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Statement by Mr. Villar, Mr. Guerra, Mr. Moreno, and Ms. Arevalo Arroyo on Toward an Integrated Policy Framework (Preliminary) Executive Board Meeting September 28, 2020

We thank staff for the insightful paper and the continuous engagement with the Executive Board and country authorities during the process of developing the Integrated Policy Framework (IPF). The IMF should be at the forefront of policy discussions regarding the use and complementarities of the different instruments to ensure that policymakers are better equipped to face difficult tradeoffs in the pursuit of their stabilization objectives within a systematic framework. In order to do this, analytical work is of the essence and the IPF is a welcome example.

We believe the IPF offers valuable analytical insights into how country characteristics and circumstantial conditions might warrant the short-run deployment of multiple policy tools. We recognize that the paper strives to present a careful balance between the need to maintain the key messages of the Fund on the first-best policies— which include flexible exchange rates and openness to international capital flows—and the need to understand the complexities of second- and third-best policy decisions that many countries have implement when facing restrictions under specific circumstances. However, echoing the IMF's view on the importance of developing sound economic fundamentals for long-term crisis prevention and mitigation, we would encourage a stronger message and further research on the role of capital account liberalization in the context of an integrated policy framework. As reliance on the IPF tools is not a substitute for deep markets, healthy balance sheets, and strong institutions, the message and policy strategy should focus on the optimal policy path for achieving long-term macroeconomic and financial stability while enhancing monetary policy autonomy.

Lessons and future work

The IPF contributes to fine-tune the IMF's traditional approach to macro policy and to identify conditions in which a policy mix, which could be traditionally seen as unorthodox, can still achieve stabilization objectives. A relevant finding of the IPF conceptual framework is that not all instruments work equally under different circumstances and the optimal combination of instruments may differ depending on the specific country context.

The paper presents very interesting information in this regard. For instance, Fig. 2 shows the significant differences among emerging market economies regarding policy reactions when those economies where faced with the retrenchment of capital flows in 2018. Some countries like Chile, Mexico, and Colombia allowed free adjustment of the exchange rate with no or negligible foreign exchange interventions. Other countries, however, used sizable FX interventions. In this sense, the incorporation of the types of frictions common to EMDEs in the model is useful as the results show how FXI, MPMs and CFMs play different roles according to countries' circumstances.

That said, we welcome the emphasis on the fact that while IPF tools can be effective in achieving a particular objective, that does not imply their appropriateness for meeting broader macroeconomic objectives or maximizing the welfare of the country. Also, we find reassuring that staff notes that these tools are not a substitute for exchange rate flexibility, deep FX markets and healthy balance sheets. In that sense, the stronger message should clearly state that the tools should not prevent necessary economic and fiscal adjustment or allow unsustainable policies to persist. Furthermore, we take positive note of how CFMs are framed within the IPF, where a clear distinction is made between regulations on capital inflows (which typically apply in boom periods in which financial vulnerabilities are building up), and policy recommendations on capital controls on outflows (that are typically used in imminent crises).

The results conclude that countries with deep FX markets, continuous access to external financial markets, and well-anchored inflation expectations can achieve both output and inflation stabilization using only monetary policy and allowing the exchange rate to adjust freely. In this line, we believe that this should be the final objective for all countries. As such, policy recommendations on the appropriate policy mix should aim to balance short-term benefits and costs to construct a long-term objective path.

Specifically, on the model, we consider its calibration may not be the best fit for all open economies. An additional parameter dividing Emerging Market Economies and Advanced Economies could improve the analytical framework. Making a reference in the paper to the extent to which the IPF may apply to small-open economies with soft pegs would also be instrumental for several countries of the Fund's membership. Moreover, understanding the FX market depth definition used to assess a country's classification is fundamental to fully understand the model's practical implications. Furthermore, several practical challenges may arise when it comes to implementing policies in an integrated fashion. First, the policies considered in this paper may be assigned to different agencies in some countries, and coordination between them may be imperfect. Second, while each policy tool could have its merit in certain circumstances—as outlined in this paper—in practice, central banks will need to consider how to carefully incorporate multiple objectives and tools into their policy and communication strategy. Third, the identification of shocks in real-time may be difficult. Therefore, we agree that transparent policy guidance based on metrics observable in real-time could facilitate the application of IPF tools, complemented by expert judgment.

The summary of main lessons puts forward a set of useful comprehensive topics to determine the path forward. **While we broadly endorse and welcome the current work, we believe there is still need for further analytical and empirical developments for the IPF to better serve policy discussions and the IV review.**

- **We welcome the intention to include the fiscal policy dimension as it is crucial to enhance the effectiveness of the IPF toolkit.** An underlying assumption of the IPF is that fiscal policy responds with a lag. It is conceivable that it may need adjustments at any given point in time. For example, suppose fiscal policy is not consistent with public debt sustainability, or it is not considered in the framework as an essential resource for policymakers in the short-term against exogenous shocks. In that case, the use of IPF tools may increase the risk of a disorderly adjustment. Thus, including it would be necessary for various reasons:

- It interacts in important ways with monetary, FX, and macroprudential policy. In fact, policy recommendations made by the IPF should consider these interactions.
- Beyond fine-tuning the economic cycle, fiscal policy serves too as an anchor of the macroeconomic framework. This is particularly relevant for emerging market economies.
- Fiscal policy could also have short-term effects on financial markets. For instance, a prudent fiscal stance would enhance market confidence in a given country, making it more resilient to changing external conditions and financial market volatility.

In sum, it is difficult to provide effective guidance on the optimal policy mix that excludes fiscal policy.

- **Multilateral spillovers.** Staff presents the case for further work regarding the multilateral implications of the use of IPF tools on other countries. While the paper does a great job in delimiting the circumstances under which policy tools are substitutes or complements, it does not consider trade-offs from a multilateral point of view (i.e., the framework does not explain who bears the cost of unilateral capital flow measure adoption). It is very likely that in cases where, for a given country, a policy combination is marginally better than its second-best policy alternative (and thus trade-offs might be negligible from that country's point of view), spillovers affect countries with similar structural characteristics. If the latter is unable to replicate the dominant policy strategy due to institutional or political economy concerns, it will end-up internalizing the negative effects of volatility. We believe policy dialogue on how to address capital flow volatility should be centered on a careful assessment of the multilateral costs and benefits of alternative policy instruments to achieve stabilization goals. Moreover, the risk of cross-border spillovers among emerging markets that may arise out of some specific types of CFMs are discussed, but we would call for a deeper analysis on this issue; *specifically, could staff clarify if the possible implications that IPF measures could have on other countries will be considered in providing advice to EMEs under the IPF?*

- **The agenda should focus more on how to reduce vulnerabilities, not only on measures to palliate them.** Staff recognizes that an aspect that needs to be addressed is the implications that IPF tools may have on long-term market development. In this regard, we welcome the technical assistance and capacity development on areas such as development of markets and institutional frameworks, with emphasis on the removal of obstacles and barriers that may affect such development.

- **Explicit link between time horizons and the inherent tradeoffs as well as endogeneity of country conditions.** We continue to be concerned about the policy recommendations of the framework if they do not incorporate a more explicit link between different time horizons. However, we take positive note that staff underscores the relevance of considering greater clarity of intertemporal tradeoffs and look forward to further work to capture this in the model and empirical analysis. We would like to highlight that, while a policy may be optimal in the very short term, it could also be suboptimal or even very damaging in the medium- and long term. The main mechanism that may lead to this result is the endogeneity of country conditions on its policy strategy. For instance, as highlighted in Box 3, two key determinants of the optimal policy mix in the models are the extent of currency mismatches and the depth of FX markets. But currency mismatches and FX deep markets may be the results of specific policy strategies. Very shallow FX markets and excessive unhedged dollar liabilities may not be exogenous characteristics of a given country, but the result of the incentives created by excessive central bank intervention or by the persistent use of CFMs. Taking in mind such endogeneity, as well as the different horizons at which each policy works is extremely important to avoid recommendations that could eventually lead to vicious circles**. In this sense, the IPF**

could have a more explicit recognition that economies with flexible exchange rates are more likely to deepen their FX markets, becoming in that way more resilient to shocks in the long run.

- **The experience of the COVID-19 pandemic with UMP should be reflected in the IPF framework.** The incorporation of unconventional monetary policy measures is relevant for the model, more so on the wake of the pandemic and the reaction of EMEs central banks as they have used non-conventional monetary policy instruments more broadly, functioning as *dealers of last resort*.[1] *Could staff comment on how these policies could be included in the IPF framework and analysis?*

- **Different modalities of FXI.** Central banks have been using different types of FXI, including for example NDFs. *Could staff comment on how this could be included in the models?* Moreover, the existence of algorithm-based strategies and high frequency trading in the foreign exchange market has forced central banks to adapt to new strategies for FXI.

- **Additionally, it would be useful to analyze the impact on the IPF framework of the development of the non-banking sector.** The rise of the non-banking sector, fintech, and digital solutions has the scope of accelerating cross-border flows and volatility, which may require specific measures within the framework.

Operationalizing the framework

The IPF umbrella is very comprehensive and entails complex and changing aspects. In this regard, as further analytical work and fine-tuning of the model is required, we would caution on several aspects that are relevant for operationalizing the framework.

We welcome the intention to develop safeguards. Before the IPF is fully operationalized, we would like to stress the importance of having a broader sense of the metrics that may help identify conditions under which using IPF tools would be inappropriate.

We see merit on advice regarding the use of IPF tools to face shocks and ensure stabilization in the short run, but it is not straightforward how the IPF could provide policymakers guidance on the necessary adjustment that the macroeconomic framework requires to enhance resilience in the long term. As mentioned before, it is crucial to find the right balance between short- and long-term benefits and costs of using various tools. *How will staff plan to provide policy advice under the IPF to balance short-term stabilization needs, in which second- or third-best policies have to be implemented and long-term structural distortions or reforms have to be addressed?*

Clear communication of the framework will be crucial to ensure that there is no misinterpretation of a radical shift of the Fund's policy advice, in particular to the role of the flexible exchange rate and the use of multiple objectives, in order to avoid reputational risks and credibility concerns. First, it should be clear in the communication of the framework, as it is in the document, that the IPF tools do not substitute for strong policy and institutional frameworks and warranted macroeconomic adjustment, which should constitute the first line of defense. In this sense, the message should provide assurance that IPF advice, given country circumstances, provides a flexible approach to the optimal policy mix without the notion that it is an endorsement of an "anything goes" context.

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[1] See for example Hofmann, et al. Emerging market economy exchange rates and local currency bond markets amid Covid-19 pandemic. BIS Bulletin No. 5, April 2020. and Arslan, et. al, Central bank bond purchases in emerging market economies. BIS Bulletin No.20, June 2020.

Communication challenges could arise when providing different policy advice under the IPF to countries with comparable characteristics. A clear general challenge of the IPF is that of the appropriate comparison in a systematic way of country characteristics and policy frameworks. As a new tool, it would be useful to analyze specific country case studies to better understand the framework, including a comparison of IPF policy prescriptions with those actually implemented by countries.

In addition, a clear communication strategy should be developed in the publication of this and related researches; it should be highlighted that it is work in progress, to avoid misperceptions of the extent of the implementation of the current proposals by country authorities or market participants.

Finally, we are pleased to see that the analytical findings from the paper are not intended to be a new Fund policy, but rather to help inform on the upcoming review of the Fund's Institutional View. In this sense, we see merit in the use of IPF work as an additional element in our future review of the IV. We reiterate our position that the IV has served the IMF and its membership well, and that there is no need for a major overhaul to the guiding principles regarding policies to address capital flow measures. A recommendation could be to make a clear and comprehensive distinction between those metrics used for IV purposes and the resulting ones for IPF advice. This would help national authorities better understand the main differences in the approach and structure of the IV and IPF and their boundaries.