

Disinflation, Capital Inflows, and Financial Stability

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Inflation Stabilization and Financial Development

2017 Money and Banking Conference

Banco Central de la Republica Argentina

September 25-26th, 2017

Roadmap

- **Global setting : Low inflation and low interest rates**
- **Inflation stabilization and capital inflows**
- **Real exchange rate concerns and the speed of disinflation**
- **Fiscal concerns: Inflation tax or debt financing?**
- **Financial deepening or credit boom?**
- **Macroprudential**

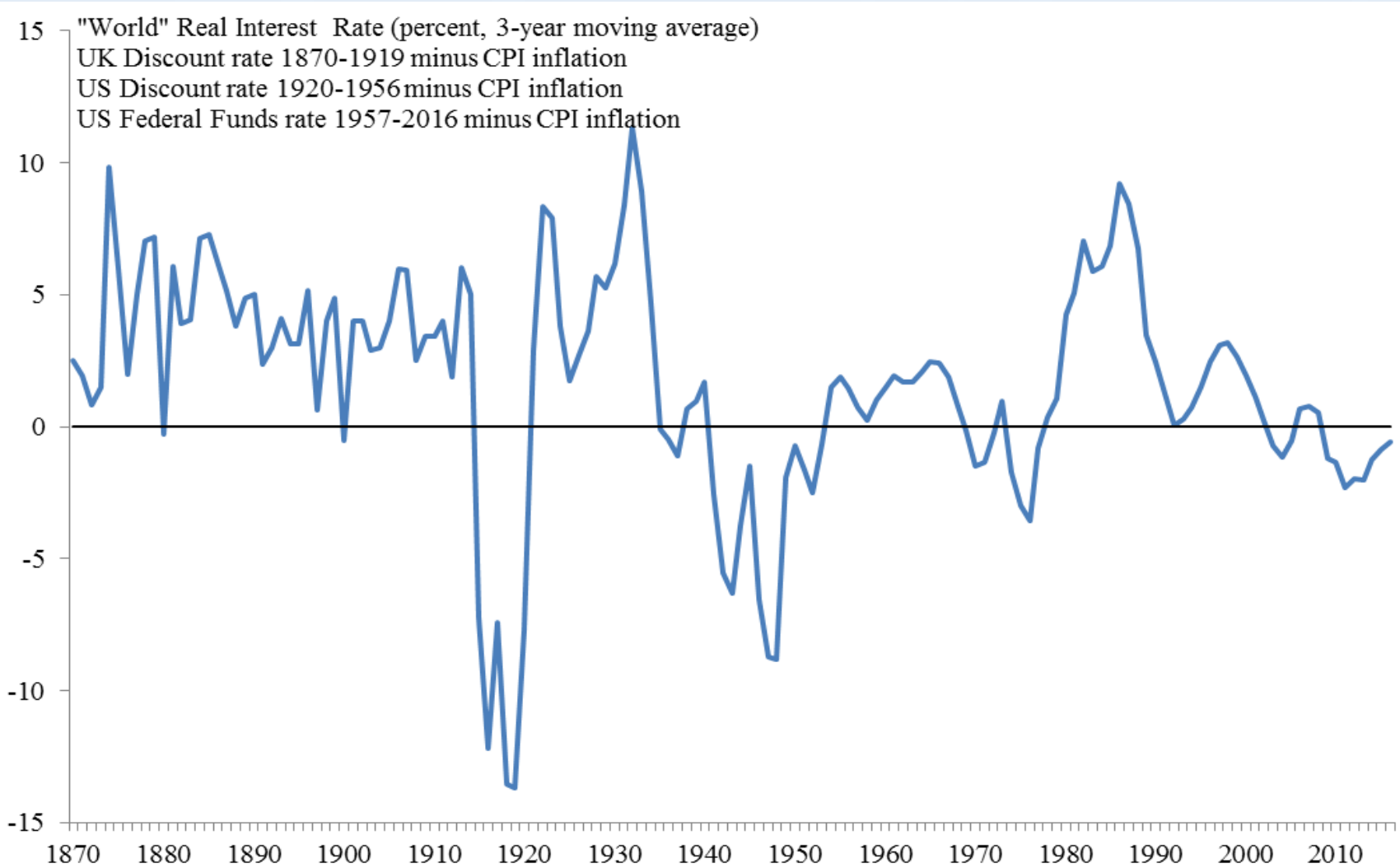
Global setting

- (i) sustained low or negative real interest rates (Fed tightening notwithstanding)**
- (ii) a large footprint of the official sector in the financial sector;**
- (iii) Compelling reasons for gradualism in “normalization” by major central banks.**
- (iv) Low inflation international environment by historical standards**

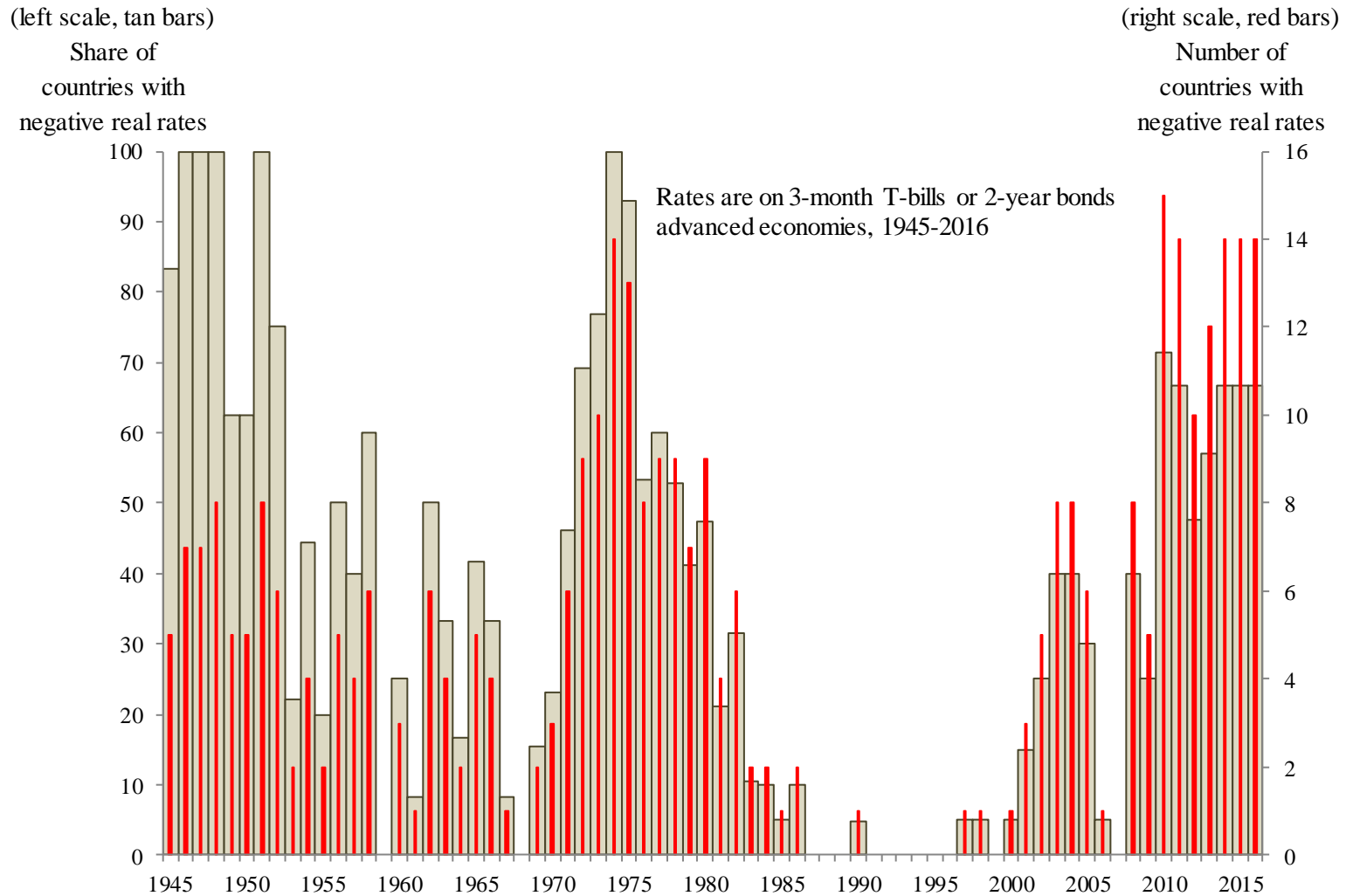
**The next few slides make
the case that the global
environment feeds
the eternal search for
high yield.**

**This is where Argentina
comes in.**

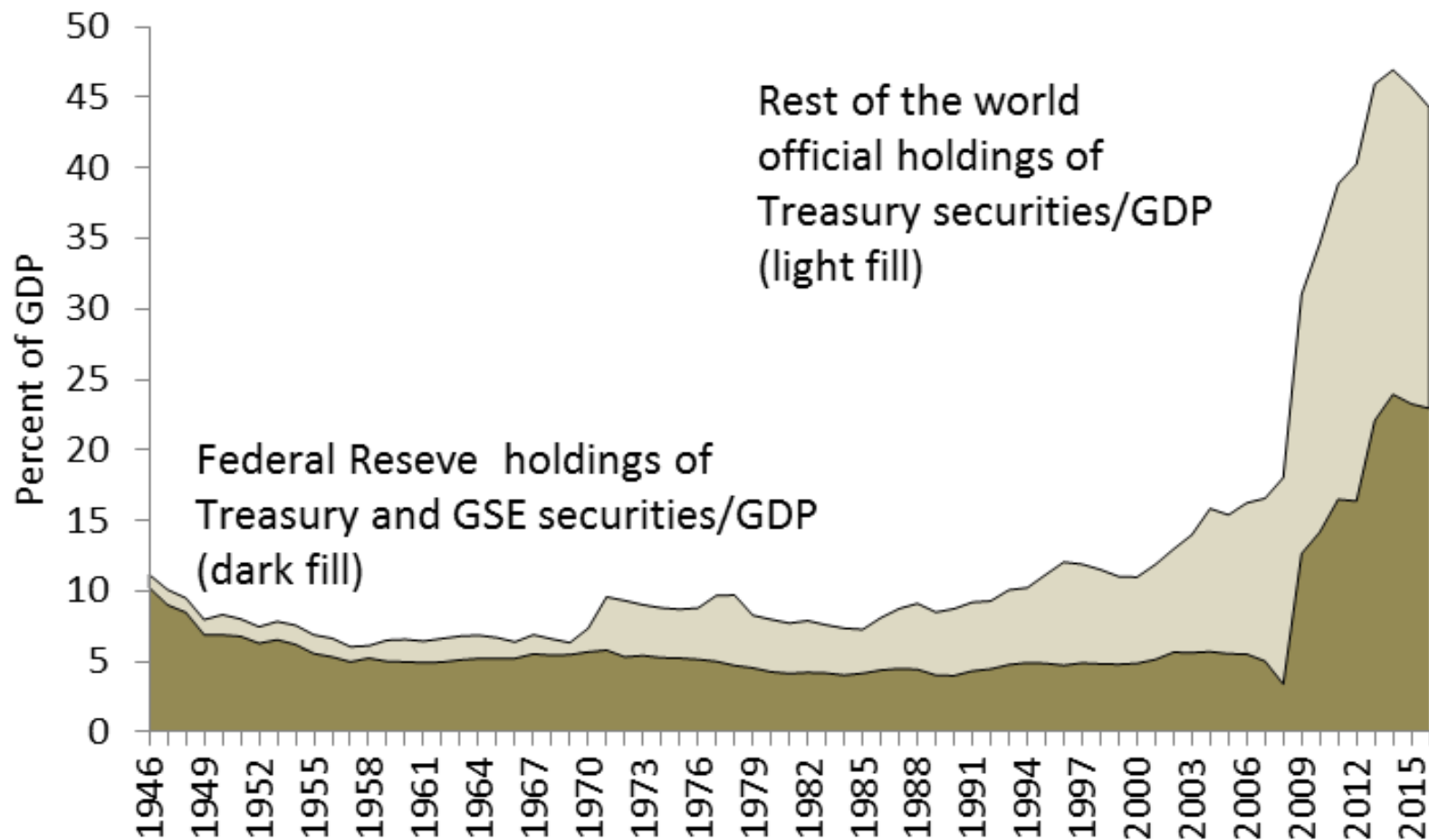
"World" Real Short-term Interest Rates, 1870-2016



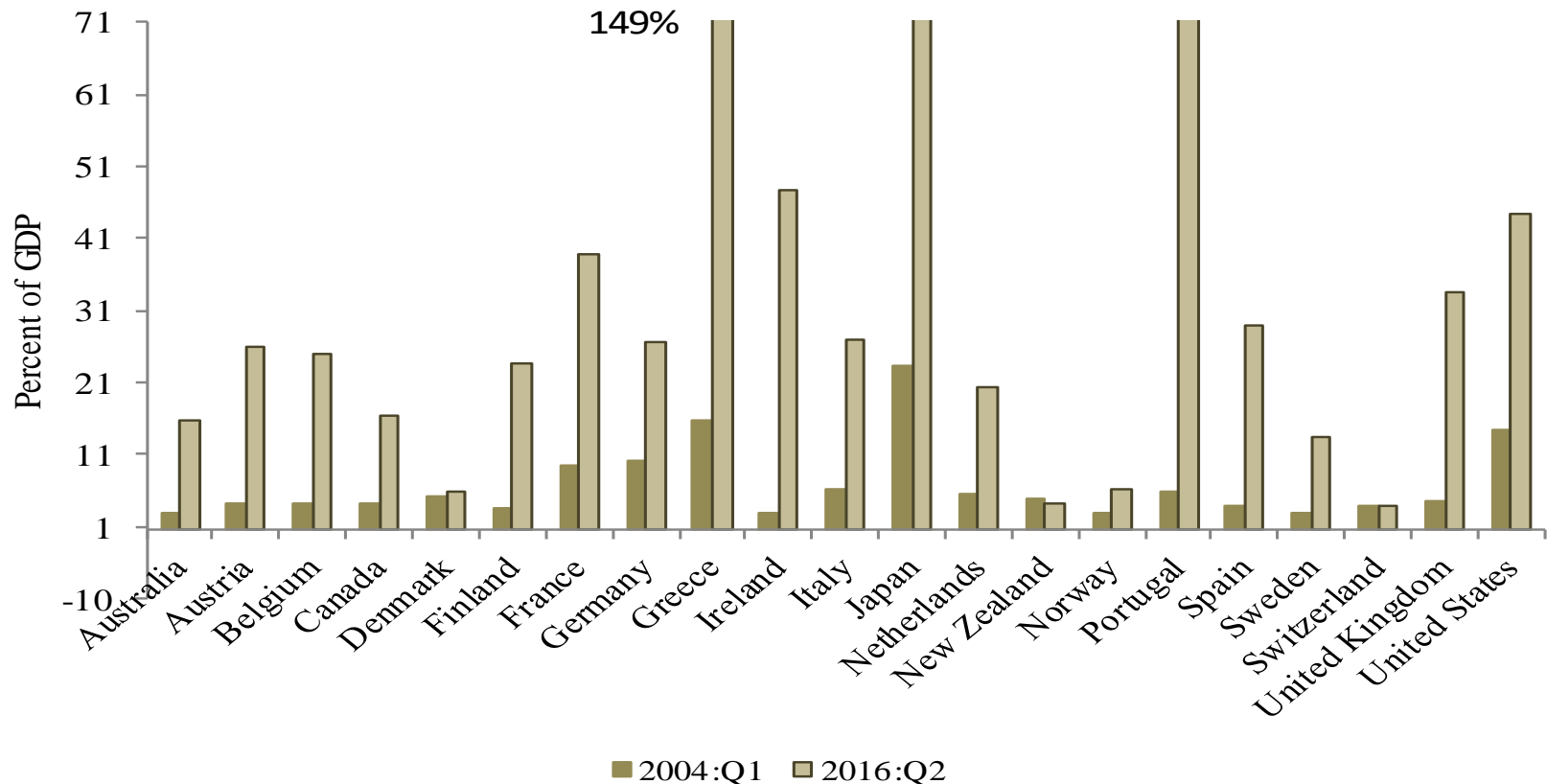
The incidence of negative real short-term interest rates in advanced economies, 1945-2016



The combined effect of domestic and official players calls into question to what extent interest rates remain “market-determined”



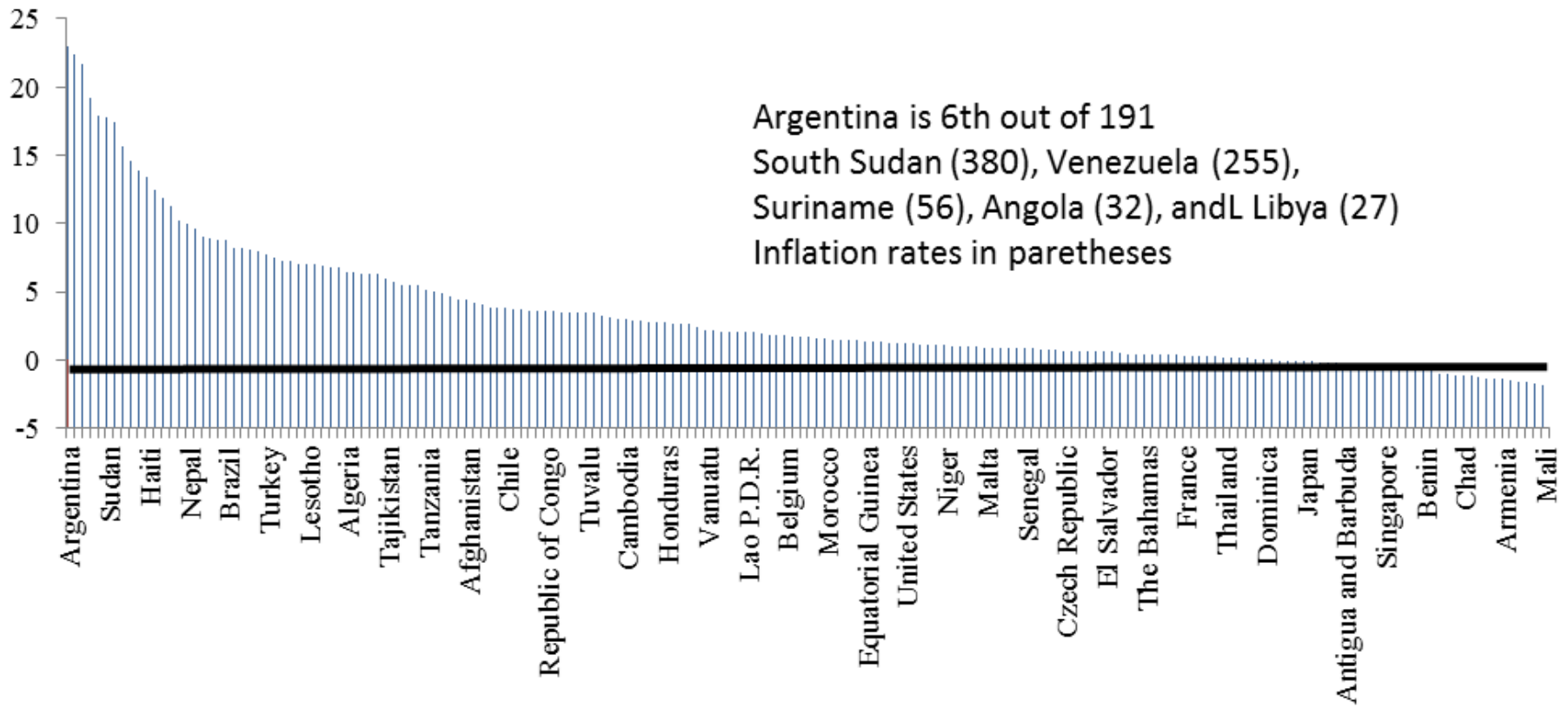
The expanded role of the official players is not just a US phenomenon. General government debt held by official sectors/GDP, 2004-2016



Notes: Domestic official sector refers to the central bank; foreign official sector is comprised of foreign central banks, multilateral institutions, and foreign governments. For the US, purchases of GSEs are included.

**The global setting also adds to
the pressures to stabilize**

Inflation worldwide: 2016 (International Monetary Fund, WEO)



Eternal, Internal and External Pressures

Inflation stabilization (ERBS and MBS)

- Real appreciation (both)
- High real rates (both)
- Financial deepening/credit boom (later for MBS than ERBS)
- MBS-recession then recovery
- ERBS-boom (especially consumption) usually followed by bust

Recurring “Capital inflows problem”

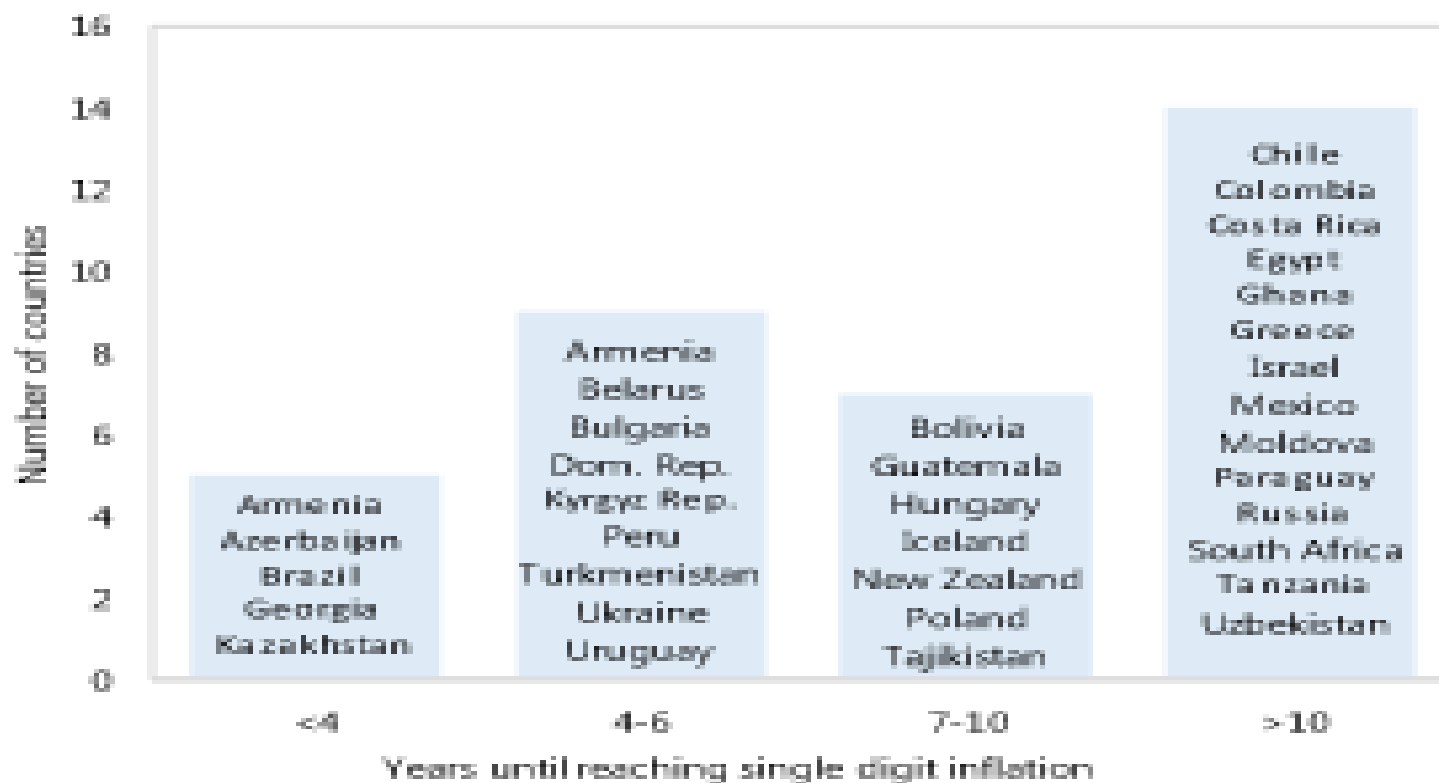
- Real appreciation
- Asset price boom
- Credit boom
- Deteriorating balance sheets
- Overheating-consumption boom
- Worsening current account balance
- Bonanzas often end badly

Real exchange rate concerns and the speed of disinflation

Inflation stabilization in moderate (10 to 40 %) chronic inflation cases: trajectory

International Monetary Fund (2016)

Moderate Inflation Episodes and Convergence to Low Inflation



What the study does NOT mention is that in cases like Chile and Colombia (among others) it took longer because of a “soft” PPP rule

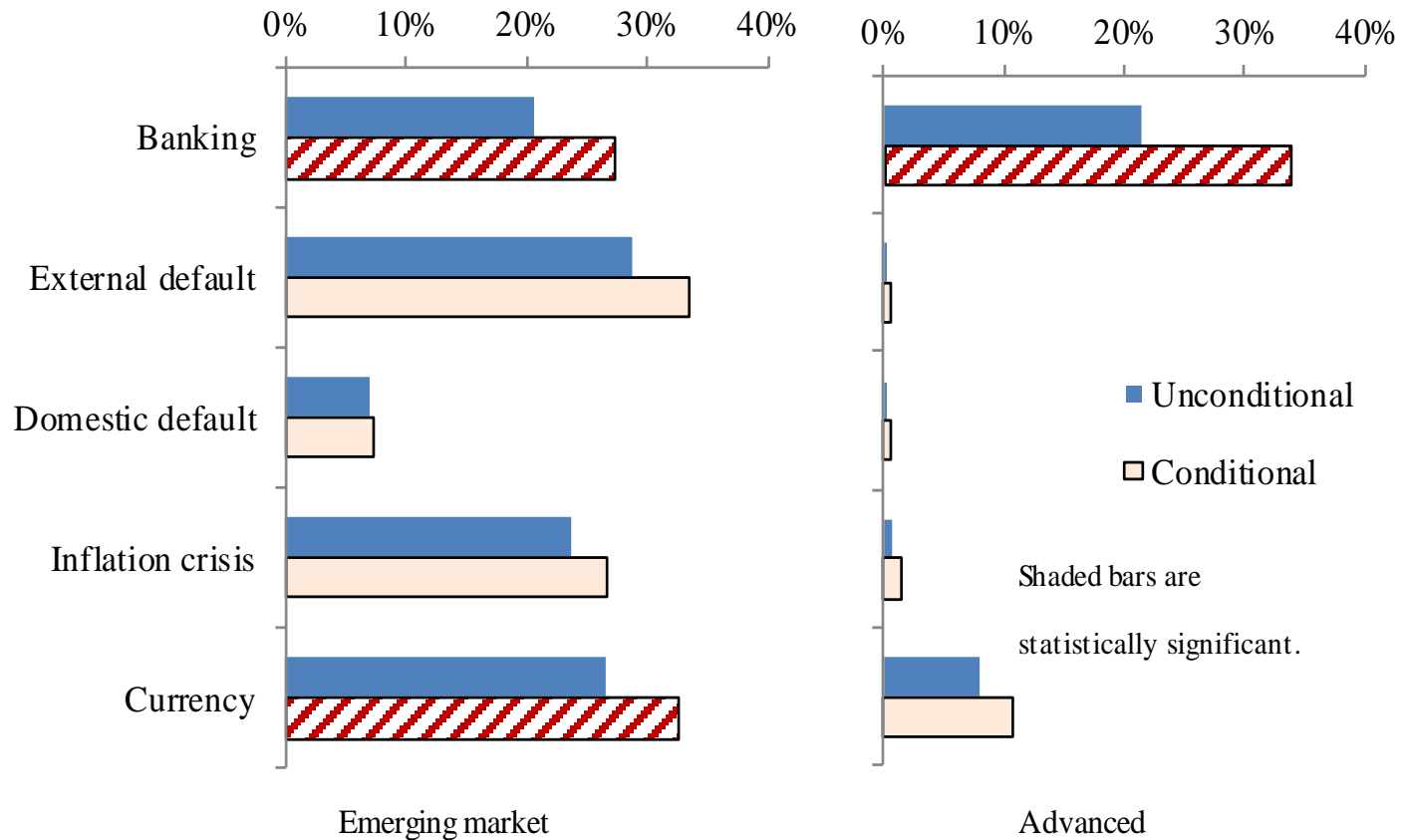
Note: This approach was motivated by the adverse outcomes usually associated with overvaluation, which is the most robust leading indicator of crisis (according to KR and others).

**Capital inflows often end
badly. A reminder of what you
already know and should
always remember.**

Crisis probabilities and the aftermath of capital inflow bonanzas

Reinhart and Reinhart (2015)

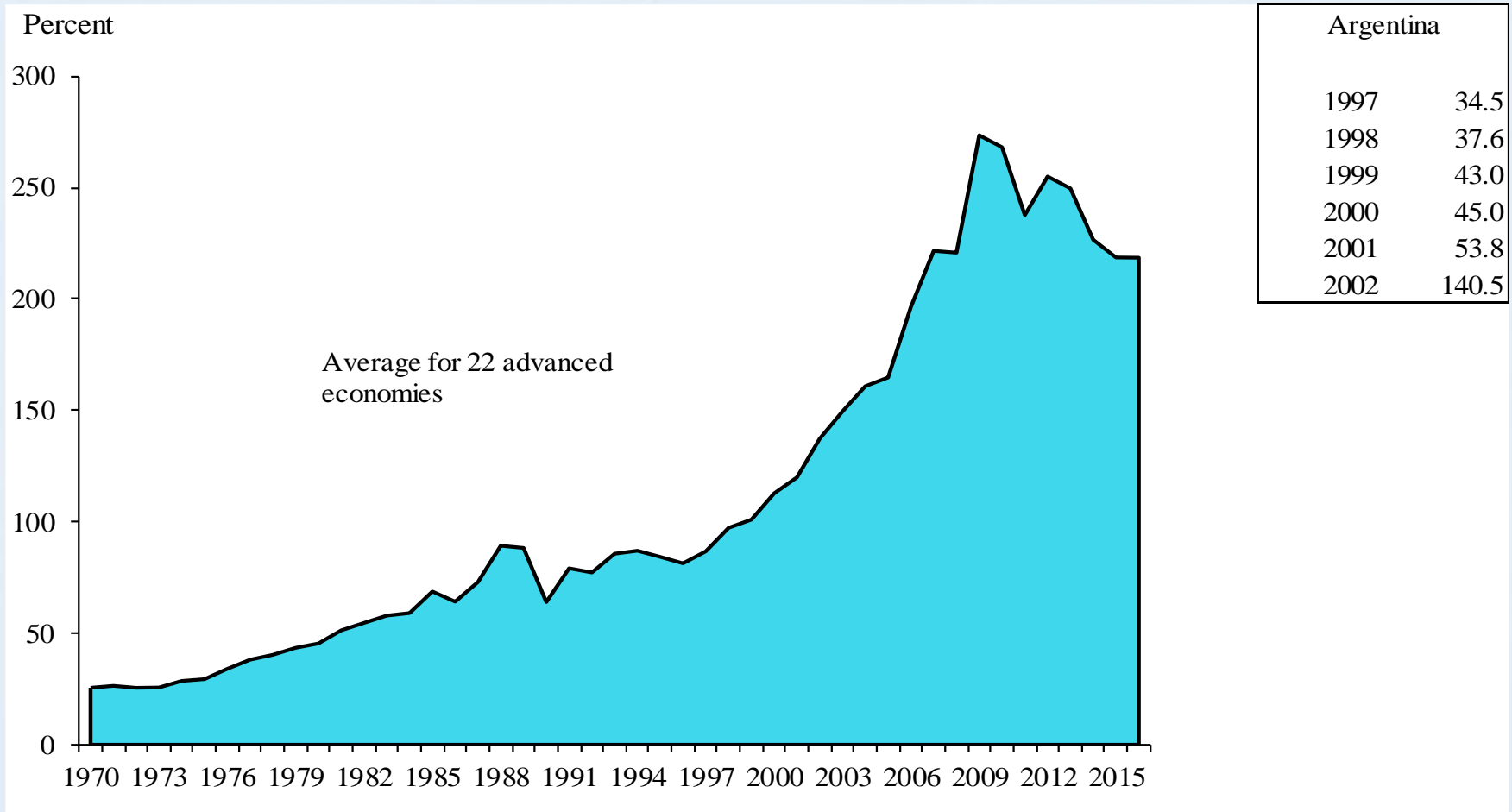
Probability of a crisis, by type, and the benefit of observing a current account bonanza
 Share of countries, 1982 to 2014, percent



Source: Reinhart and Reinhart (2009) and Reinhart (2010), updated.

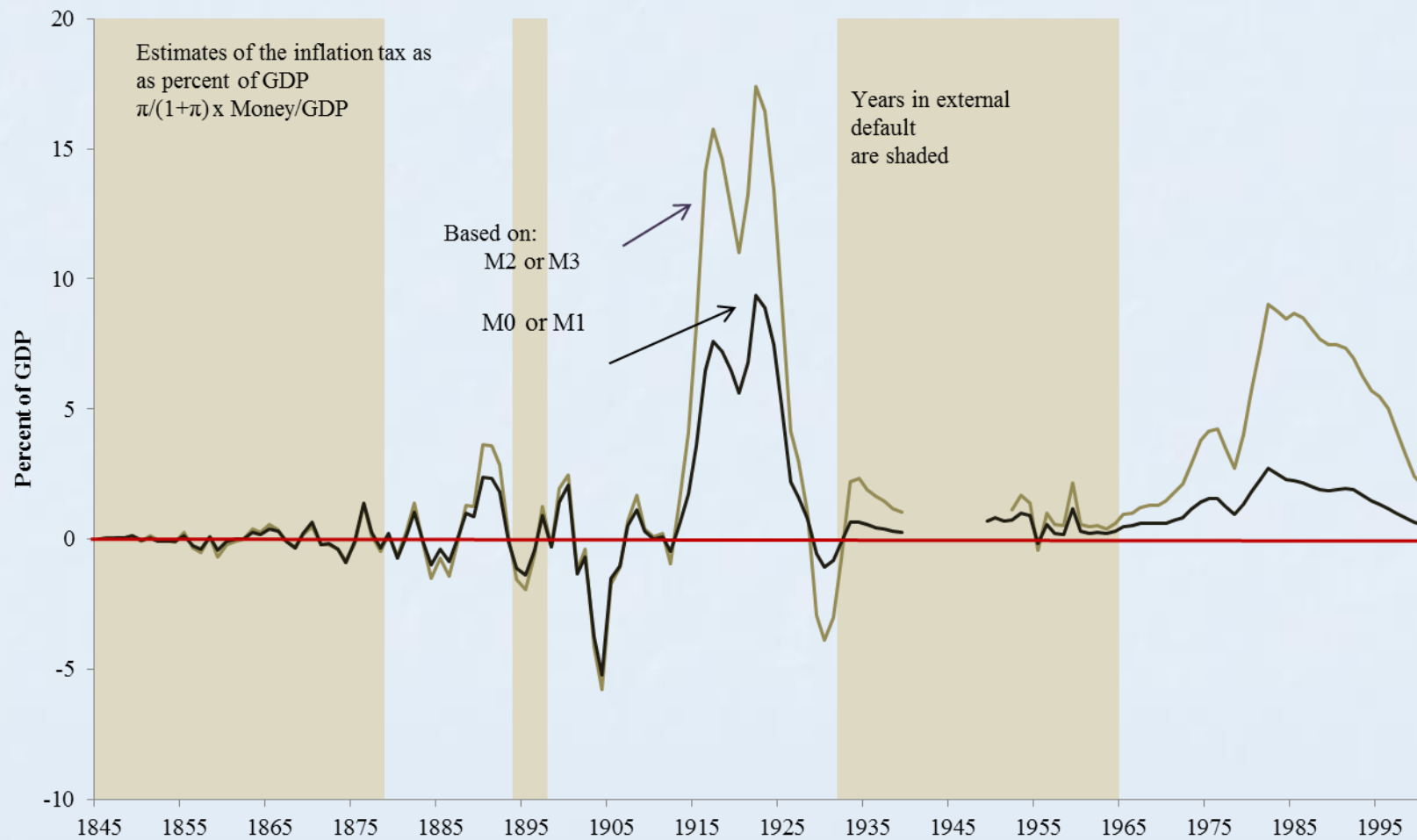
Fiscal concerns: Inflation tax or debt financing?

Total External Debt: What is low external debt for Argentina?

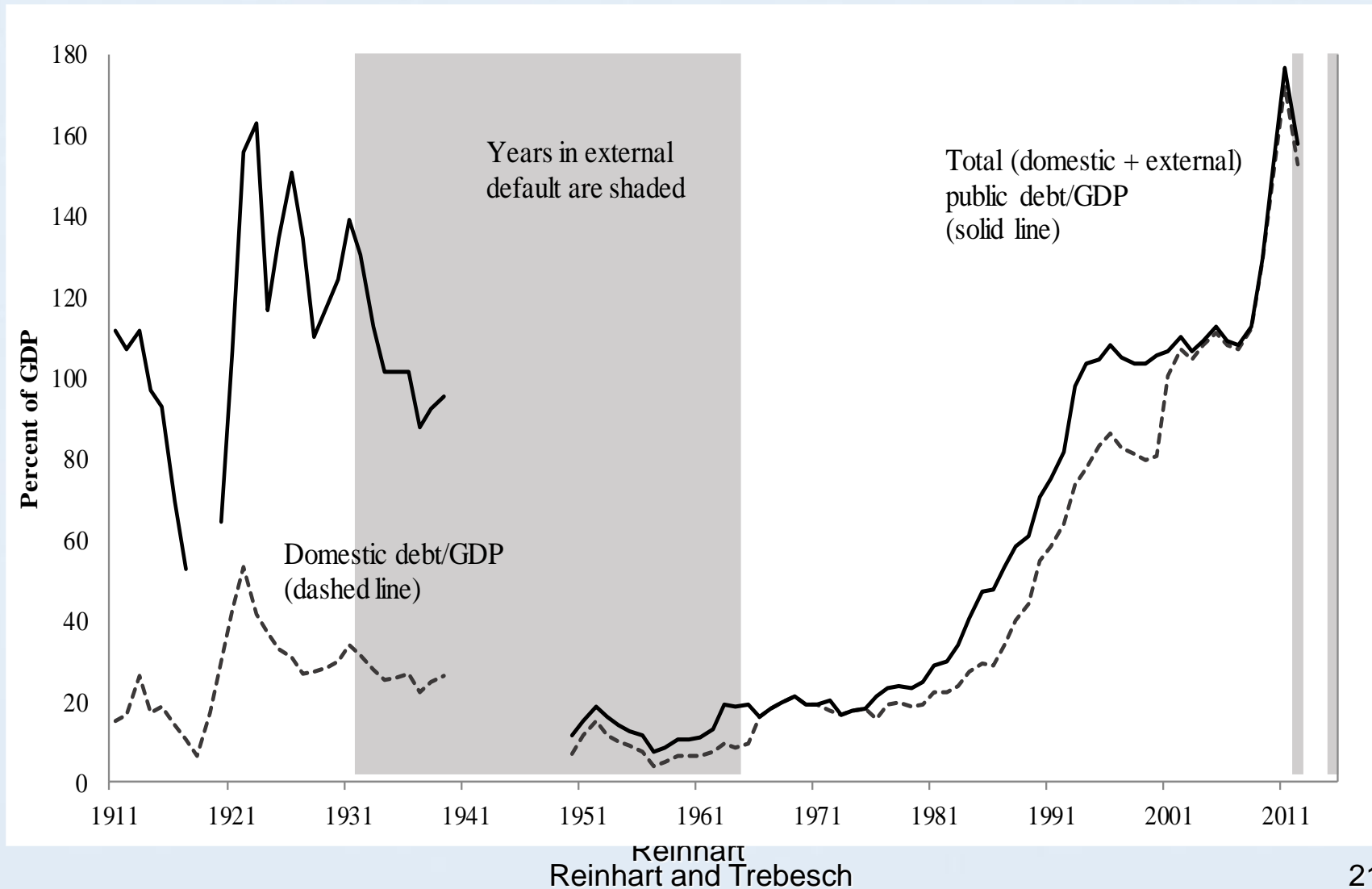


**An interesting example:
Post-inflation stabilization,
internal debt financing was no
bargain for Greece...**

Pre-Euro revenues from the inflation tax, Greece 1845-2000 (Reinhart and Trebesch, 2016)



Public debt, its domestic component (as a percent of GDP), and external default: Greece 1911-2015



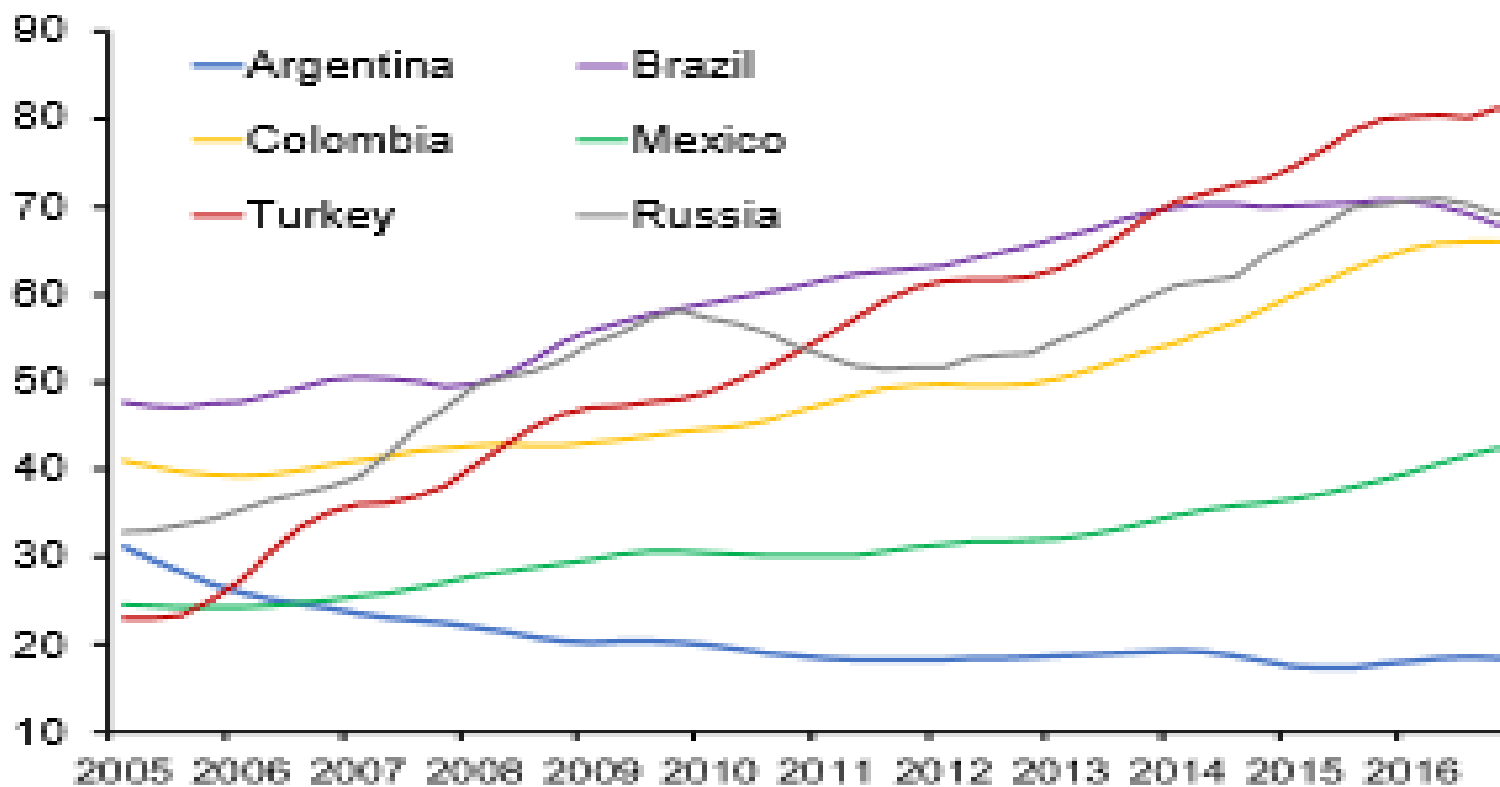
Financial deepening or credit boom?

**Mendoza and Terrones show a
strong systematic connection
between capital inflows and
domestic credit booms—
inflows tend to lead domestic
credit
by 1-3 quarters**

The compelling case for financial deepening: Argentina's legacy of chronic inflation and financial repression

EMs: Credit to the private sector

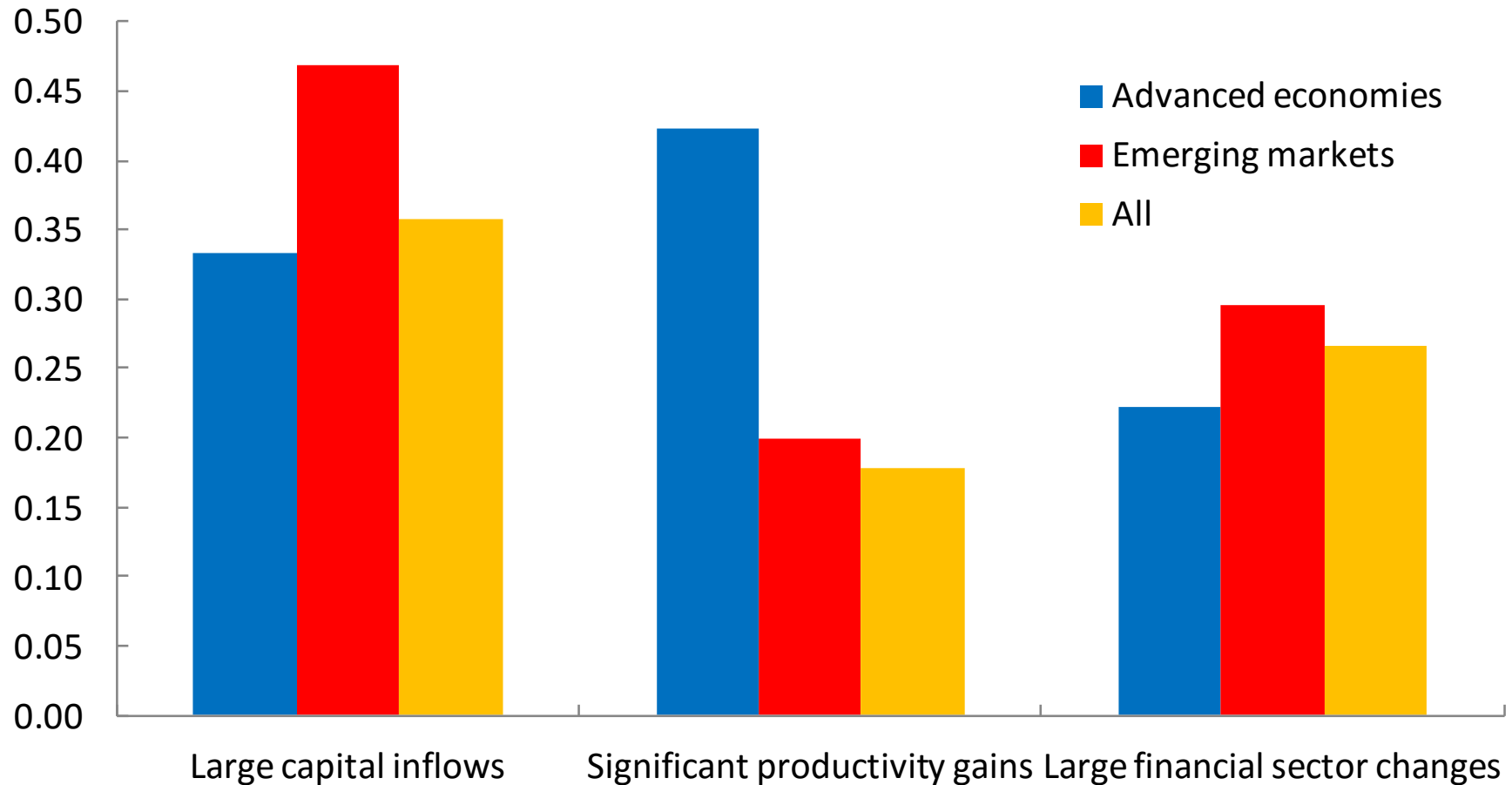
% of GDP



Source: BIS

**But beware of *seemingly*
undoing in a couple of years the
damage that was inflicted over
a very long history.**

Credit booms and potential triggers (frequency analysis from Mendoza and Terrones)



Should this have sounded alarm bells for Mexico in 1993?

The subtle issues about credit quality and speed of
expansion

	Domestic Credit/GDP			
	1993	1994	1995	1996
Mexico	32.9	39.2	41.3	31.3
Australia	75.1	77.4	80.3	83.3
Netherlands	98.6	100.2	104.5	109.7

Note: Crises Years are shaded

Mitigating risk of credit booms in semi dollarized economies: Some possibilities

FX-related prudential measures

- Discriminate according to the currency, not the residency, of the flow**
- Applied to regulated financial institutions, primarily banks**
- Examples: limits on banks' open FX position (as a proportion of their capital), and limits on FX lending by domestic banks (or higher capital requirements)**
- Other prudential measures**
- Reduce systemic risk without discriminating based on residency/currency**
- Examples: LTV ratios, limits on credit growth and sectoral lending, dynamic loan-loss provisions, and counter-cyclical capital requirements**

Some uplifting reflections

A dividend of inflation stabilization: Passthrough (thus far) has been modest by historical standards...

October 2013 to January (or February) 2016		Inflation (eop)			
Currency depreciation (percent)		2013	2014	2015	2016
Brazil	84.6	5.9	6.4	10.7	7.2
Chile	44.1	2.8	4.7	4.4	3.5
Colombia	77.9	1.9	3.7	6.8	6.0
Malaysia	31.7	3.2	2.7	2.7	2.1
Mexico	42.0	4.0	4.1	2.1	3.2
Peru	26.6	2.9	3.2	4.4	2.9
Russia	140.8	6.5	11.4	12.9	5.9
South Africa	65.1	5.4	5.3	5.2	6.7
Turkey	50.8	7.4	8.2	8.8	9.1
October 2013 to February 2017					
Mexico	55.0				

Sources: International Monetary Fund, *International Financial Statistics* and *World Economic Outlook*

**The post-bonanza wave of defaults has not yet materialized: Low international interest rates, better fiscal and macro-management of inflows, or both?
Reinhart, Reinhart and Trebesch (2017)**

