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Capital inflows, exchange rate regimes and credit dynamics in emerging market economies

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ABSTRACT

This paper investigates the impact of the exchange rate regime (ERR) on the cycle of capital flows, the private credit growth rate and the level of dollarization in emerging market economies. We consider two different panels including 12 and 22 countries over the periods 1980–2010 and 1994–2008, respectively. We estimate a Panel Smooth Transition Regression (PSTR) model in order to assess whether the impact of ERR on credit dynamics is affected by the cyclical component of capital flows. Our findings are threefold. First, the ERR has no impact on the cyclical component of capital flows. Second, credit expansion is procyclical in economies with pegged currencies. Third, during capital inflows or low outflows periods, economies with fixed exchange rate regimes show a higher level of dollarization. When outflows are sizeable, ERR no longer impacts the level of dollarization. These results suggest that ERR should be an important variable in conceiving the policy mix to cope with domestic credit expansions and liability dollarization.

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1. Introduction

Emerging market economies have initiated important structural reforms from the late 1980s such as financial account liberalization, fiscal imbalances reduction and desinflation programs in order to gain access to international capital markets. International financial integration of EMEs as well as higher rates of return in these economies have led international banks and investors to look for borrowers and portfolio opportunities in EMEs, especially since the early 1990s (Committee on the Global Financial System, 2009). Moreover, a surprising consequence of globalization has been a decrease in the business cycle correlation between advanced and emerging economies, then fostering diversification strategies from investors.[2]

From the perspective of recipient countries, foreign borrowing can finance investment and foster economic growth, as well as increase welfare by facilitating consumption smoothing (Bekaert et al., 2005). However, capital flows to EMEs appear to be unstable and volatile, subject to over-shootings and brutal reversals (Agosin and Huaita, 2010). More precisely, they are at least partially driven by global factors, on which EMEs have no control (Ghosh et al., 2014). Since the early 1990s, as capital flows to EMEs became significant, a very extensive literature has paid attention to the macroeconomic consequences they may induce on recipient economies. Without listing them all, the main concerning issues have been inflationary pressures and real exchange rate appreciation (Calvo et al., 1994), the procyclicality of capital flows with business cycle (Kaminsky et al., 2005; Reinhart, 2008) capital flows on asset prices (Calvo, 2011).

As argued by the Committee on the Global Financial System (2009), increased financial integration and strengthening of domestic banking systems in EMEs may have been at the core of a rapid credit growth in these economies during the last few years. Basically, banks can finance domestic credit either through domestic deposits or borrowing in domestic and external markets. The CGFS (2009) shows that banks in EMEs have experienced increasing loan-to-deposit ratios since the early 2000s, which induce a higher reliance on external funding for credit issuance.[3]

Financing credit expansion with foreign liabilities instead of deposits may have at least two negative consequences on banks balance sheets. First, the rise in LTD ratios noted by the CGFS (2009) induces a decrease in banks liquidity. They may not be able to face their obligations when the cycle reverses, thus a more important deterioration in domestic economies. Second, banks are most likely to seek for foreign currency lending as foreign capital flows increase.[4] This situation may cause an "indirect currency mismatch"[5] for banks, especially concerning loans to households and small and medium-sized enterprises as argued by the CGFS (2009) Therefore, one should be concerned with the rise of foreign liabilities ratios in EMEs.

In a recent paper, Rey (2013) points out that capital flows and credit growth in both advanced and emerging economies are driven by the global financial cycle.[6] She concludes that the impossible trinity principle is no more relevant since these conditions apply to every country. However, she does not control for the effect of the exchange rate regime[7] and only shows the average effect of global conditions on periphery countries. Our estimations suggest that exchange rate flexibility may play a role, flexible regimes allowing some counter-cyclical measures during extreme capital flows episodes. For instance, Schularick and Taylor (2012) show a close relation between credit aggregates and financial crises while 73.91% of credit booms identified in Mendoza and Terrones (2008) data set occur

[2] This decrease in business cycle correlation is called "decoupling" by Kose et al. (2012).

[3] Especially in Emerging Europe defined as Central Europe (the Czech Republic, Hungary and Poland), the Baltic states (Estonia, Latvia and Lithuania), Southeastern Europe (Bulgaria, Croatia, Romania and Turkey) and two CIS states (Russia and Kazakhstan).

[4] Therefore, it is not a higher level of foreign liabilities that causes a raise in credit growth, but more capital flows providing easy refinancing conditions for domestic banks.

[5] The banks being exposed to currency depreciation through the indirect channel of the lower credit quality of borrowers with currency mismatches.

[6] The latter being highly correlated with the VIX index and the Fed policy rate.

[7] Considering that global banks will transmit monetary conditions, whatever the exchange rate regime in a particular country.

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