exchange rate, at least in the short run
  - MPMs and pre-existing CFMs can reduce the domestic buildup of financial vulnerabilities stemming from easy global financial conditions
  - Evidence on the impact of CFMs on overall capital flows is mixed
  - Appropriate use of FXI, MPMs, and CFMs may free up monetary policy
  - Policy combinations are more effective than using a single instrument

Next steps

- Fund's policy advice remains guided by the Institutional View (IV)
- Changes to the IV could be considered during its forthcoming review
  - Key inputs: IPF and Independent Evaluation Office report on the *IMF Advice on Capital Flows*
- Analytical work on the IPF will continue
  - Develop metrics to guide implementation and safeguards to prevent misuse
  - Explore fiscal and multilateral considerations more deeply
  - Extend analysis of intertemporal tradeoffs/undesired side effects
  - Derive relevant lessons from the COVID-19 crisis

Thank you!

Fiscal and multilateral considerations

- Fiscal stance and the level/composition of public debt affect initial conditions and make some shocks more likely

- Fiscal policy and IPF tools are not good substitutes
  - IPF tools are better targeted to address financial stability risks and easier to adjust
  - IPF tools are not a substitute for appropriate fiscal policies or structural reforms

- Multilateral dimension: Coordinated use of IPF tools is likely appropriate after global shocks such as COVID-19
  - Standard monetary policy and exchange rate flexibility by countries with fewer financial frictions, and mix of IPF tools by those with more frictions
  - Negative spillovers if flows deflected to countries with frictions or if tools are misused

Safeguards against inappropriate use

- In model frameworks, IPF tools are aimed at well-defined macroeconomic and financial stability objectives
- In practice, there is risk of misuse to:
  - Support misaligned exchange rates
  - Substitute for warranted macroeconomic adjustment
  - Impede competition and price discovery
- Differentiating between appropriate and inappropriate use of IPF tools will require developing suitable metrics

Other practical challenges

- Shocks and country characteristics can be difficult to identify in real time
- Need to consider additional short-term, long-term, and spillover effects
  - IPF delivers broad principles and helps understand/quantify the tradeoffs
  - Judgment will be essential in applying the framework
- Governance and credibility
  - Coordination and communication of multiple tools may be difficult
  - At the same time, a systematic framework can help central banks employing multiple tools to communicate policy decisions and enhance credibility