

THE INTERNATIONAL FINANCIAL SYSTEM AFTER COVID-19

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Credibility of Emerging Markets, Foreign Investors' Risk Perceptions, and Capital Flows

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editors



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In March of 2020, international markets seized up with a violence unequalled since the Global Financial Crisis (GFC) nearly a dozen years before. As economies around the world locked down in the face of the potentially deadly but completely novel SARS-CoV-2 virus, stock markets fell, firms and governments scrambled for cash, liquidity strains emerged even in the market for U.S. Treasuries, and capital flows to emerging and developing economies (EMDEs) reversed violently. Once again, the world economy appeared on the brink of collapse—until it was pulled back by monetary and fiscal interventions that outstripped even those of the 2008–2009 Global Financial Crisis.

The GFC erupted after five years of global financial-market expansion following the Asian crisis of the late 1990s, the dot.com collapse and Enron corporate fraud scandal, and the 9/11 attack on the United States. Following the GFC, macroeconomists questioned their earlier theoretical paradigms, financial firms altered their business

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models, and regulators rethought their oversight frameworks. Those paradigms, models, and frameworks needed to change: they had complemented each other in allowing the most severe financial crisis since the 1930s.

The Covid-19 crisis originated in a totally different type of shock—one coming exogenously from outside the financial system rather than from within—and it provided a kind of stress test for the amended international financial system. So far the system has survived tolerably well, even in the face of a global public-health response that has underperformed on many levels. But a collapse in 2020 was avoided only thanks to unprecedented policy support, previously unthinkable in magnitude and scope, which it would be rash to rely on for the future. And now, support is being withdrawn.

This paper reviews the evolution of global financial markets since the GFC, changes in academic thinking about the domestic impacts of these markets, the strains seen during the Covid-19 crisis, and perils that may lie ahead. A key theme is that stability will be enhanced if the global community embraces reforms that elevate market resilience, rather than depending on skillful policymakers wielding aggressive but ad hoc policy interventions to ride to the rescue again. Next time could be different—and not in a good way.

The plan of this paper is as follows. Section 1 surveys trends in financial market activity since the GFC, focusing especially on the huge demands that the Covid-19 shock placed on markets. Section 2 reviews the emerging evidence that global asset and commodity prices, capital flows, and intermediary leverage are driven by a global financial cycle linked to U.S. monetary policy. Section 3 summarizes measures central banks took to counteract the effects of the Covid-19 shock, focusing on the case of the Republic of Korea. For EMDE central banks, the episode stood in sharp contrast to earlier crises, in which their authorities sometimes felt forced to react procyclically. But it is too early to argue that EMDEs have entered a new world of copious policy space. Section 4 argues that with advanced economies defeating the pandemic more quickly than EMDEs, the world is having an uneven rebound in which lagging and more indebted EMDEs are likely to be hit by a contracting global financial cycle, driving them into liquidity or solvency crises.

That potential scenario is just one threat to financial stability that the Covid-19 crisis has highlighted. Accordingly, section 5 outlines several areas where reforms at both the global and national levels could improve the resilience of international financial markets.

1. TRENDS IN INTERNATIONAL FINANCIAL MARKETS

Starting in the 1990s, the scale and scope of global financial markets exploded. Eventually, additional financial vulnerabilities owing to massive and largely unregulated cross-border financial flows came to outweigh incremental gains from asset exchange, resulting in the global financial distress of 2008–09. Figure 1 shows an index of global capital flows since the mid-1980s. By the mid-1990s, growth in international financial transactions outstripped that in output or trade, even as the growth in the latter was amplified in the first decade of the new millennium by the proliferation of global value chains. The extreme bulge in capital flows in that same decade cannot be explained by a sudden rise in opportunities for mutually advantageous, socially beneficial asset trade. Instead, it reflected market distortions that came to tears before the end of the decade. Since the Global Financial Crisis, international capital flows have fluctuated wildly in response to various shocks, though never again reaching their earlier 2007 peak. Korea has not been immune to these capital-account surges and stops.

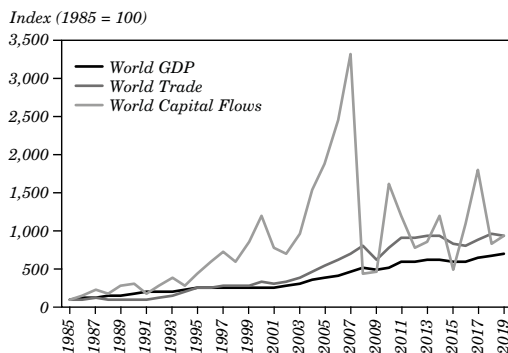
Key to these developments has been the regulatory regime around international financial flows: the set of guardrails governments maintain to manage the volume and character of cross-border finance, as well as its uses within the domestic financial system. Figure 2 reports the Chinn-Ito (2006) measure of financial account openness, updated to 2018. This index is a *de jure* measure, which codes the level of official restrictions as reported by the IMF, as opposed to a *de facto* index of actual international capital movements. After the early 1990s, high-income countries quickly removed remaining restrictions, approaching maximum levels of financial openness by the early 2000s.¹ Like other high-income countries, Korea has for several years been characterized by nearly complete *de jure* financial openness. Lower-income countries also began a liberalization process around the early 1990s, but it has been slower and has remained incomplete, even backtracking slightly after the Global Financial Crisis. Accordingly, flows between advanced economies account for the bulk of the early-millennium surge seen in figure 1. In general, middle- and low-income countries with current-account surpluses invest them in advanced markets, which then recycle them to developing markets with current-account financing needs. However, in the past two decades, the volume

1. For a discussion of this process, see Obstfeld (2021a).

of direct flows between developing markets has risen²⁾, also supporting rising gross levels of external assets and liabilities on the part of the less prosperous economies.

Figure 1. Comparing the Growth of World GDP, World Trade, and World Capital Flows

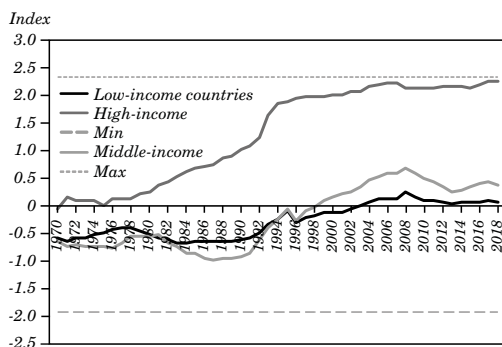
(nominal U.S. dollars, all series rebased to 1985 = 100)



Sources: IMF, *World Economic Outlook* database, April 2021, IMF Balance of Payments and International Investment Position Statistics database, and UN Comtrade database. World trade is measured as world imports.

Figure 2. Chinn-Ito Index of Financial Account Restrictions, 1970–2018

(simple country-group averages)

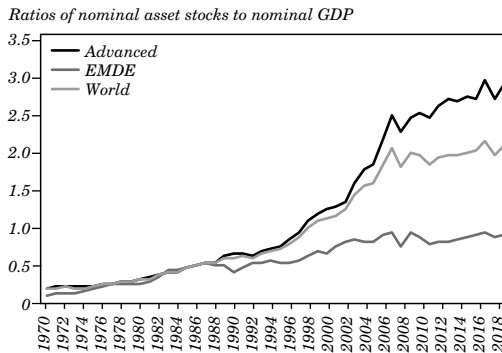


Source: Chinn and Ito (2006) data, updated by authors through 2018.

2. See Broner and others (2020) and CGFS (2021).

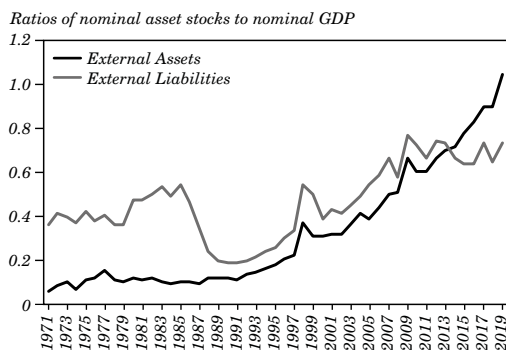
A country's level of gross external assets and liabilities relative to GDP furnishes one possible de facto measure of international financial integration. For the EMDE-country groups, figure 3 shows the average of external assets and liabilities as a ratio to GDP, based on the data of Lane and Milesi-Ferretti (2018). The rapid run-up in advanced economies, starting in the early 1990s but slowing sharply after the Global Financial Crisis, is evident and quite consistent with figure 2. The very high numbers (recently around three times GDP) reflect in part the extreme sizes of the balance sheets of financial centers, including offshore havens. Also consistent with figure 2, EMDEs show a less extreme (though still pronounced) increase after the early 1990s. However, that trend has pretty much stalled relative to the de facto openness levels reached just before 2008, in contrast to the continuing slow rise seen for advanced economies. Figure 4 shows the external assets and liabilities of Korea, also as a share of GDP. The magnitudes are similar to those for the EMDE grouping in figure 3. In Korea's case, however, while the growth of gross external liabilities (relative to output) has stalled since the Global Financial Crisis, external assets have continued to grow, consistent with Korea's ongoing current-account surpluses (which in 2015 reached 7.2 percent of GDP, falling to a still substantial 4.6 percent in 2020).

Figure 3. 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 (2018) data, updated by authors through 2019.

Figure 4. Korea: Ratios of External Assets and Liabilities to GDP, 1971–2019



Source: Lane and Milesi-Ferretti (2018) data, updated by authors through 2019.

Extreme as they may seem compared with world trade, the capital-flow numbers graphed in figure 1 far understate true gross levels of international transactions in financial instruments. To see why, note that figure 1 shows the sum of all countries' capital (or financial) inflows (which equals the sum of global capital outflows apart from errors and omissions in the official data). By definition, a country's capital (or financial) inflow equals foreign purchases of assets issued by domestic residents less foreign sales of assets issued by domestic residents, that is, net foreign purchases of domestic assets. Capital outflows are defined analogously as domestic residents' purchases of foreign assets less their sales of the same. However, reported capital inflows and outflows—often referred to as 'gross' capital flows because their difference is the *net capital inflow* or current-account deficit (again, apart from errors and omissions)—actually are themselves the result of netting the purchases and sales carried out on the same period by a particular set of actors. In principle, such 'gross' capital flows thus understate the absolute levels of two-way flows.³ To get an accurate assessment, we need the gross 'gross' numbers, that is, purchases and sales of domestic and foreign residents before netting.

Such data are hard to come by, but at least for the United States, we can calculate a workable lower bound from the U.S. Treasury's Treasury International Capital (TIC) System data and compare

3. See Koepke and Paetzold (2020).

those numbers both with the net capital flow required to offset the current account and the conventionally defined gross capital inflow and outflow. The TIC data are monthly and report:

(a) Gross U.S. resident sales to foreign residents of U.S. stocks and U.S. long-term bonds (for example, excluding Treasury bills, but including long-term corporate bonds). These necessarily equal foreign purchases of the U.S. assets.

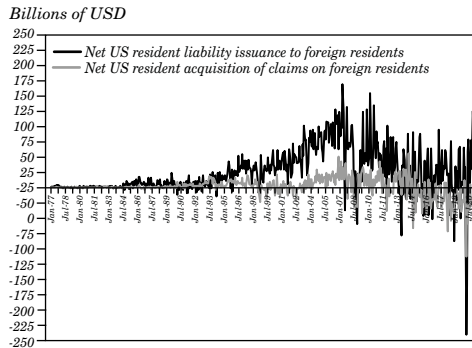
(b) Gross U.S. resident purchases of U.S. stocks and U.S. long-term bonds from foreign residents. These necessarily equal foreign sales of the U.S. assets.

(c) Gross U.S. resident purchases of foreign stocks and bonds from foreign residents.

(d) Gross U.S. resident sales of foreign stocks and bonds to foreign residents.

These data therefore capture much of portfolio capital flows; they exclude, in addition to transactions in short-maturity U.S. Treasury bills, foreign direct investment flows, and flows of bank loans. In conventional balance-of-payments accounting, U.S. capital inflows relate closely to (a) less (b), whereas U.S. capital outflows relate closely to (c) less (d).

Figure 5. U.S. Conventional ‘Gross’ Monthly Long-Term Portfolio Inflows and Outflows



Source: U.S. Treasury, Treasury International Capital System, Monthly Transactions in Long-term Securities.

Figure 5 graphs these two proxies for the U.S. ‘gross’ capital inflow and outflow. In terms of overall magnitude, the absolute values of the series stay below USD 250 billion, which is just slightly more than 1 percent of projected 2022 annual U.S. GDP. Because these are monthly flows and not expressed at an annual rate, however, the correct comparison is with one-twelfth of annual GDP. So we are looking at monthly inflows and outflows that can be on the order of 10 percent of GDP. If the TIC data offered a comprehensive picture of U.S. international financial flows, the U.S. current-account deficit would equal the difference between capital inflows (a) less (b) and capital outflows (c) less (d).⁴ The deficit was about three percent of GDP over 2020—roughly one-third the magnitude of ‘gross’ capital inflows and outflows. Also notable in figure 5 are the abrupt contractions in international positions—with foreign residents selling U.S. assets and U.S. residents selling foreign assets—around the Lehman shock in 2008 (see figure 3) and the Covid-19 shock in the early spring of 2020. U.S. recovery and fiscal stimulus early in 2021 bring a surge of capital inflows.

Figure 6 graphs the true gross capital-account transactions (gross ‘gross’ flows)—the sales and purchases considered separately. Often these may be legs of a single transaction, corresponding to offsetting bookkeeping entries in the balance of payments, but nonetheless, the magnitudes of transaction volumes are breathtaking.⁵ The numbers have tended to grow over time, falling after Lehman but then rising back up and reaching very high levels in the volatile market conditions of the Covid-19 crisis. Transaction volumes for U.S. long-term assets have recently approached USD 7 trillion per month, which would exceed monthly U.S. GDP by a factor between three and four (and these numbers exclude trade in short-term assets.) One interesting (if unsurprising) feature of the data is that in trades involving U.S. residents, transaction volumes for U.S. assets are consistently much higher than those for foreign assets. This is a reflection of continuing “home bias” by U.S. residents, of the outsized role of the dollar in global

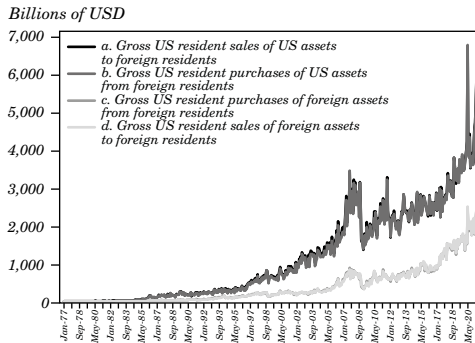
4. Thus, if the financial flow data were comprehensive, the current-account deficit would also equal $(a) + (d) - [(b) + (c)]$: gross U.S. resident sales of all assets to foreigners (whether claims on the United States or a foreign country) less gross U.S. resident purchases of all assets from foreigners.

5. That is why the series are so highly correlated. Suppose a foreign resident holder of a U.S. brokerage account shifts from U.S. bonds to U.S. stocks. The U.S. is selling them a stock but buying back a bond in payment. The trade gives rise to offsetting items in category (a) and (b) above, with no net impact on U.S. capital inflows $(a) - (b)$.

financial markets, and of the United States’ big net debtor position. Moreover, the gap between transaction volume in U.S. assets and in foreign assets appears to be secularly widening over the 2000s.

Net capital flows (the current account) matter as a component of aggregate demand. Conventionally defined gross capital flows matter as a measure of the net global demand for country assets. A general collapse in gross flows may signal a global risk-off episode, while a collapse in gross inflows (a sudden stop) can leave an economy with depressed asset prices as well as an inability to pay maturing debts.⁶ The enormous volume of truly gross two-way asset trade indicates how small are the asymmetric proportional changes that can potentially spark crises. The same is true of foreign portfolio shifts between a given country’s asset classes. Such shocks could be amplified if the financial system’s plumbing leads to liquidity shortages, fire sales, failed settlements, or other dysfunction. The volume of global financial transactions seems disproportional to any fundamental economic need or activity, yet produces a system prone to fragility.⁷ Like the Global Financial Crisis, the Covid-19 shock in the spring of 2020 illustrated the need for massive central-bank intervention as a backstop to market stability.

Figure 6. Gross U.S. Resident Monthly Long-Term Portfolio Asset Sales to and Purchases from Foreign Residents



Source: U.S. Treasury, Treasury International Capital System, Monthly Transactions in Long-term Securities.

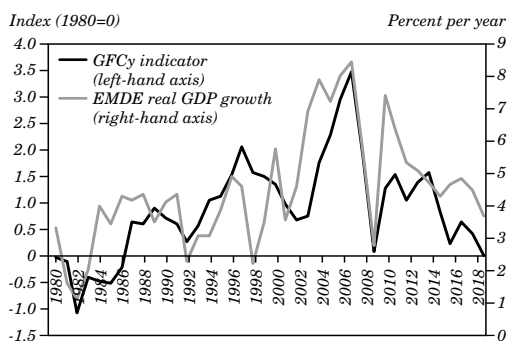
6. See Forbes and Warnock (2012).

7. Trading levels may be socially inefficient for several reasons, among them: tax arbitrage schemes or money-laundering motives, investor overconfidence (Odean, 1999), externalities from liquidity management (He and Kondor, 2016), or the design of fund managers’ incentive contracts (Kashyap and others, 2020).

2. GLOBAL CYCLES IN ASSET PRICES, COMMODITY PRICES, AND ASSET FLOWS

The last section described the distinct upward trends in international financial integration and transaction volumes. But what forces underlie the fluctuations around trend that the data also show? Recent research points to a pattern of synchronized international movements in financial conditions such that asset prices, commodity prices, capital flows, and intermediary leverage tend to surge and ebb together across a range of national markets (Miranda-Agrippino and Rey, 2021). Given the central role of U.S. financial markets and the dollar in global markets, U.S. financial conditions and Federal Reserve monetary policy are key drivers of the global cycle. Financial conditions and monetary policies in other developed markets also play roles, and global fluctuations in risk aversion certainly correlate with the cycle, partly as cause and partly as effect. Figure 1 suggests a cyclical behavior in global capital flows, most notably in the run-up to the Global Financial Crisis.⁸

Figure 7. Growth in Emerging and Developing Economies and the Global Financial Cycle



Source: *GFCy* variable with data updated through 2019 is available at <http://silviamirandaagrippino.com/code-data>. The raw monthly data are averaged to derive annual observations. Real GDP growth is from IMF, World Economic Outlook database, April 2020.

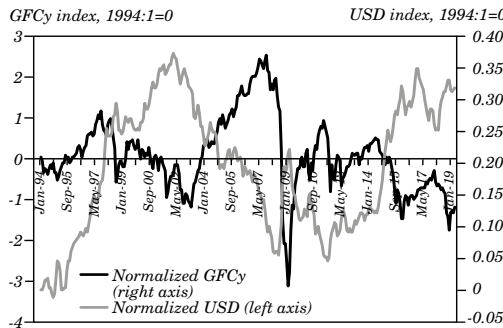
8. There is disagreement over the scope of the global financial cycle. For example, Cerutti and others (2019) argue that the cycle encompasses asset prices but not capital flows.

For countries with some degree of integration into world markets, these cycles reflect global financial-market impulses with potentially powerful effects on exchange rates, growth, prices, and financial stability. Researchers have therefore sought to measure the global financial cycle and to ascertain its effects and the variables that drive it.

Miranda-Agrippino and Rey (2020) use a monthly dynamic factor model of equity, bond, and commodity prices spanning five continents to estimate a single-global factor accounting for 20 percent of the common variance of the asset prices. Scheubel and others (2019) develop alternative measures based on a latent factor model that includes not only asset prices, but also non-price indicators including portfolio inflows to EMDEs, global credit volume, and the leverage of broker-dealers. Davis and others (2021) apply a related approach to explain net and gross capital flows (gross being defined in the conventional sense). They find that two factors, a global financial cycle factor and an energy-price factor, have high explanatory power for gross and net flows across advanced economies and EMDEs. Both the Scheubel-Stracca-Tille factor and the Davis-Valente-van Wincoop financial factor correlate well with the factor of Miranda-Agrippino and Rey, which I denote by *GFCy*.

Figure 7 illustrates the close relationship between the global financial cycle index *GFCy* and real output growth in EMDEs, which are especially vulnerable to the vicissitudes of international capital flows. For the annual data in the figure, changes in EMDE growth rates track broadly the swings in *GFCy*.

Figure 8. *GFCy* Index versus BIS Broad Nominal Dollar Index



Source: *GFCy* variable with data updated through 2019 is available at <http://silviamirandaagrippino.com/code-data>. Exchange-rate data from Bank for International Settlements, available at <https://www.bis.org/statistics/eer.htm>.

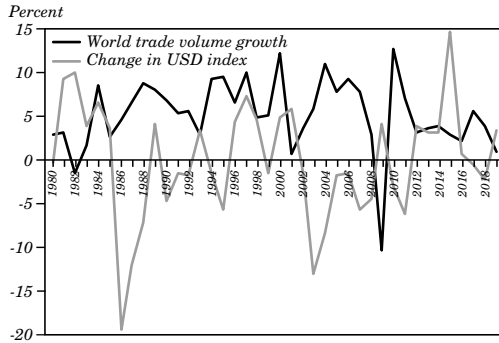
Several studies identify the U.S. dollar nominal effective exchange rate as a bellwether for global financial conditions, operating through international banking activity—as in Bruno and Shin (2015) and Shin (2019)—and possibly other channels. This association likely reflects, in part, the impact of U.S. monetary-policy shocks on the dollar exchange rate, restrictive policy implying dollar appreciation and tighter lending conditions. In this case, cross-border U.S. dollar flows will react most strongly, yielding an especially powerful negative impulse given the dollar’s centrality in cross-border transactions.

Using a vector-autoregression framework, Miranda-Agrippino and Rey (2020) show how alternative measures of U.S. contractionary monetary-policy shocks induce dollar appreciation, falls in financial intermediary leverage, credit, and banking flows, and a decline in the global cycle index *GFCy*. As to the mechanisms at work, Cesa-Bianchi and others (2018) present evidence to support a model in which currency and house-price appreciation inflate collateral values, thereby amplifying the expansionary effect of capital inflows. The association could also reflect dynamics in which causality flows from exogenous shifts in global risk appetite into simultaneous movements of the dollar (through a safe-haven effect) and the global asset prices that underpin *GFCy*.

Looking at the data from 30,000 feet, the unconditional negative correlation between the dollar’s strength and the Miranda-Agrippino and Rey global cycle factor is striking. Figure 8 shows the relationship since 1994: the correlation coefficient between the two monthly series is -0.35 . More impressive than the negative month-to-month correlation, however, is the strong negative relationship between low-frequency swings in the series. The figure thus suggests that the dollar foreign exchange value is indeed a powerful inverse indicator of the global financial cycle.⁹

9. Figure 8 should be interpreted with caution, as the *GFCy* index is based on asset prices measured in dollars. However, Miranda-Agrippino and Rey (2020, online appendix) state that its general behavior is robust to estimation based on assets’ local-currency prices.

Figure 9. U.S. Dollar Appreciation Correlates with Lower Growth in the Volume of World Trade



Source: International Monetary Fund, World Economic Outlook database, April 2021, trade volume of goods and services; FRED, dollar exchange-rate series TWEXMANL, trade-weighted based on goods trade with major-currency trading partners (Euro area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden).

The mechanisms linking the dollar and the cycle affect EMDEs with special force, which helps to explain figure 7. One factor is the prevalence of foreign-currency borrowing in some countries, which implies that a depreciation of local currency against the dollar will batter domestic balance sheets with contractionary macro effects. Even where sovereigns have largely graduated to domestic-currency borrowing and banks avoid currency mismatch, duration mismatches in foreign currency matter, and EM corporates borrow extensively in foreign currency. Moreover, foreign holders of domestic-currency debts may be especially sensitive to prospective exchange-rate movements, creating outsized capital-flow responses that can destabilize domestic financial markets unless the domestic investor base is deep (Carstens and Shin, 2019). Two additional mechanisms follow from the dollar’s impact on global trade and commodity prices.

A striking relationship in the data is the strong negative association between nominal dollar appreciation and world trade volume. Figure 9 shows this relationship in annual data from 1980. This relationship is not fully understood, but likely owes to at least five primary (and complementary) mechanisms. First is a direct effect of dollar-induced financial tightening, operating through the need for trade finance credit. This effect has likely become stronger with the proliferation of global value chains since the 1990s (Bruno and Shin, 2021). A second potential mechanism works through the dollar’s safe-haven tendency

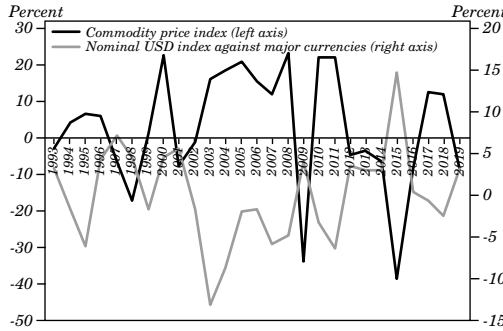
to strengthen in global crises, when risk appetite falls sharply as trade contracts. A third mechanism would be a contractionary effect of a stronger dollar on export demand when export prices are invoiced in U.S. dollars and sticky.¹⁰ Gopinath and others, (2020) show how dollar appreciation reduces ex-U.S. world merchandise export growth, even controlling for global GDP growth and risk aversion (as proxied by the VIX). A fourth possible mechanism is a global decline in investment when the dollar strengthens and funding conditions tighten, insofar as international trade is particularly sensitive to investment (IMF, 2016). Finally, a fifth mechanism is driven by the fall in real commodity prices that tends (as I document next) to accompany a stronger dollar.¹¹

Trade fluctuations have disproportionate effects on smaller and more open economies, especially EMDEs. Another channel through which dollar exchange-rate movements affect many of them is the dollar's association with commodity prices. (In 2019, about 20 percent of world trade consisted of primary commodities, but the exports of poorer countries were disproportionately concentrated on commodities.) Figure 10 shows the strong negative correlation between nominal dollar appreciation and changes in dollar commodity prices. The simple correlation coefficient is -0.72 over 1993–2019. Part of the strong negative correlation between the GFCy index and the dollar comes through the dollar's negative association with commodity prices. It may not be immediately obvious that commodity-price declines due to a stronger dollar harm the real incomes of the exporting countries. Let $E_{lc/\$}$ be the local-currency price of the U.S. dollar, let $P_{\comm be the world dollar price of commodities, and let P_{lc}^{GDP} be the local GDP deflator in terms of domestic currency. Then the price of commodities in terms of exporter GDP equals $E_{lc/\$} P_{\$}^{comm} / P_{lc}^{GDP}$. If a stronger dollar means that all nominal dollar prices fall in proportion—as in the case of a purely monetary shock in a flexible-price world—then $E_{lc/\$}$ rises (local currency depreciates) in the same proportion as $P_{\comm falls. With the local price level unchanged, the real price of the commodity export in terms of local output would remain unchanged, as would local real incomes.

10. As Bruno and Shin (2021) point out, dollar invoicing of exports likely increases the demand for dollar-denominated trade credits (since the short dollar position is naturally hedged), thus accentuating the impact of dollar appreciation through the previous mechanism.

11. See also Druck and others (2018).

Figure 10. Dollar Commodity Prices Tend to Fall when the U.S. Dollar Appreciates in Nominal Terms



Source: International Monetary Fund, World Economic Outlook database, April 2021, trade volume of goods and services; FRED, dollar exchange-rate series TWEXMANL, trade-weighted based on goods trade with major-currency trading partners (Euro area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden). The price index covers fuel and non-fuel commodities.

Table 1. Monthly Correlation Between Change in Nominal Dollar Index Against Major Currencies and Change in Real Local Commodity Price, February 2006–June 2021

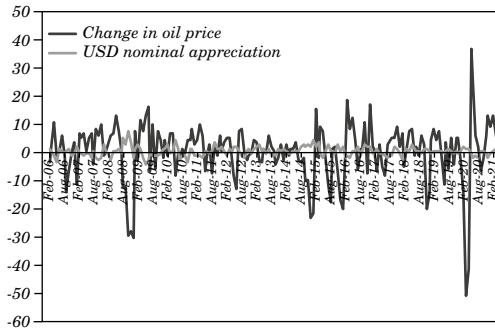
<i>Brazil</i>	<i>Chile</i>	<i>India</i>	<i>Saudi Arabia</i>	<i>South Africa</i>	<i>Thailand</i>
-0.20	-0.35	-0.44	-0.58	-0.21	-0.45

Source: U.S. nominal effective exchange rate against advanced country currencies from Federal Reserve Board of Governors. Monthly dollar commodity price index from IMF Primary Commodity Prices website. Monthly local CPI data and country exchange rates against the U.S. dollar from FRED. For Thailand, CPI from national sources via Macrobond.

But this is far from what happens in practice when the dollar becomes stronger. When the dollar appreciates by x percent in nominal effective terms against other advanced-country currencies, $E_{lc/\$}$ may well rise by less than x percent: some commodity exporters intervene in foreign exchange to limit exchange-rate movements (“fear of floating”), while others may peg their currencies to the dollar outright. More importantly, $P_{\comm will tend to fall by more than x percent, as is evident from the much larger scale of the left axis in figure 10. Both factors result in a fall in the relative price $E_{lc/\$} P_{\$}^{comm} / P_{lc}^{GDP}$ when the dollar appreciates, and a consequent fall in exporter real income. A stronger dollar, if not accompanied by a rise in global commodity demand, will

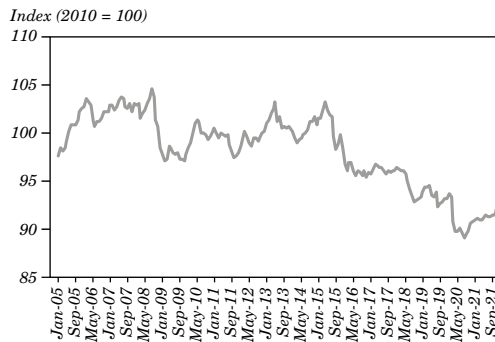
hammer primary exporters' terms of trade and real incomes. For six emerging markets, table 1 shows the negative correlations between monthly movements in the real local value of the IMF commodity price index (using CPIs to stand in for GDP deflators) and the Federal Reserve effective dollar index against advanced-country currencies.

Figure 11. U.S. Dollar Appreciation and Change in Dollar Oil Price, Monthly Data



Source: IMF dollar oil price index from IMF Primary Commodity Prices website. Exchange rate is effective nominal dollar rate against advanced economies, as reported by the Board of Governors of the Federal Reserve System.

Figure 12. Emerging-Market Nominal Broad Effective Exchange-Rate Index, 2005–2021



Source: Monthly data from J.P. Morgan via Macrobond.

Figure 11 focuses on the case of oil prices, showing their outsized fluctuations compared with those in the dollar nominal effective rate. The correlation coefficient between the price changes for the dollar and oil is -0.39 over the period shown.¹²

Rey's (2013) important paper on the global financial cycle focused attention on the degree to which more flexible exchange rates can help countries, and especially EMDEs, steer an independent policy course amid the monetary and financial shocks arriving through global capital markets. An earlier "fear of floating" literature (Calvo and Reinhart, 2002) pointed out that with faster passthrough of exchange rates to domestic prices and more dollarized domestic debts, EMDEs faced a harsher policy tradeoff between stabilization and inflation in responding to adverse foreign shocks with currency depreciation, and would therefore opt for more limited exchange-rate flexibility.¹³ Even earlier, Cooper (1999) argued that exchange-rate movements driven by capital flows could be a source of discomfort for policymakers.

The "trilemma versus dilemma" description of this problem is simplistic. Even among the most ardent proponents of flexible exchange rates, few have contended that they would provide perfect insulation against all shocks. Countries may well face more difficult tradeoffs owing to fluctuations in global financial conditions: this happens when some instruments become less effective at promoting desired macroeconomic responses while simultaneously inflicting more unintended consequences. Yet, exchange-rate flexibility still affords a precious degree of freedom for policy, without which macro outcomes would be worse overall.¹⁴ The need for flexibility may be greatest during crises, when exceptional policies can be brought to bear to mitigate the adverse side effects of large exchange-rate movements, for example, allocating foreign exchange reserves to the economy's systemically important foreign-currency debtors. In both the Global Financial Crisis and the crisis associated with the outbreak of Covid-19, many EMDEs allowed the currencies to depreciate sharply (figure 12).

Recent studies affirm that policy tradeoffs are indeed worse for EMDEs, but that exchange-rate flexibility mitigates the negative impacts of various shocks. Klein and Shambaugh (2015) conclude that

12. Simple ordinary least squares (OLS) regression of the oil-price change on dollar appreciation (both in natural logarithms) yields a coefficient of -2.45 (standard error of 0.42 , $R^2=0.15$).

13. Gourinchas (2017) presents a notably clear account of this tradeoff.

14. See Obstfeld (2015).

for EMDEs, capital controls afford relatively little policy autonomy unless they are extensive, whereas policy autonomy (in the sense of independence of short-term interest rates) rises with more exchange-rate flexibility. Looking in detail at the case of Chile, Gourinchas (2017) estimates a dynamic model in which a conventionally responsive domestic monetary policy will help mitigate spillovers from foreign shocks, so that “flexible exchange rates remain the primary line of defense against foreign monetary policy and global financial cycles alike.”¹⁵ Based on quarterly 1996–2018 data for 55 emerging markets and 14 advanced economies, Kalemli-Özcan (2019) finds that tighter U.S. monetary policy propagates powerfully to EMDEs (though not to advanced economies) through capital flows and increases in interest-rate risk premia. However, she also finds that exchange-rate flexibility can moderate the impact on economic activity. In data for a quarterly panel of 40 emerging market economies over 1973–2016, Ben Zeev (2019) finds that countries with pegs fare significantly worse (in terms of output, exports, asset prices, and other key variables) in the face of contractionary Gilchrist-Zakrajsek credit shocks than countries with more flexible regimes. Using a large global set of monthly data spanning 30 advanced and emerging economies over 1990–2018, Degasperi and others (2021), reaffirm the Kalemli-Özcan result that U.S. monetary policy affects emerging markets through higher term premia regardless of exchange-rate regime, but conclude (pp. 3–4) that “both real and nominal spillover effects are larger in countries with more rigid exchange-rate regimes.” This relatively short list of studies is selective rather than complete, but it stands in for a much larger body of evidence pointing in the same direction.

The Global Financial Cycle impacts all countries in some way, whether advanced, emerging, developing, or a high-income emerging market like Korea that is nonetheless subject to volatile capital flows. Higher-income economies seem to absorb the resulting shocks more easily, due to deeper and more fluid financial markets, their wealth, their productive diversity in many cases, the generally greater credibility of their policy frameworks, and elements of the global financial safety net from which they benefit disproportionately. Nonetheless, the initial phase of Covid-19 indicated that emerging market economies too had policy space to address the crisis—in part by exploiting exchange-rate flexibility, and with an assist from macroeconomic support policies in advanced economies.

15. Gourinchas (2017, p. 282).

3. EMERGING MARKET POLICY RESPONSES TO THE INITIAL COVID-19 SHOCK

The appearance of the global pandemic inflicted massive external real and financial shocks on EMDEs. Global trade collapsed in the first quarter of 2020, to a degree comparable with 2008's trade collapse. Korea of course did not escape this shock but suffered to a degree less than the global average. The financial shock manifested in a sharp reversal of capital inflows in March 2020. Figure 13 shows the pattern of portfolio capital inflows for a group of 26 mostly middle-income countries, including Korea. Figure 14 shows the Korean data, which suggests a March-2020 capital-flow reversal comparable with that around the Lehman event.

Korea is a high-income economy with a very flexible exchange rate, credible policies, and an evolved macroprudential framework including measures targeting foreign-currency liabilities (IMF, 2017a; Lee, 2017). Its monetary and financial policy reactions to the Covid-19 crisis parallel those successfully used elsewhere in many economies and notably in EM economies.

English and others (2021) offer an excellent compendium on central banks' responses to the initial phase of the Covid-19 crisis, with the chapter by Céspedes and De Gregorio (2021) focusing on emerging economies. While the details differ among EMs—indeed, Indonesia went so far as to allow temporarily direct financing of the fiscal deficit by Bank Indonesia—a partial list of measures undertaken by EM central banks often included the following:

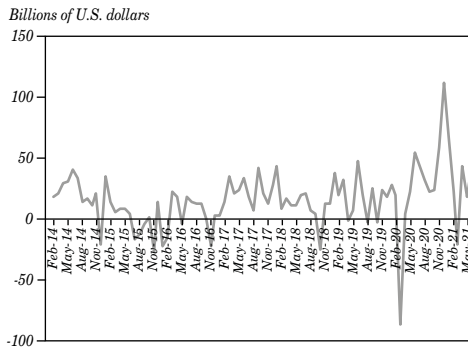
- Interest rate cuts.
- Large-scale central-bank purchases of domestic assets, mostly sovereign debt.
- Foreign exchange intervention.
- Looser reserve requirements (including loosening those discouraging capital inflows).
- Liquidity enhancing operations.
- Measures to promote bank loans to businesses.
- Macroprudential easing (e.g., relaxed capital requirements).
- Market functioning enhancements.

EMDEs benefited, however, from the massive monetary and financial stimulus provided by advanced economies early in the crisis and especially from the easing actions of the U.S. Federal Reserve. These actions underpinned the sudden reversal of negative capital inflows after March 2020, evident in figures 13 and 14. Although

capital flows have continued to be volatile since then, even turning negative again in a few months, the financial environment has generally remained benign for EMDEs so far, as a new expansive phase of the global financial cycle has set in. In particular, the generalized wave of EMDE sovereign defaults that some predicted at the outbreak of the crisis did not materialize in 2020–2021, despite those countries' aggressive use of their monetary and fiscal policy space.

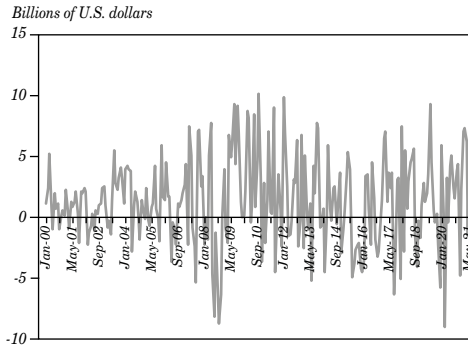
Providing important support to the global economy, the Fed extended dollar swap lines to 14 central banks, reducing the cost and lengthening the tenor of its offerings. Although only two emerging economies—Brazil and Mexico—were offered swap lines, as they were in 2008, the facilities offered to advanced economy authorities can help stabilize conditions in a broader region that includes emerging markets (for example, the impact on emerging Europe of swap lines to Nordic central banks). In the current crisis, the locus of swap line usage shifted geographically compared with the Global Financial Crisis, from Europe to Asia. This time, drawings by the Bank of Japan exceeded those by the ECB, and the Bank of Korea and the Monetary Authority of Singapore also participated (Gislén and others, 2021).

Figure 13. 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).

Figure 14. Capital Inflows to the Republic of Korea, 2000–2021



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

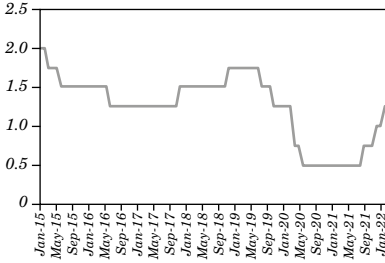
Figure 15 summarizes aspects of Korea’s response. The BoK promptly cut its policy interest rate, though not all the way to zero [panel (a)]. It also expanded its balance sheet [panel (b)]. (The BoK has already raised the rate three times more recently in the face of inflation and financial stability concerns.)

Céspedes and De Gregorio (2021) emphasize how emerging-market central banks were able to maintain domestic credit growth in 2020, unlike the experience in the Global Financial Crisis. For Korea, this pattern is evident in panel (c). Credit growth rose once the Covid-19 crisis hit, unlike its decline in 2008–2009 (albeit then, from very high levels that were symptomatic of the forces generating the previous crisis). In line with lower interest rates and the growth in domestic credit, panel (d) indicates that Korea has participated in the current expansive phase of the global financial cycle, with a sharp increase in its equity prices, as in the United States and other countries following the initial crash in March 2020.

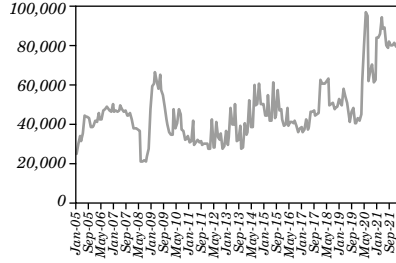
Korea drew several times on its \$60 billion swap line with the Fed [panel (e)], auctioning these dollars to domestic banks with dollar funding needs. Even the announcement of the swap agreement had a dramatic impact on the foreign exchange market. Korean authorities allowed the won to depreciate sharply during the generalized panic after the WHO’s March 11, 2020 declaration of a global pandemic [panel (f)]. The won/dollar exchange rate reached a high point on March 19; later that day the Fed announced the Korean dollar swap line, prompting an immediate reversal in the won’s depreciation.

Figure 15. Korea Responses to the Covid-19 Crisis

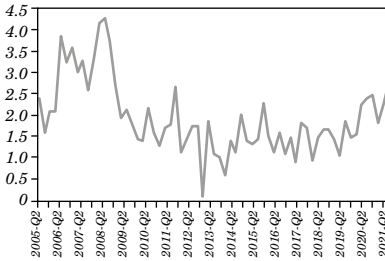
(a) BoK policy interest rate (percent)



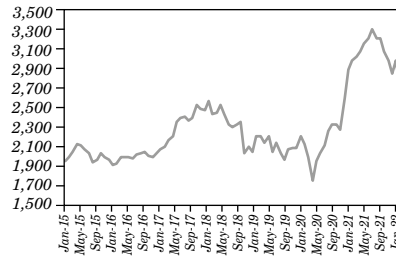
(b) Central-bank domestic assets (billions of won)



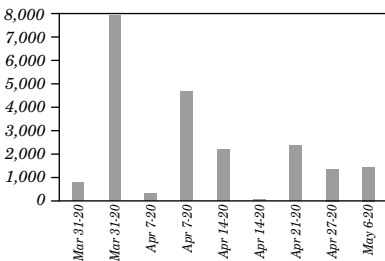
(c) Credit to the private nonfinancial sector from all sources (percent change in won value)



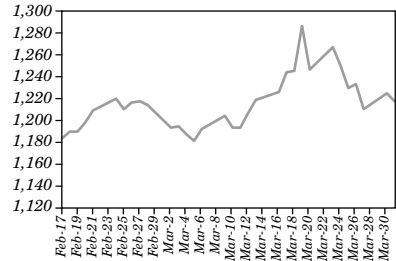
(d) KOSPI stock market index



(e) Korea swap line drawings (millions of USD)



(f) Won / USD closing exchange rate, February 17- March 31, 2020



Sources: Federal Reserve Bank of New York; accessed via Macrobond; Bank for International Settlements, Bank of Korea, and Korea Stock Exchange.

4. CONTINUING VULNERABILITIES FOR EMDES

EMDEs' ability to use monetary (as well as fiscal) policies to mount strong counter-cyclical responses was a positive surprise at the start of the Covid-19 crisis. In general they built on the accumulated capital of monetary-policy credibility (which had reduced EMDE inflation rates to low levels compared with past decades), on the increasing intellectual sophistication and operational expertise of their policymakers, on a comparatively strong cyclical position at the start of 2020, and on a strong lift from expansionary policies in advanced economies in the face of a shock with initially deflationary consequences. They departed from past practice also in more fully exploiting exchange-rate flexibility, cutting interest rates even as their currencies depreciated in the face of a capital-flow sudden stop.¹⁶ This response suggests that the trilemma has not collapsed to a simple dilemma: open capital account without monetary autonomy, or closed capital account with monetary autonomy—regardless of the exchange-rate regime.

Nonetheless, EMDEs could be vulnerable to sudden stops in the near-term future as the next contractionary phase of the global financial cycle is getting underway.¹⁷ Two current factors make this more likely.

First, the rollout of vaccines has been slower in most EMDEs than in advanced economies, and in many cases much slower. Moreover, some EMDEs are using less effective vaccines (notably less effective against the Delta variant of SARS-CoV-2), while often even vaccines that are available can go to waste due to underdeveloped infrastructures for getting shots into arms. The Covax mechanism has failed to meet even its modest targets as rich countries have effectively hoarded vaccine doses. In the longer run, this imbalance will threaten even highly vaccinated countries because unvaccinated regions will remain breeding grounds for new resistant variants; but in the near term, it implies a more rapid recovery in the advanced world than in EMDEs, with a consequent rise in global interest rates while EMDEs are still struggling.

Second, EMDE fiscal responses to the crisis have made them more vulnerable to hikes in advanced-economy interest rates—which could set off a contractionary phase of the global financial cycle. In

16. See also Aguilar and Cantú (2020).

17. Kalemli-Özcan (2021), IMF (2021), and Obstfeld (2021b) voice similar concerns.

advanced and less prosperous countries alike, fiscal deficits grew in 2020 as governments intervened to support firms and households during lockdowns, raised public-health spending, and lost revenues due to compressed economic activity levels. In many EMDEs, public revenue fell even as a percent of their lower levels of GDP. While fiscal responses in EMDEs were not as extensive as those of advanced economies, the EMDEs have historically been constrained to lower debt levels due to their less-developed revenue capacities and capital markets. Being able to fund sovereign debt in domestic currency is no panacea because higher debt levels undermine inflation credibility more quickly for EMDEs and raise their vulnerability to capital-flow reversals (Carstens and Shin, 2019).

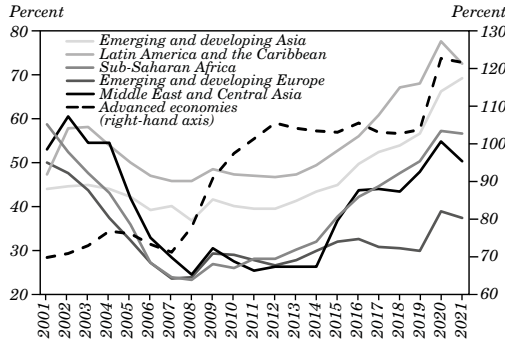
Figure 16 shows the development of general public debt-GDP ratios in advanced economies and in emerging and developing regions. (Figures for 2021 are IMF projections as of October 2021.) While the 2020 runup in advanced economies (tracked on the right-hand axis) is bigger in absolute terms, all EMDE regions also show significant jumps for that year. Moreover, in all regions, debt-GDP ratios had already been rising since the early 2010s. Figure 17 offers a more relevant comparison of the percent increases in debt-GDP ratios in the country groupings. Here, advanced economies are in the middle of the pack for 2020. Broadly speaking, EMDEs' changes in debt-GDP ratios were comparable to those of advanced economies, conditional on the lower debt capacity of the former group. The improvement in EMDE debt ratios the IMF assumes for 2021 relies on relatively optimistic growth forecasts and also reflects less ambition in fiscal support policies—although greater fiscal support might be needed to generate the assumed growth.¹⁸

In short, higher interest rates in advanced economies will put greater stress on public finances in EMDEs. They will also harm the fortunes of EMDE corporates that borrowed more since the crisis began, a downside legacy of the continuing domestic credit growth that supported EMDE economies in 2020. The same observations apply to the macroprudential easing policies that were positive for growth in 2020.¹⁹

18. The sharp 2021 reduction in debt ratios for the Middle East and Central Asia is the result of elevated energy prices in that year, driven by global recovery and a fairly restrictive policy by OPEC+.

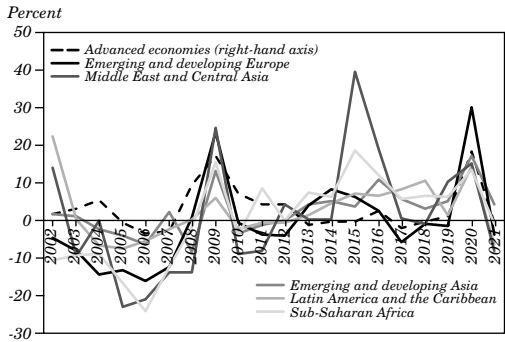
19. See Bergant and Forbes (2021).

Figure 16. General Government Debt-GDP Ratios, Advanced and EMDE Economies



Source: IMF, *World Economic Outlook* database, October 2021.

Figure 17. Percent Changes in General Public Debt-GDP Ratios, Advanced and EMDE Economies



Source: IMF, *World Economic Outlook* database, October 2021.

Figure 18 focuses on one particular source of potential fragility, the concentration of new sovereign-debt issuance on domestic bank balance sheets in a number of EMDEs.²⁰ This pattern sets up the possibility of a sovereign-bank doom loop. As Kalemli-Özcan (2019) shows, U.S. monetary tightening transmits to EMDEs via a rise in longer-term bond premia, and therefore a fall in bond prices. By weakening EMDE bank balance sheets, that development could set up

20. See Sachdeva and Harvey (2020), and IMF (2021).

destabilizing expectations of government fiscal intervention to support the banking sector, higher deficits, more accommodative monetary policy, and yet lower bond prices. Figure 18 also indicates that in the first year of the Covid-19 crisis, foreign investors on the whole reduced their sovereign exposures. Higher domestic saving due to the lockdowns facilitates the domestic placement of sovereign debt, but with recovery, higher saving rates will not persist. A further challenge, facing advanced and less prosperous economies alike, comes from the inflationary pressures that supply-chain disruptions are exacerbating.

We should therefore expect heightened financial fragility as an uneven rebound unfolds in the world economy. Apart from the home-grown problems that advanced economies may face emerging from a period of prolonged policy accommodation, they could face significant spillovers from EMDE woes. How resilient will global financial markets prove in the face of these pressures?

5. ENHANCING THE RESILIENCE OF GLOBAL FINANCIAL MARKETS

Reforms in several directions could strengthen the global financial system to face the turbulence that may lie ahead. Most of these proposals reflect long-standing needs, although the experience in the recent Covid-19 crisis underscores the urgency of action.²¹

In the spring of 2020, banks avoided the widespread distress of the Global Financial Crisis. In large part this success owed to the origin of the Covid-19 shock being outside of the banking sector. But some credit is also due to the national and international banking sector reforms that followed the 2008–2009 crisis and the euro-area crisis, which augmented bank capital, enhanced the liquidity of balance sheets, and upgraded prudential regulatory frameworks in many countries.

A predictable side effect, however, has been the migration of financial activity from the more constrained banking sector to unregulated or loosely regulated nonbank financial actors. In its recent report, the Committee on the Global Financial System (CGFS) of the BIS notes several changes in the structure of international capital flows, but first among them is the growing share of market-based capital flows (CGFS, 2021).²² Since 2007, the share of bank loans in

21. See also Eguren-Martin and others (2020).

22. See also Lane and Milesi-Ferretti (2018).

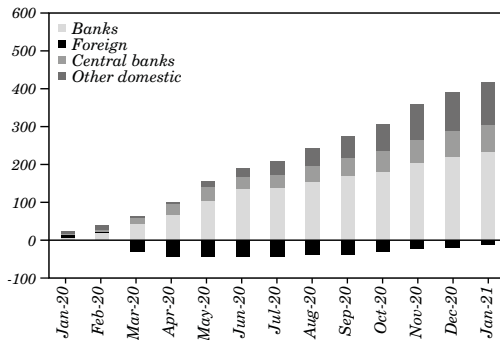
the external debt of advanced economies has shrunk from about 35 percent to about 22 percent, whereas the share of portfolio debt has risen from about 43 percent to 50 percent. At the same time, the share of bank loans in the external debt of emerging-market borrowers has fallen from around 52 percent to 45 percent, and the share of portfolio debt has risen from around 24 percent to nearly 40 percent. Advanced economy cross-border bank claims (which include debt securities, not just loans) declined from about 70 percent of home-country GDP at the time of the GFC to around 50 percent in 2019 (CGFS 2021, graph 1.2). Eguren-Martin and others (2020) document the dominant role of nonbank actors in the reversal of EMDE capital flows in March 2020.

Returning to the TIC data, figure 19 shows how the foreign position of U.S. banks and other financial institutions has essentially been stagnant in nominal terms since just before the GFC.

At the same time, and as noted earlier, the cross-border activity of emerging-market banks has risen—according to CGFS (2021)—from about seven to nine percent of home GDP between 2008 and 2019. However, it remains small in scale compared with advanced economies’ international bank activity.

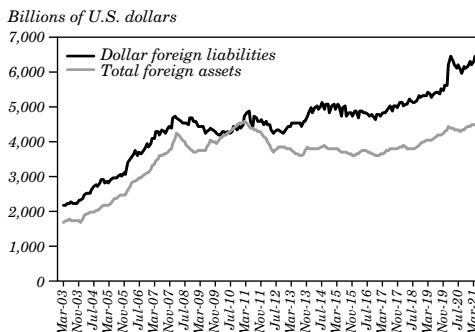
Figure 18. Domestic Sovereign-Bond Holdings in 12 Emerging Market Economies

(cumulative change, billions of U.S. dollars)



Source: Updated data for figure 1.6.6 in IMF (2021), provided by IMF Money and Capital Markets Department.
 Note: The emerging market economies include Brazil, Colombia, Mexico, Indonesia, Malaysia, Ukraine, Turkey, Thailand, South Africa, Poland, Hungary, and Romania.

Figure 19. U.S. Banks' and Other Financial Institutions' Foreign Assets and Liabilities, 2003–2020



Source: U.S. Treasury, Treasury International Capital System, U.S. Banking Data. Monthly asset data are interpolated quarterly data. The dollar liability data cover about 95 percent of total liabilities (that is, liabilities in all currencies). The liability series also encompasses all non-U.S. holdings of short-term Treasury securities.

From a policy perspective, this evolution points to the need for more thinking about financial stability risks coming from the nonbank sector, for example, through increasingly complex intermediation chains that may ultimately also impinge on the banks. The spread of innovative fintech platforms only increases the risks, including from cybersecurity breaches, and may render prudential oversight more difficult. All along, climate-related risks are only rising. The challenges that the international dimension raises are particularly big, owing to the seams between national regulatory systems. The Financial Stability Board (FSB) has outlined an extensive program to assess the risks from nonbank financial institutions in light of the Covid-19 market turmoil of spring 2020 (FSB, 2020). However, it seems fair to say that even bank regulation now needs to encompass an even broader set of potential systemic risks than were envisioned in the immediate post-GFC reforms. The trend of emerging-market banks increasingly venturing abroad into other emerging markets only raises the stakes for those countries.

Another part of the financial market infrastructure in need of strengthening is the global financial safety net (GFSN). Bilateral swap lines have become increasingly important in the GFSN (Perks and others, 2021). Federal Reserve swap lines were essential in stabilizing global markets in the spring of 2020 in light of the dollar's continuing dominance as a funding and investment currency. But the

geographic coverage and market reach of those swap lines were limited, especially because dollar funding activity has tended to migrate from the European theater that was dominant in the GFC to Asia and emerging markets (CGFS, 2020).

The need to extend central-bank swap lines multilaterally, especially the Fed's, has long been apparent,²³ though it remains unclear what institutional structure would be most politically acceptable to the issuers of funding currencies, and what lending safeguards would be necessary. At the least, building trust would demand a higher degree of coordination in financial regulatory policies than now exists. In 2017, IMF staff developed a proposal for a Short-term Liquidity Swap facility to "provide liquidity support for potential balance-of-payments needs of a short-term, frequent, and moderate nature, resulting from volatility in international capital markets" (IMF, 2017b). The facility was meant to be available to countries with "strong fundamentals," and without ex-post conditionality. The IMF Executive Board divided on the proposal, which some major shareholders opposed, and turned it down. Amid the market disruption in April 2020, however, the Fund Board approved a similar Short-term Liquidity Line (SLL) facility intended to address some of the gaps in the network of bilateral swaps. Unfortunately, potential beneficiaries seem not to view the SLL (or the Fund's two other precautionary credit lines originating in the GFC period) as equivalent to central-bank swaps, and indeed, not a single country has drawn on the SLL so far. Plant and Rojas-Suárez 2021 provide an excellent discussion of the likely reasons, as well as of ways the IMF could encourage take-up of the facility. The IMF declined to adopt the pandemic support facility that Fisher and Mazarei (2020) proposed, but such a policy instrument would also strengthen the GFSN during the current pandemic and could be mobilized in future contagious outbreaks. Also relevant is the proposed Resilience and Sustainability Trust, which would provide an IMF umbrella for richer countries to lend SDRs for investments in climate adaptation, health, and other areas of vulnerability.²⁴ The upcoming Sixteenth General Review of IMF quotas will provide another opportunity to strengthen the GFSN through enhanced non-borrowed lending resources.

The U.S. market for Treasury securities showed unexpected dysfunctionality in March 2020, notably during a "dash for cash" later in the month when Treasuries became temporarily illiquid as

23. For example, see Obstfeld (2009).

24. See also G30 Working Group on Sovereign Debt and Covid-19 (2021).

domestic and foreign holders rushed to sell them for money (Duffie, 2020; FSB, 2020). The dollar remains by far the central currency in the international financial system (CGFS, 2020) and, for better or worse, no serious competitor is yet in view. At the same time, central-bank dollar reserves play a key role in the overall resilience of the GFSN. If central banks or sovereign wealth funds cannot rely on converting their Treasury holdings at par, those reserves become less effective in providing insurance to their holders. Thus, the health of the Treasury market is vital to that of the GFSN, and measures that strengthen its functioning also strengthen the GFSN.²⁵

To enhance the liquidity of Treasuries amid the turmoil, on March 31, 2020, the Fed established the Foreign and International Monetary Authorities (FIMA) repo facility for converting official foreign Treasury into cash. It became a standing facility on July 28, 2021. (Reflecting ongoing tensions in domestic markets, in June 2020, the BoK floated an analogous facility to allow domestic banks, insurance companies, and brokerages to swap U.S. Treasuries into dollar cash.)²⁶ Several changes would enhance the plumbing of the U.S. Treasury market, the most far-reaching of which would be central clearing of transactions in the market, including repo.²⁷

For EMDEs, improved defensive policies can bolster resilience—and thereby global resilience. Their vulnerability to the global financial cycle makes it understandable why so many less affluent economies, even emerging market economies, have stopped short of full financial opening (recall figure 2). In 2012 the IMF officially recognized this reality by developing an “institutional view” (IV) on capital controls that allows for their use in some circumstances, notably when financial flows threaten economic or financial stability and the capital-flow measures (CFMs) do not substitute for necessary adjustments in macroprudential, monetary, or fiscal policies (IMF, 2012).²⁸ The Fund’s acceptance of CFMs as a legitimate policy tool was a huge shift in approach: an aversion to exchange control resides deep within the institution’s DNA, and even an attempt to focus surgically on cross-border financial transactions could spill over to the current account.

25. Euro reserves are also an important component of global international reserves and, in the spring of 2020, euro bond markets also experienced liquidity problems.

26. See Roh and Park (2020).

27. For reform proposals, see Duffie (2020), G30 Working Group on Treasury Market Liquidity (2021), and Hubbard and others (2021).

28. Even before the IV, however, IMF staff accepted and even recommended capital controls in some individual country cases. For the case of Iceland in 2008, see Honohan (2020).

Nonetheless, the IV is in several ways too restrictive. Research shows that CFMs are rarely imposed in the temporary manner the IV envisions, in response to cyclical tides in the global capital market. Instead, they are generally structural and thus long-lived in nature. Notwithstanding the IV, many Fund members feel that global markets might stigmatize them if they vary CFMs reactively. Thus, the Article IV surveillance process has regularly featured disagreements between Fund staff and country authorities as to whether particular policy measures should be labeled as CFMs or MPMs (macroprudential measures), with the authorities often advocating for the latter designation (Everaert and Genberg, 2020).²⁹ A particular cause of disagreement has been policy in some countries (including some richer countries such as Canada) to limit foreign speculative purchases of property in soaring real-estate markets. Finally, the IV is asymmetric with respect to inflow and outflow controls, restricting the use of the latter to situations of imminent or ongoing crisis. The Fund's internal Independent Evaluation Office (2020) recognized these criticisms in a comprehensive review and recommended rethinking the IV.

Recently the Fund has proposed an Integrated Policy Framework that conceptualizes the use of CFMs, foreign exchange intervention, monetary policy, fiscal policy, and macroprudential policy as distinct instruments that may all be needed to reach multiple policy goals in a small open economy (IMF, 2020).³⁰ Importantly, the approach has the potential to place capital control and foreign exchange intervention policies on an equivalent plane with monetary, fiscal, and macroprudential policies, and thereby remove some of the stigma that currently adheres to CFMs. In light of this work and the limitations of the IV, the Fund is currently reconsidering its advice on CFMs and could go further in the direction of regularizing their use in a wider set of circumstances.³¹ This approach would also be in line with the

29. CFMs can play a macroprudential role—for example, when they limit foreign funding of imprudent domestic investments—but they can also play other policy roles that IMF rules proscribe—for example, preventing adjustment of an undervalued exchange rate. In contrast, a hypothetical 'pure' MPM would not discriminate in its implementation between domestic and foreign residents. The overlap in the roles of MPMs and CFMs has sometimes blurred the distinction between them, as has the difficulty smaller countries face in counteracting the global financial cycle through MPMs without the support of measures that could be characterized (at least partially) as CFMs.

30. See Jeanne (2021) for a related framework.

31. As Honohan (2020, p. 25) aptly puts it, the 2012 IV approach "is quite different from seeing [capital-flow] measures as a tool to be actively integrated with monetary, exchange-rate, and macroprudential measures."

recent recommendations of a group of ASEAN central banks (ASEAN WC-CAL, 2019). Following a 2016–2019 review, the revised OECD Code of Liberalisation of Capital Movements addresses some of the same criticisms IMF member countries have raised concerning the IV (OECD, 2020).

If a future sudden stop in capital flows to EMDEs is protracted, and especially if the pandemic lingers on, liquidity support may not be enough to stave off solvency problems. Despite some recent improvements, however, the current international architecture for external debt restructuring is inadequate to handle a rash of sovereign defaults, some potentially affecting systemic countries.³² Earlier hints by the Group of Twenty pointing toward mandatory private-sector participation in debt restructurings have fallen by the wayside as global financial conditions have remained easy. It should not take a renewed financial crisis to revive those ideas.

32. See G30 Working Group on Sovereign Debt and Covid-19 (2021).

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