How do Capital Flows Challenge Monetary Policy in CESEE?

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Presentation based on:

- Joint work with Joshua Aizenman
- Ideas influenced by several important papers written by other economists in World Bank, IMF and academia
- Full list of references in Aizenman-Pinto (2011)
- Caveat:
  - Views expressed here are my own.

Volatile Capital Flows

- Not a new problem for emerging markets (EM)
- Clear lessons from EM history:
  - On capital flows, financial integration and growth
  - On capital flows, financial integration and crisis

Lessons on Fin Integration and Growth

1. Fast growing EMs tend to self-finance growth
   – This is a robust result
   – Could CESEE be an exception? Forthcoming World Bank report paints a positive picture on foreign savings–growth link for Emerging Europe (Gill and Raiser 2011)
2. Finding on self-financed fast growth unaltered over the 1990s in spite of massive financial liberalization
3. Financial integration will help growth only if it helps bridge TFP levels between EMs and advanced economies (AEs)
4. Type of flow matters. FDI has more positive growth effects than net portfolio debt or equity flows

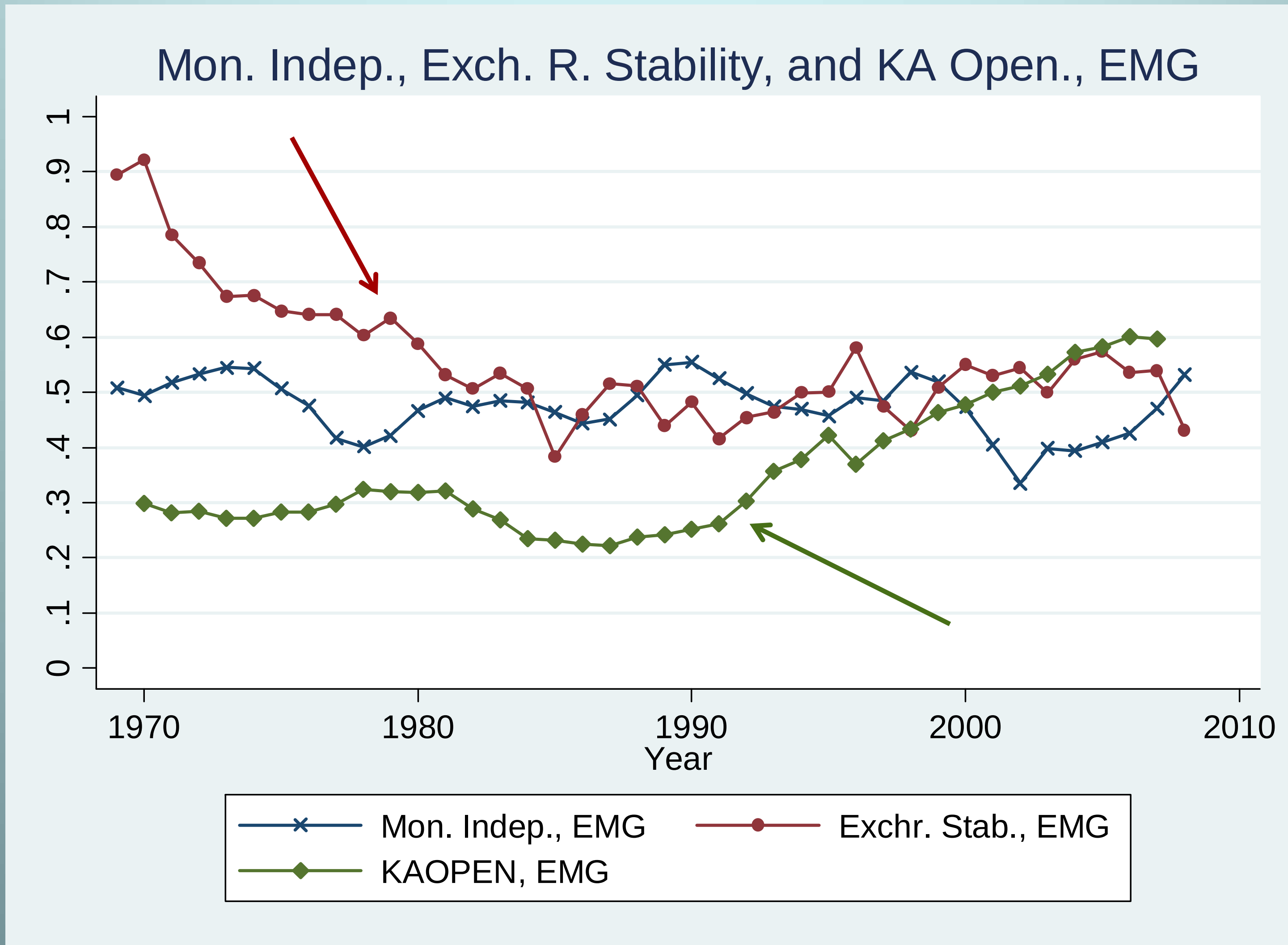
Lessons on Fin Integration and Crises

- Southern Cone 1979-82 (Diaz-Alejandro: goodbye fin repression, hello fin crash)
- Mexico 1994
- East Asia 1997-98; Russia 1998; Brazil 1999; Turkey, Argentina 2000-01.
- Need I say more? Yes!
  - EM Crises of 1997-2001 exposed domestic vulnerabilities esp in fiscal and financial sectors
  - EMs learnt from these crises and crossed a threshold
  - This made them resilient during the Great Recession and Global Financial Crisis of 2008-09

What did EMs do after 1997-2001?

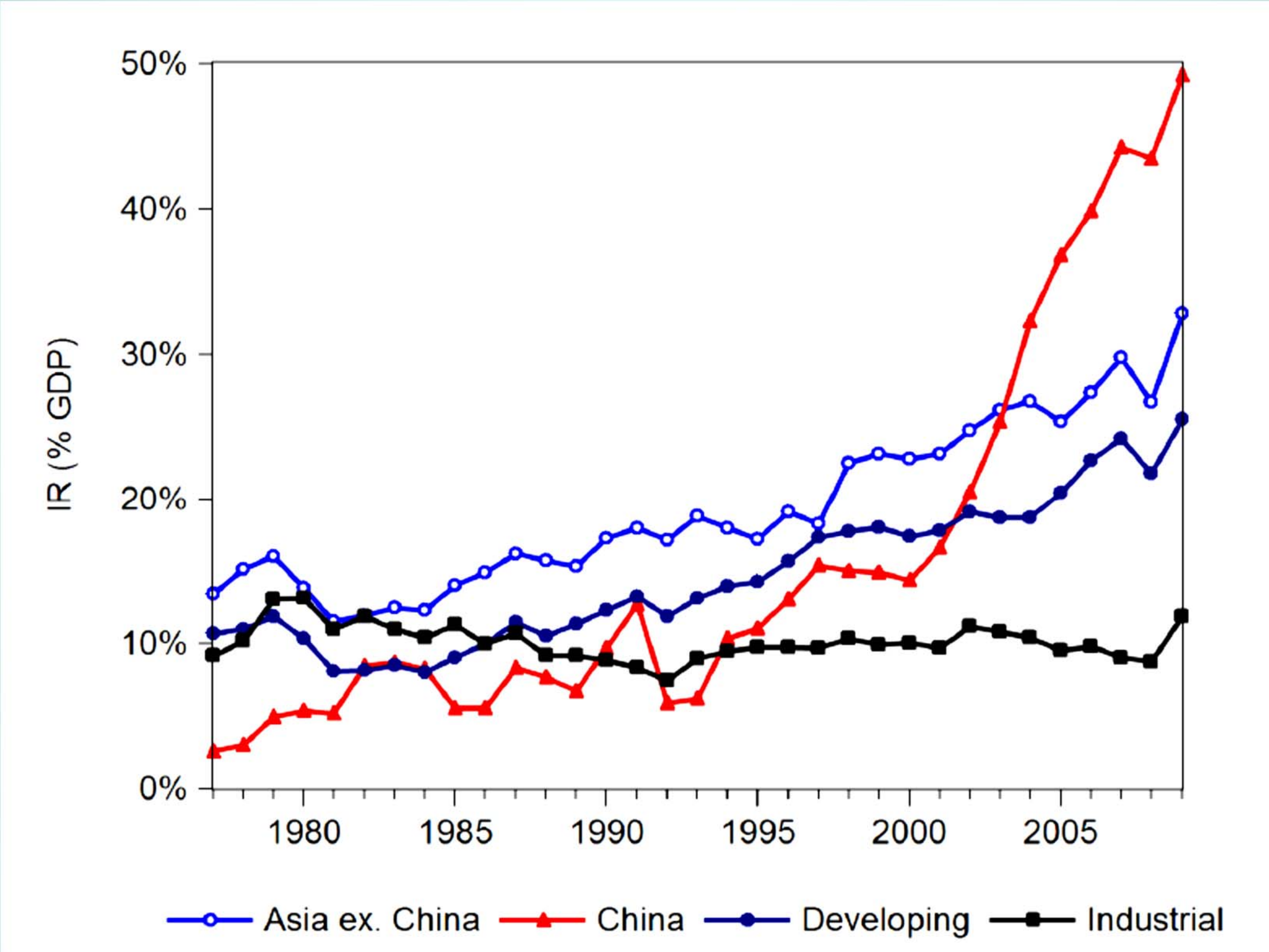
- They moved to the middle ground of the macroeconomic trilemma policy space marked by exchange rate flexibility while financial integration rose (Figure 1)
- They accumulated massive FX reserves (Figure 2)
- They adopted a 'public finance' approach to fin integration and macro risk management:
  - Put fiscal house in order to create space for tail risks
  - Control contingent liabilities from private sector balance sheets
  - Strengthen financial sector supervision and regulation with emphasis on macro-prudential regulation to min systemic risk and costly externalities
- In short: A Package Approach to Self-Insurance (Table 1)

Fig.1: Trilemma Middle Ground



Source: Aizenman, Chinn and Ito (2010)

Fig.2: Intl Reserves/GDP %



Source: Aizenman and Pinto (2011)

Table 1: Self-insurance package

Goal	Policies	Comments
1. Restore sustainable debt dynamics ***(First generation)***	• **Raise primary fiscal surpluses for prolonged period** • **Improve expenditure composition and tax regime** • **Strengthen fiscal institutions.**	**Might have to cut even good public investments in order to raise primary surpluses (similar to external debt overhang of 1980s)**
2. Lower contingent liabilities associated with private sector ***(Third generation)***	• **Shift to flexible exchange rates** • **Monitor private external borrowing and currency mismatches** • **Strengthen financial institutions.**	**Flexible exchange rates will reduce incentive for currency mismatches but direct controls may also be needed by central bank on volume of private external debt and loan-to-deposit ratios of commercial banks**
3. Insure against shifting market sentiment and possible sudden stops ***(Second generation)***	• **Build up foreign exchange reserves** • **Restrict currency mismatches on government and private balance sheets.**	**“Ideal” level of reserves will depend upon short-term external debt, flexibility of exchange rates and extent of currency mismatches**

Source: **Chapter 7, Pinto (forthcoming).**

Lessons going forward-1

- Must go beyond monetary policy to max growth benefits and min crisis risks from capital flows
  - Keep public debt on sustainable trajectory
  - Maintain international liquidity
  - Take decisive steps to keep commercial banks deposit-based and min currency mismatches
  - Monitor lending and take steps to min asset bubbles in real estate and housing (huge externalities and high fiscal costs)
- Key is to let regulation and macroprudential measures evolve dynamically so they do not lose their bite.

Lessons – 2

- Central Banks must be decisive and overcome skepticism that macro-prudential controls will not work:
  - Earlier this decade: self-insurance will not work. It did for EMs (it went beyond just reserve accumulation – Table 1)
  - "Debt intolerance" was decisively overcome by Brazil and Turkey
- V for Vigilance, not Victory:
  - Greece, Ireland, Portugal: cautionary tale for CESEE
  - How to get reliable, high frequency info on incipient asset bubbles in real estate, vulnerabilities on bank balance sheets and external borrowing surges
- Open questions:
  - How much policy space remains to combat new round of extreme volatility?
  - How to coordinate and share info across CESEE and EMs?

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Serdecznie Dziekuje!