The OeNB's 79th East Jour Fixe: Capital Flows to CESEE – Impact on Macro-Financial Stability and Policy Responses[1]

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The 79th East Jour Fixe hosted by the OeNB on November 4, 2016, focused on recent developments and driving factors of capital flows in CESEE countries, the impact of capital flows on macro-financial stability and the effectiveness of policy responses so far. After a keynote speech by Joshua Aizenman on international capital mobility, session 1 reviewed the driving forces behind the interaction of capital flows and the boom-bust cycles the CESEE region has experienced in the last two decades. Session 2 looked at international country experiences in coping with volatile capital inflows and reviewed the effectiveness of different capital flow management measures. Finally, a panel discussion completed the workshop and derived policy lessons for CESEE countries. This summary will highlight the most important statements and conclusions of each speaker.

In her welcome address and introductory statement, *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department, pointed out that the topic of capital flows to emerging economies has featured prominently in the global economic policy debate of recent years. Against the background of the crisis that followed the bankruptcy of Lehman Brothers in 2008, the general focus has shifted to the question which measures can be taken to mitigate risks and negative effects of capital flow dynamics. As a starting point, Ritzberger-Grünwald raised several questions of particular relevance: What are the benefits of capital flows? What are the implications of different types of capital flows? How do excessive capital flows translate into the buildup of macro-financial imbalances? To which extent are capital flows driven by local, regional and global factors? Subsequently, she reminded the audience of key stages of the boom-bust cycle CESEE economies have experienced since the early 2000s and highlighted current challenges arising for instance from search-for-yield flows.

Ritzberger-Grünwald then welcomed keynote speaker *Joshua Aizenman,* who serves as the Dockson Chair in Economics and International Relations and Chair of the Economics Department at the University of Southern California. His speech gave an overview of gains and costs arising from financial liberalization. One of Aizenman's key points was that gains from the financial liberalization of emerging markets tend to be front-loaded while the related costs are often hidden and rise with the buildup of balance sheet vulnerabilities, until a financial crisis eventually reveals them. With pre-existing distortions, the net gains may even be negative. Aizenman highlighted moral hazard as a prevalent distortion, when investors expect to be bailed out of bad investment by the taxpayers or other third parties. He reminded the audience that already the sudden stop crises of the 1990s had raised serious doubts about the welfare gains associated with the financial integration of emerging economies. Regarding developments in CESEE in the 2000s he stated that: "What seemed to be the exception to the Lucas Paradox morphed into

[1] *The presentations and the workshop program are available at: https://www.oenb.at/en/Calendar/terminarchiv-2016/2016/79th-OeNB-East-Jour-Fixe.html.*

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another falling domino in the row of sudden stop emerging market economies crises." Aizenman derived the strongest argument in favor of financial opening from trade integration as the latter erodes the effectiveness of capital flow restrictions over time. He also pointed out that cross-border equity exposure is less risky than debt exposure. Focusing on prudential regulation, he expressed sympathy for regulations prohibiting or limiting FX mortgage funding, taxes on external borrowing in hard currency (as proposed by Hyun-Song Shin) or raising the capital ratio for banks to about 25% (as proposed by Anat Admati and Martin Hellwig) given that measuring leverage is usually much easier than measuring and controlling risk exposure.

After the keynote address, participants had a lively discussion about the costs and gains of capital flows in CESEE. It was pointed out that capital flows to CESEE prior to the global financial crisis (GFC) had also been beneficial, evidenced by the fact that no major commercial bank failed in CESEE in the course of the GFC. Aizenman countered that, in his view, CESEE was no exception to the rule that costs eventually outweigh gains and referred to bailouts via taxpayers. Asked about the role of FDI, Aizenman emphasized that, while debt-related FDI flows are rather risky, equity-related (greenfield) FDI flows are more beneficial as they strengthen international technology transfers. Finally, Aizenman concluded that a cyclical upswing in regulatory activity after or during a crisis is not sufficient to prevent a new crisis but, at least, some of the newly implemented measures (especially in the macroprudential area) should be helpful in minimizing the costs of the next crisis.

Session 1, chaired by *Ritzberger-Grünwald,* was devoted to current risks related to external funding and drivers of capital flows to the CESEE region. *Emil Stavrev,* Deputy Head of the Emerging Economies Division of the IMF's European Department, contributed to this session by presenting an update of the IMF's April 2014 Regional Economic Issues report on external funding patterns and risks in CESEE. He illustrated that the CESEE region is highly reliant on external funding, with FDI representing an important source and the private sector accounting for most of external debt. Both, the private and the public sectors are subject to foreign exchange risk, as a large part of their debt stock is denominated in foreign currency. Yet, it should be noted that the level of debt and the debt structure shows considerable heterogeneity across CESEE economies. Furthermore, Stavrev highlighted that Western banks' exposure to CESEE is showing signs of stabilization after a long period of deleveraging. He also warned that although external financing conditions are supportive at the moment, they could reverse at some point. Among remaining crisis legacies that still need to be resolved he mentioned high shares of nonperforming loans (NPLs) and private sector debt.

The second speaker in this session, *Markus Eller,* Principal Economist in the OeNB's Foreign Research Division, examined the drivers of capital flows to CESEE on the basis of a dynamic factor model. He started his presentation by pointing to the boom-bust cycle in CESEE and strong global co-movements in capital flows. Eller argued that global and regional factors explain most of the variance in gross capital flows to CESEE. More specifically, Eller identified the global financial cycle as the most important driving force, followed by the global real business cycle. He also stated that the growing role of idiosyncratic factors in CESEE in the pre-2008 boom period may be related to the strategic positioning of

Western banks in the region during that time. Regarding policy implications, Eller touched upon various issues such as spillover effects, costs and benefits of capital account restrictions, the effectiveness of macroprudential measures and the role international policy coordination could play.

Session 2, chaired by *Peter Backé,* Deputy Head of the OeNB's Foreign Research Division, reflected the recent focus on macroprudential policies (MPPs) and other capital flow management measures (CFMs) to cope with large and volatile capital inflows. The speakers of the session provided novel evidence on how effective such measures have actually been in smoothing cyclical capital flow fluctuations and in mitigating the related macroeconomic challenges and financial stability risks.

In his presentation, *John Beirne,* Economist in the ECB's International Policy Analysis Division, focused on the impact of MPPs, such as capital controls to the financial sector and/or FX-related prudential regulations. Based on a large panel of 75 advanced and emerging economies including data for the period 1999–2012, he showed that the structure of the domestic financial system plays an important role for the effectiveness of MPPs with respect to reducing bank-related gross capital inflows. In particular, better regulatory quality and a higher credit-to-deposit ratio increase MPP effectiveness, while a higher cost-to-income ratio has the opposite effect. The same holds if nonbank-related, other investment inflows are considered, which points to spillovers of MPPs across different asset classes within countries. At the same time, Beirne provided evidence for cross-country spillovers dependent on banking sector conditions: Better regulatory quality and higher credit-to-deposit ratios in neighboring countries apparently reduce the spillovers from the implementation of MPPs abroad.

In her presentation, *Deniz Igan,* Deputy Chief of the Macro-Financial Division in the IMF's Research Department, built a bridge between the analysis of credit booms and capital flows based on the empirical regularity that credit booms are often preceded by financial account liberalization and capital inflow surges. Based on a panel of about 30 countries covering the period 1980–2011, she was able to show that portfolio and especially other investment inflows boost credit growth and increase the likelihood of credit booms in both household and corporate sectors. Firm-level data corroborate these findings and indicate that other investment inflows are related to more rapid credit growth for firms with increasing equity and collateral values but also in the case of financially constrained domestic banks (e.g. banks with low capitalization or a high share of NPLs). This suggests that both demand- and supply-side factors play a role in explaining how capital flows translate into more credit. In terms of appropriate policy responses, Igan stressed that MPPs should be a first line of defense in dealing with financial boom-bust cycles, especially by targeting leverage and strengthening the balance sheets of banks. Preliminary empirical evidence on MPPs suggests that they are able to reduce the procyclicality of credit, but also that they are more successful in building up buffers than preventing a boom. Turning to CESEE economies, Igan concluded that MPPs that target capital adequacy and/or non-standard liquidity have apparently been particularly effective.

Kiril Kossev, Economist in the Investment Division of the OECD's Directorate for Financial and Enterprise Affairs, pointed out that currency-based capital flow management measures (CBMs, e.g. limits on FX lending) have become a prominent policy tool in the past few years, especially among emerging market economies, and he referred to recent OECD evidence showing that CBMs have been effective in reducing cross-border bank flows. But he also stressed the tradeoff between economic growth and financial stability considerations when introducing CFMs. For instance, growth could be hampered if restrictions to capital flows resulted in limited access to finance for credit-constrained domestic enterprises. Moreover, referring to the previous speakers' evidence for cross-country spillovers, Kossev emphasized that it is important to implement CFMs in a non-discriminatory manner, i.e. by treating domestic and foreign investors equally. Potentially negative externalities affecting other economic partner countries call for the international coordination of CFM implementation. In this respect, the currently reviewed OECD Code of Liberalisation of Capital Movements (open to non-OECD adherents since 2012) could provide guidance on the least restrictive use of CFMs.

The concluding panel discussion was chaired by *Helene Schuberth,* Head of the OeNB's Foreign Research Division. She pointed out that boom-bust cycles of capital flows have indeed been more pronounced in CESEE than in other regions in recent years. The three panelists of the session focused on how governments in CESEE could manage these flows.

Evžen Kočenda, professor at Charles University in Prague, underlined that efforts to tame the capital flow cycle in CESEE are warranted because capital flows have increased vulnerability to external macroeconomic shocks and contributed to excessive credit growth. Possible domestic responses include structural and institutional reforms, exchange rate flexibilization, capital flow management, and macroprudential policies. However, as Kočenda added, internationally coordinated policies also need to be considered as capital flows are most likely to be driven by global factors, including spillovers from decisions made by the most important central banks (Fed, ECB, Bank of Japan), and the monetary policies of CESEE countries cannot be autonomous from such influences.

Russia's experience with capital flows was discussed by *Yaroslav Lissovolik,* Chief Economist at the Eurasian Development Bank. This experience includes extreme developments, e.g. record outflows of around USD 150 billion in 2014. With hindsight, Russia's pace of capital account liberalization was probably too high, and the introduction of exchange rate flexibility probably happened a bit too late. Today the political elite (but not necessarily the Bank of Russia itself) has a strong preference for a weak ruble, as this is seen to support oil companies' and the government's ruble revenues and to favor import substitution strategies. In recent years, the Bank of Russia has been very active in consolidating the banking system: In 2014–2015 about 200 credit institutions were closed, i.a. for overly risky behavior and money laundering. As Lissovolik emphasized this intervention has recently contributed to a substantial reduction of capital outflows from Russia.

Thomas Richardson, Director of the Joint Vienna Institute, agreed that global factors have indeed been responsible for increasing net capital outflows from emerging markets in the past few years. Among these factors, growth differentials between advanced and emerging economies are the main driver according to Richardson. While there are various possibilities to cope with volatile capital flows, including capital flow management measures or macroprudential policies, Richardson argued strongly in favor of better international coordination of domestic policies, even if difficult to achieve. Richardson suggested regular reviews of national macroeconomic policies to the extent that they may have spillover effects. Such reviews could be carried out by international financial institutions. A second-best alternative for CESEE countries would be to pursue extremely prudent macroeconomic policies in order to reduce their vulnerabilities with respect to international capital flow swings; however, this alternative is saddled with growth costs.

The discussion that followed focused on exchange rate flexibilization and policy coordination. As Aizenman remarked, Russia's weak ruble bias may be a sensible response to the oil price collapse, but such an exchange rate strategy is not sufficient to modernize and diversify the economy. Franz Nauschnigg, Head of the OeNB's European Affairs and International Financial Organizations Division, contended that if a global coordination of policies cannot be sufficiently realized, regional saving nets, swap arrangements or firewalls might be worth considering.

Wrapping up the event, *Dubravko Mihaljek,* Head of Macroeconomic Analysis at the Bank for International Settlements (BIS), summarized that several speakers had expressed their concerns about the riskiness of capital flows to CESEE during the workshop and would thus be in favor of capital flow restrictions in one way or the other. Ironically, unrestricted capital flows are apparently viewed as problematic while free trade is seen as fine. Instead of discussing in general terms how capital flows could be restricted, Mihaljek advocated rethinking CESEE's growth model, discussing in greater depth the banking sector's role in the economy and thinking about ways to attract beneficial types of capital flows (such as flows into nontradable sectors to improve education, healthcare, utilities or services).