GRAY/20/2936

September 23, 2020

Statement by Mr. Lischinsky, Mr. Morales, and Ms. Moreno on Toward an Integrated Policy Framework (Preliminary) Executive Board Meeting September 28, 2020

We thank staff for the report and useful engagement with our office, and welcome the impressive work on building a comprehensive analytical framework in order to guide the Fund's policy advice for countries in which using multiple tools is warranted, while complementing many other Fund toolkits and inputs. We acknowledge that the framework is designed mostly for open economies, based on the Mundell-Fleming model as the workhorse model. Deviations from the model arise from domestic and external frictions, as well as externalities. Overall, we broadly agree with the framework underscoring that optimal policy combinations should not take the form of "anything goes", while responding to the nature of shocks, country characteristics, and initial conditions.

General Comments

We note that the Integrated Policy Framework (IPF) is a work-in-progress that still needs to deal with difficult theoretical and operational challenges. There is still wide room for judgement before the policy advice can be made operational in real situations. We caution on jumping prematurely into using the principles derived from the IPF to feed into other Fund toolkits, without having properly addressed pending issues, like for instance, the scale and persistence of possible cross-border spillovers of capital account and macroprudential measures. Likewise, the forthcoming revision of the Fund's Institutional View on Capital Flow Management (IV) will cover fundamental topics such as the appropriateness of preemptive Capital Flow Measures (CFMs), for which the IPF as it is today would not be in a clear position to provide input.

We underscore and welcome that staff explicitly indicates that the IPF policy mix principles are not applicable to all countries That is, the Fund's current policy guidance—as opposed to the IPF—applies to the set of countries where i) monetary policy ensures internal balance; ii) a flexible exchange rate regime is maintained that ensures external balance; iii) FX interventions are seldom used in disorderly market conditions; iv) macroprudential polices might be implemented to ensure financial stability, and v) capital flow management measures are solely appropriate under specific circumstances. This is the case of Chile, and others, as previously pointed out by staff, in which case the implementation of multiple tools could even be detrimental.

The communication of the framework's principles and guidance is key. A complex model risks telling the wrong story. Hence, communication should be extremely careful and include the assumptions, caveats, and weaknesses associated with the framework, as expressed by Mr. Merk and Mr. Buetzer in their Gray in May 2020, keeping in mind that information asymmetries exist between policy makers, academia, and the general public, which add to the risks of misinterpretation and the need for clear messages.

Staff acknowledges that benefits from alternative policies should be weighed against corresponding costs. We would like to add that there might be reputational costs that the framework is silent about, particularly on possible negative market reaction to inflow CFMs, and/or diminished credibility on the country's rules of the game. Not all relevant trade-offs necessarily lead to a zero-sum-game situation.

<u>The Framework</u>

The framework attempts to take into account the empirical observation that many countries find it useful to combine monetary policy with active FX intervention, the introduction of capital controls and/or the adoption of macroprudential measures. The motivation for implementing multiple policies includes shallow markets, currency mismatches, competitiveness, and uncertainty about the nature and duration of shocks. Particularly relevant are the findings that average empirical relations are not enough, as stress times are different to normal ones, and that short and medium-term implications matter, as, for example, some vulnerabilities build over time. Therefore, we encourage staff to continue relying on empirical work and case studies to feed and inform the models. We would add that further and continuous analysis on medium-term considerations are relevant to assess the impact of policies, especially from the introduction of capital controls. We stress that current policies should not compromise future policy space and/or authorities' policy decisions. *Could staff comment on time consistency of policy advice given that the framework does not necessarily establish the right balance between short- and long-term benefits and costs of using various tools?*

The calibration of shocks and identification of their nature is always a challenge, even in normal conditions, but it can become much more complicated amid elevated uncertainty. *Could staff comment on how robust the optimal policy combinations are to misspecification and poor calibration of shocks?* In addition, the transmission mechanisms of the shocks can become complicated by a few additions to the model, as we understand it is the case, for instance, with the inclusion of fiscal policy.

We are concerned that the framework does not take into account endogeneity between the frictions that trigger an alternative policy mix in response to shocks—given country characteristics and initial conditions—and the policy framework that the country has in place. Dollarization, depth of financial markets, particularly FX markets, among others, feed back into the choice of monetary policy and exchange rate regime. Some examples include i) more flexible regimes usually incentivize the development of hedge markets, and ii) more open economies that allow for non-residents to invest locally, promote deepness in the capital market. Although we recognize that the impact of the tools on market developments will not be homogeneous, among countries, and that empirical evidence is not fully compelling, we believe that endogenizing such features would enrich the insights and improve the advice, with higher attention towards first-best policies. In addition, an adequate (or high) level of international reserves, which the Fund assesses as a mitigant for external shocks (low levels signal external vulnerability), could be the result of precautionary build up in the context of a flexible exchange rate regime, or because there is a need for high reserves in order to defend the currency, had the country chosen to frequently intervene. We are encouraged to learn that staff has the intention to advance in this direction.

Regarding the development of safeguards, we take positive note of the intention to minimize the risk of inappropriate use of IPF policies. As stressed for the implementation of the IPF as a whole, mechanical applications are to be avoided, and this is true also for metrics, which should be complemented by judgement. It is the case that for some of them there is no broad consensus and should be carefully established considering country characteristics. We look forward to future work in implementing these metrics and determining how staff will assess that a country is applying policies that significantly deviate from the Fund's advice. *Could staff comment on the value added of safeguards in terms of the desired goal of avoiding policy advice diversions, considering the current close engagement of country teams with authorities, and their use of judgement, balanced by authorities' views in Article IVs?*

Staff's judgement and case studies will be a crucial complement, **including to capture non-economic features that may drive the choice of policies**. Issues like political economy considerations cannot be adequately considered in this kind of framework. In some cases, interventions do not necessarily respond to economic analysis, but political pressures. In this regard, the use of CFMs and other tools could be explored with a perspective of public choice. This different approach could also be considered when defining the institutional safeguards for a good use of the policy advice, as well as from a multilateral point of view.

<u>Possible Additions to the Framework</u>

We welcome that staff is considering incorporating fiscal policy but wonder about the net gains from this effort. We take note though that indirectly, the impact of traditional fiscal policies can be replicated by the elements currently in the model. On the same line, it has been argued that restrictions of the monetary policy and fiscal policy might be similar, and so they can be thought of in a similar way. In addition, during the May briefing staff indicated that including fiscal policy in a basic way would be straightforward, but more granularity would involve trade-offs. *Considering the added complexity and trade-offs, does staff anticipate there is value added that justifies including the fiscal policy block in the framework?*

Monetary policy is well covered in its traditional role but not in an unconventional setting. During the last ten years, since the global financial crisis, unconventional monetary policies (UMP) have played a predominant role, even in explaining capital flows to emerging market economies (EMEs). During the COVID-19 crisis, EMEs joined advanced economies and deployed central bank bond purchases for the first time. We understand that at the risk of increasing the complexity of the model, staff has considered incorporating a channel through which UMP can play a role. We look forward to staff's enhanced work.

Final Comments

We believe that, regardless of the staff's modelling efforts, there is still the need to factor in the staff's advice getting trapped in second-best policy recommendations. As already mentioned, there is value in having a framework to help "organize" the policy mix for countries that choose to deploy multiple tools. Nevertheless, the Fund should aim at first-best advice when warranted, and hence assist countries in developing the necessary conditions to deal with the underlying concerns that trigger the multiple tool strategy in the first place. There is a risk of confusing the objectives, and in a way, a cost of retaining or even worse, enhancing inefficient regulatory mechanisms, by maintaining the attention on second-best policies. *In addition, could staff comment on how the IPF guidelines and policy advice could be accommodated in the context of an economy transitioning from one policy framework to another*?

The framework is yet to be operationalized, a step that we believe not only will test the applicability but might also incorporate new or complementary insights. Staff will probably be challenged when attempting to measure, for example, country characteristics in a systematic and comparable way across economies, as well as the status of the policy frameworks. A mechanic application of the model is not possible, as recognized by staff. Financial development, FX market imperfections, imperfect market credibility on monetary and exchange rate frameworks, among other characteristics, are not trivially assessed and measured, in part because not all countries might deliver the same quality of data. On a positive note, countries will have an incentive to build relevant datasets that may enrich policy analysis, and the Fund could help with technical assistance. The AREAER survey and the IMF's integrated Macroprudential Policy (iMaPP) database will be key inputs, so it is of utmost importance that they are assigned the needed human and budgetary resources, as recommended by the IEO in its latest evaluation on IMF Advice on Capital Inflows. *Has staff considered distinguishing between spot and derivatives' market exchange rate interventions, assuming there could be implications for the effect of the FXI and reserve buffers?*

On the IPF and the core functions of the Fund. We take positive note of the role of the IPF in supporting surveillance and capacity development. We would like to raise an issue that might be just communicational, but it could also have other implications. Precautionary lines do not impose pre or post conditionality, but they do assess how strong the fundamentals and policy framework are. Some of the qualification criteria coincide with the country characteristics and underlying concerns that trigger multiple policy mix. Two "very strong" countries may end up having very different policy advice, after being assessed in a rather similar way. Even though this might be clear while analyzing the reasons in a more granular way, it could be confusing for the market, and hence detrimental for these economies. *Staff's comments are welcome*.

More generally, we recognize the value of greater flexibility in policy analysis and tailoring of policy advice. However, much more work would be needed to ensure that the new toolkit offers significant advantages over the existing one. Evenhandedness may become even harder to assess because there will be numerous ways to justify a given policy advice, considering the significant number of variables at play. On the other hand, the safeguards, if at all binding, will allow the Fund to not deviate too much from current advice. We believe that the implementation of this framework still has numerous challenges and obstacles to overcome, a task that will require strong teams, and most probably additional resources. If this framework is to become the leading toolkit for Fund policy advice it should be one of the budget priorities at the departmental levels.