Monetary policy and financial stability

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Catching-up strategies after the crisis

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The views expressed in this presentation are those of the author and not necessarily those of the BIS.

Outline

1. Global monetary conditions and emerging markets
2. Regulatory reforms and credit supply
3. Implications for monetary policy and financial stability in CEE

1. Global monetary conditions and emerging markets

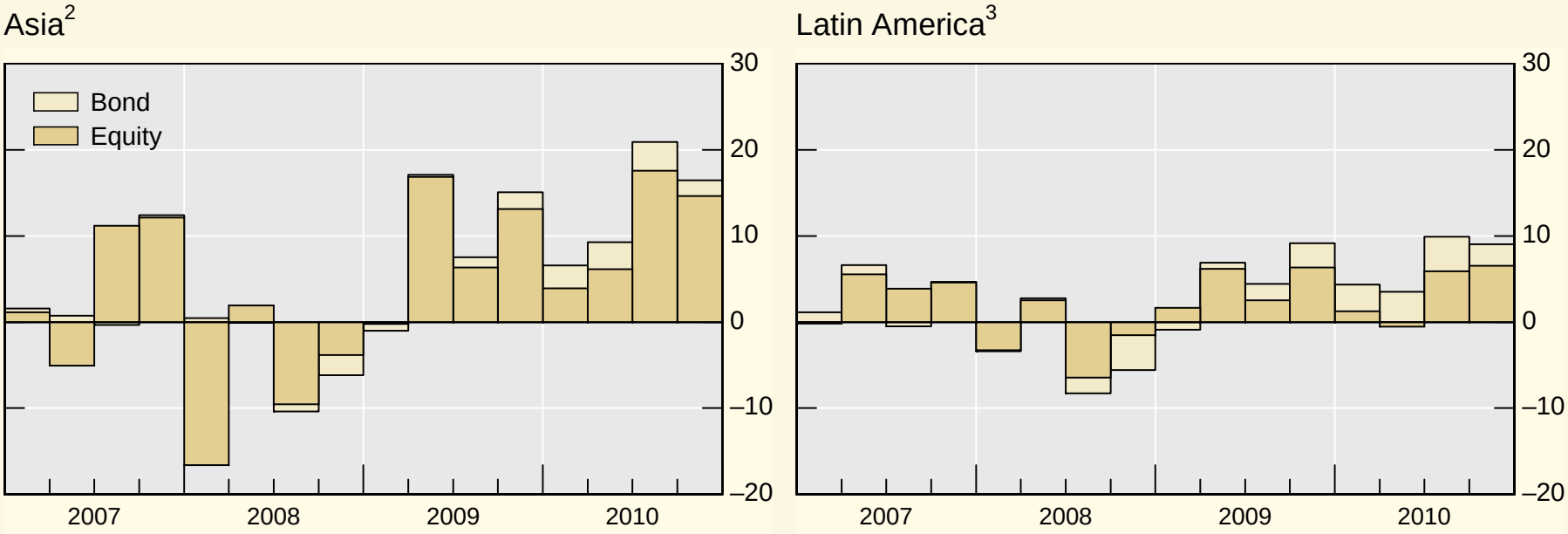
- Growth divergence across the global economy:
  - US and Japan;
  - within the euro area;
  - advanced economies vs emerging markets
- Global monetary conditions to remain easy:
  - QE2 in US
  - comprehensive monetary easing in Japan
  - Falling bond yields in the G3 economies

Capital flows to emerging markets

Strong portfolio inflows to emerging Asia and Latin America…

Net flows into emerging market equity and bond funds[1]

In billions of US dollars



[1] Sums of weekly data up to 3 November, 2010; sums across economies listed. [2] China, Chinese Taipei, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.

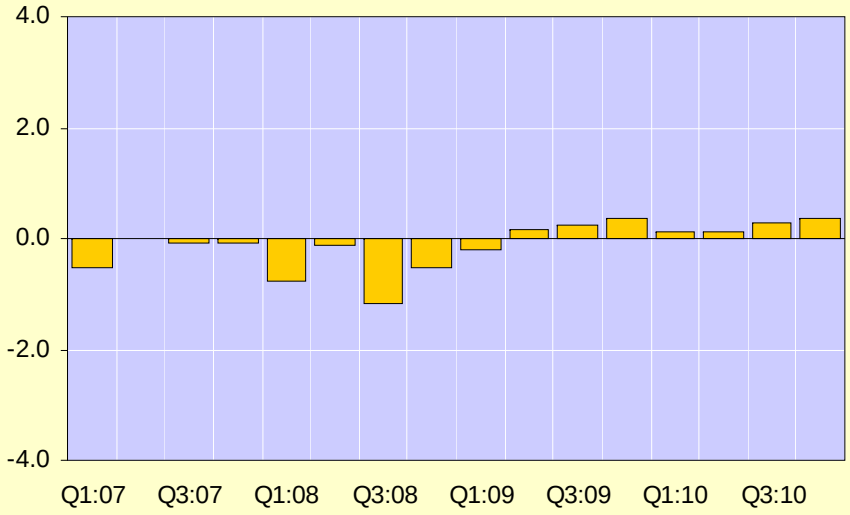
Source: EPFR.

… but not yet in CEE, except Russia and Turkey

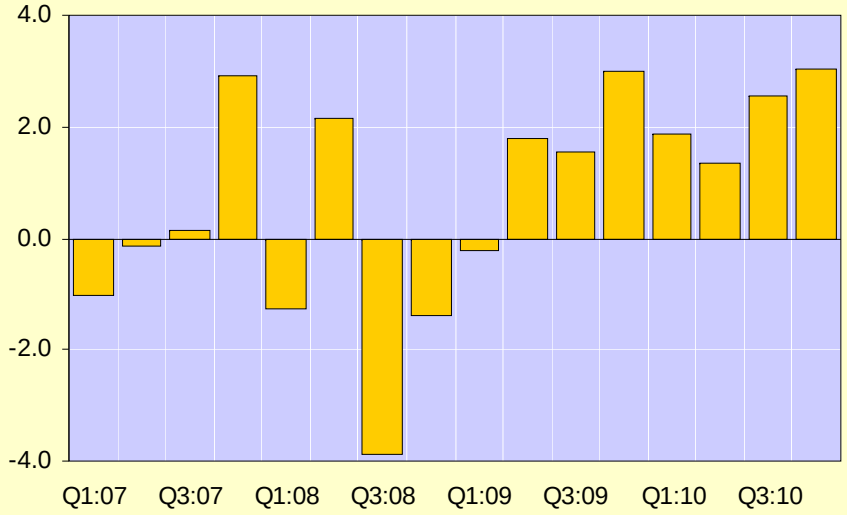
Net flows into CEE equity and bond funds[1]

In billions of US dollars

Central Europe[2]



Russia and Turkey



[1] Sums of weekly data up to 10 November, 2010; sums across economies listed. [2] Czech Republic, Hungary and Poland.
Source: EPFR.

Cross-border bank lending to emerging markets:

Resumed to emerging Asia & Latin America (inflows higher than 2007); stopped declining in CEE; still declining in CIS

Table 1 **Cross-border bank lending to emerging market economies**[1]

In billions of US dollars

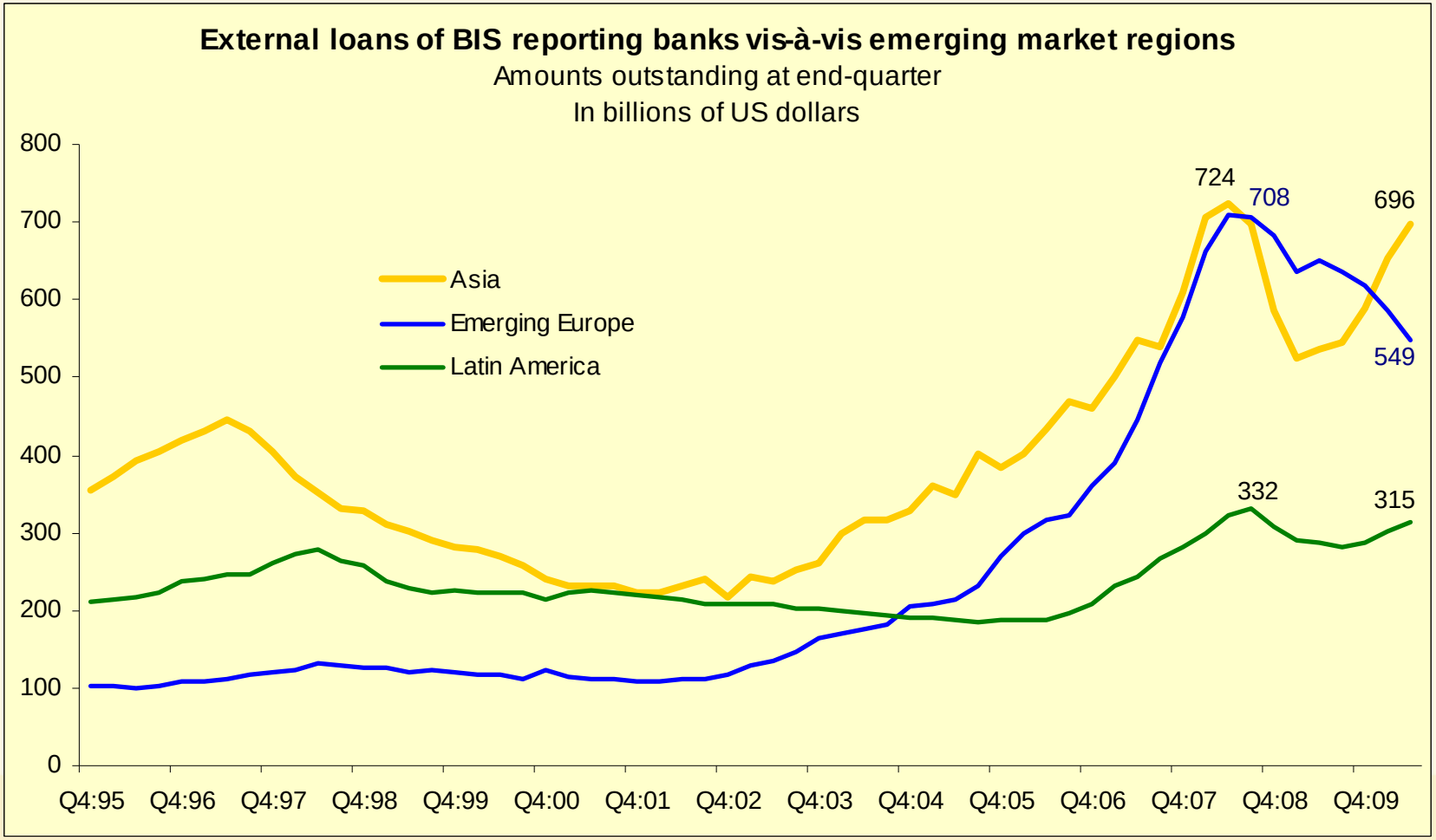
	2007	2008	2009	2009		2010	
				Q3	Q4	Q1	Q2
Total EMEs	512	128	–149	–62	68	116	95
Asia[2]	111	–59	11	8	47	72	48
Hong Kong and Singapore	140	42	–48	–35	32	40	40
Latin America[3]	61	22	–19	–7	6	17	15
CEE[4]	125	107	–39	–8	–2	–9	0
CIS[5]	75	16	–53	–20	–14	–4	–8

[1] External loans of BIS reporting banks (on the residence basis) vis-à-vis individual emerging market economies; exchange rate adjusted changes in gross amounts outstanding. Does not include changes in reporting banks' holdings of emerging market securities. [2] China, Chinese Taipei, India, Indonesia, Korea, Malaysia, the Philippines and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] Total of 10 new EU member states from central and eastern Europe, south-eastern Europe (including Turkey). [5] Russia, Ukraine and Kazakhstan.

Source: BIS, locational banking statistics.

Cross-border bank lending to emerging markets:

External loans outstanding near peak pre-crisis levels, except in CEE

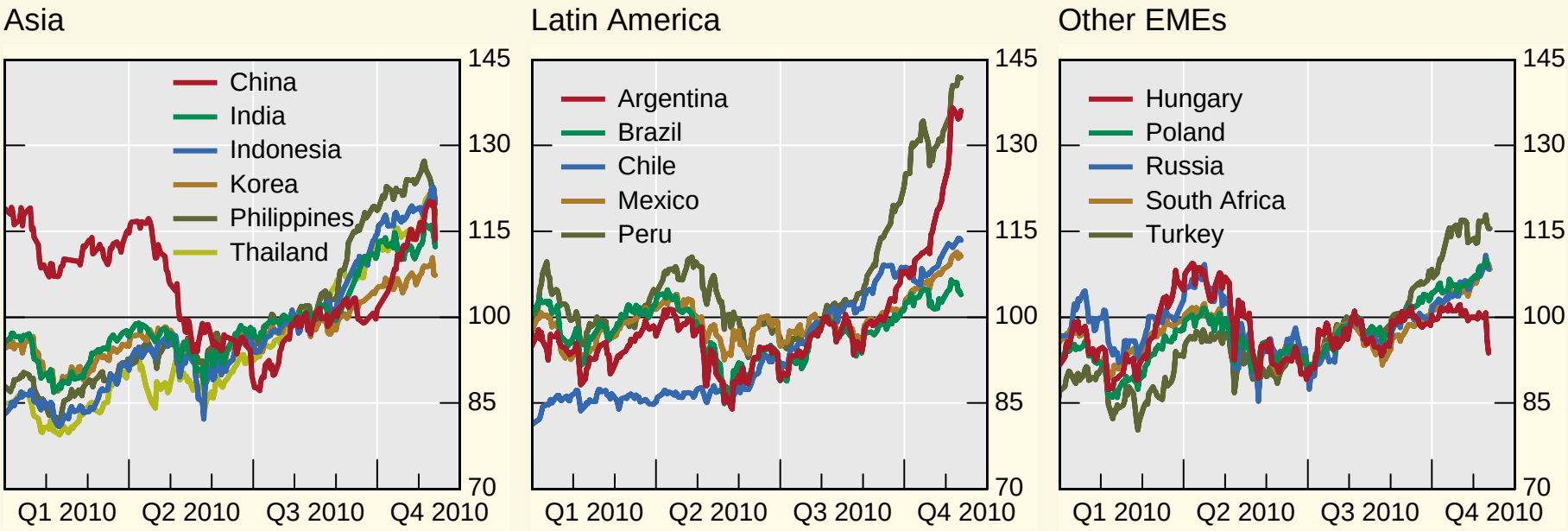


Policy challenges related to capital inflows:

Rising equity prices add to pressures in emerging Asia, Latin America, Turkey

Equity prices[1]

2 August 2010 = 100



[1] In local currency.

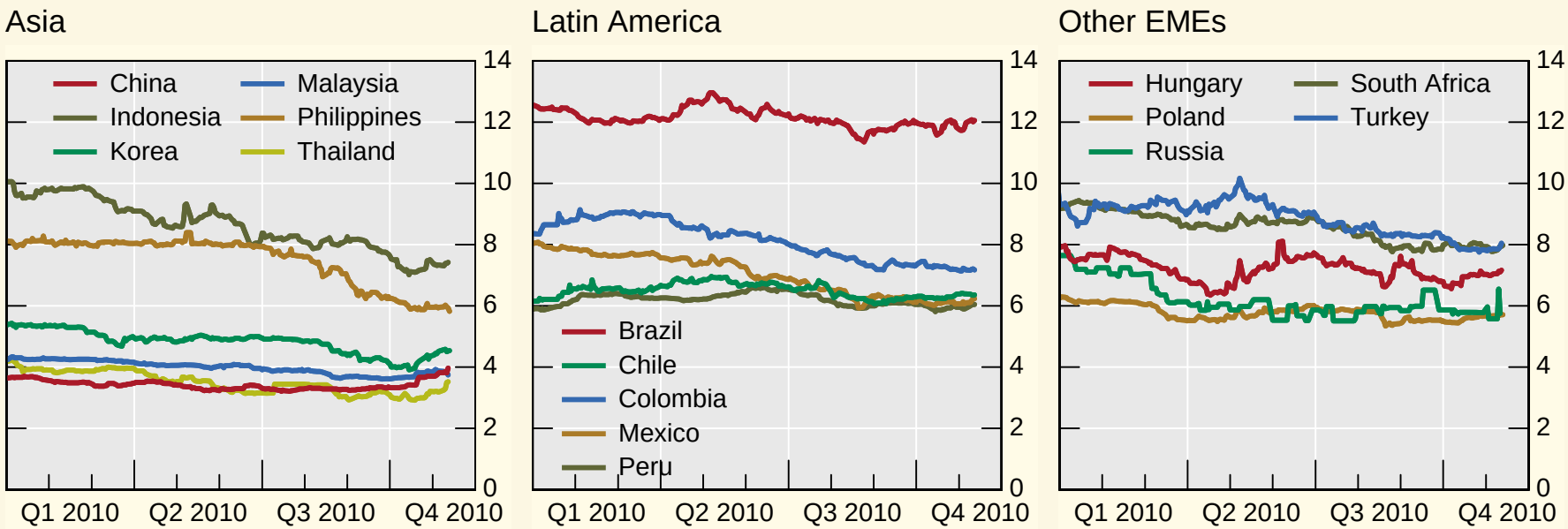
Sources: Bloomberg; Datastream.

Policy challenges:

Falling local currency bond yields, despite policy rate hikes.
Rising foreign investor ownership of local bonds.

Local currency bond yields[1]

In percent



[1] Ten-year government bonds; for Brazil, 3 year; for Chile, 9 year; for Turkey, 2 year.

Sources: Bloomberg; national data.

Policy challenges:

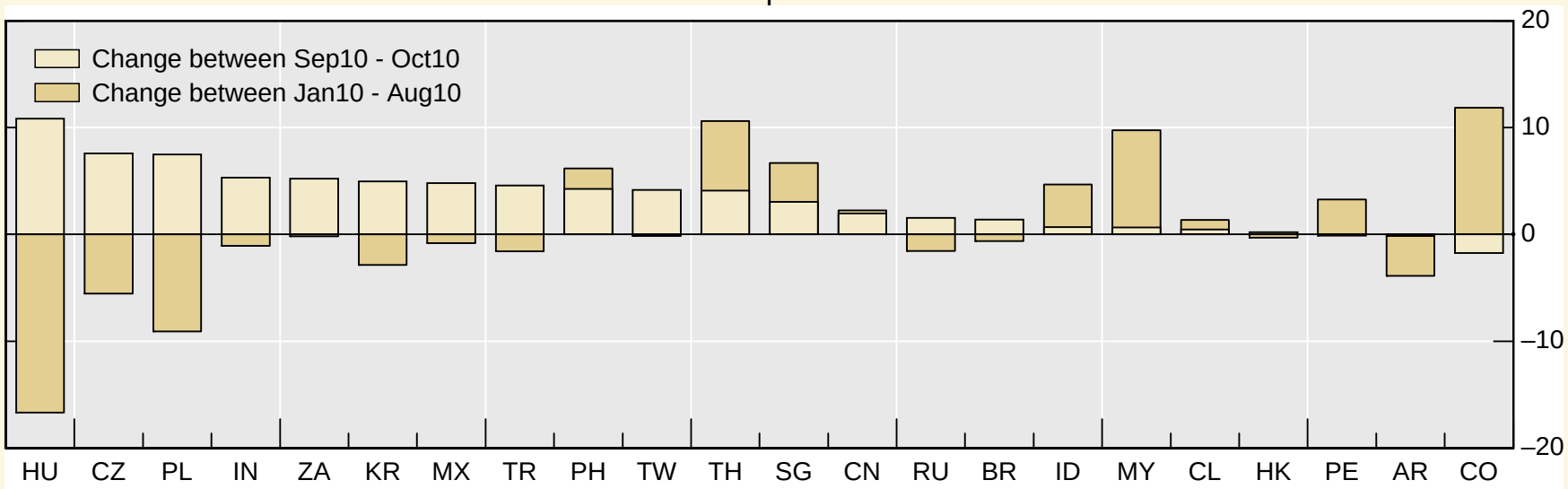
Will inflows stay or reverse?

Appreciating exchange rates, concerns about volatility, competitiveness.

(CEE countries have not resisted ER appreciation, unlike other EMEs)

Changes in nominal exchange rates[1]

In percent



[1] US dollars per unit of local currency; an increase indicates appreciation of local currency.

AR = Argentina; BR = Brazil; CL = Chile; CN = China; CO = Colombia; CZ = Czech Republic; HK = Hong Kong SAR; HU = Hungary; ID = Indonesia; IN = India; KR = Korea; MX = Mexico; MY = Malaysia; PE = Peru; PH = Philippines; PL = Poland; RU = Russia; SG = Singapore; TH = Thailand; TR = Turkey; TW = Chinese Taipei; ZA = South Africa.

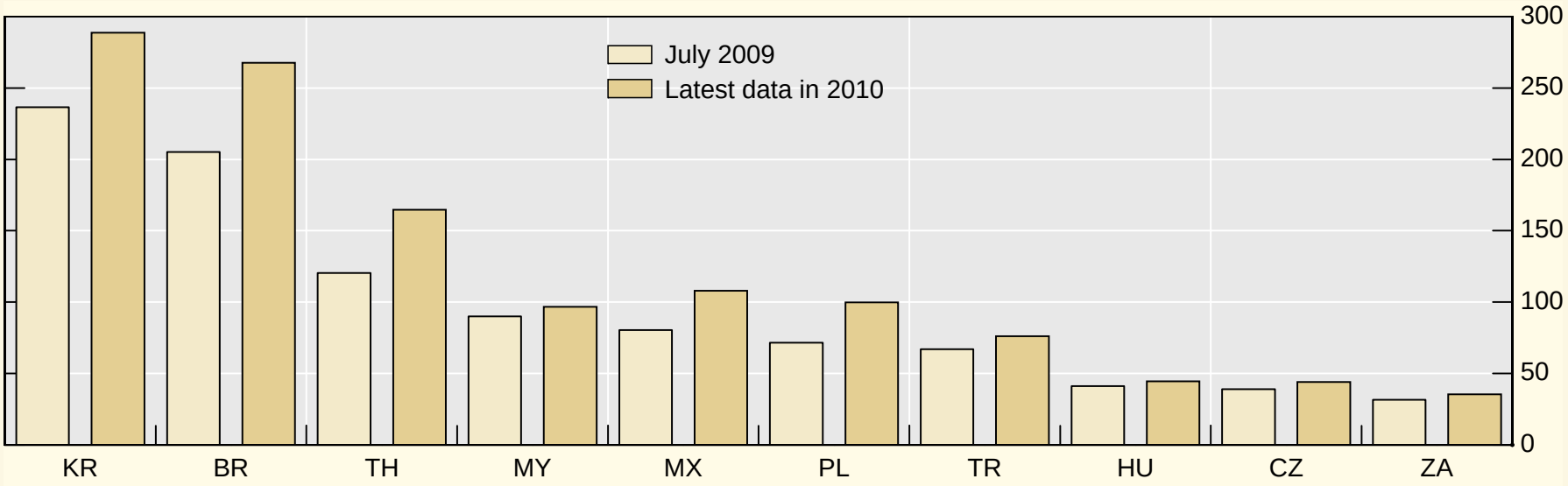
Sources: Bloomberg; Datastream; national data.

Policy responses to capital inflows

Reserves accumulation: resumed in Asia, Latin America, not in CEE

Reserve accumulation

In billions of US dollars



Sources: CEIC; Datastream; IMF, *International Financial Statistics*; national banks.

2. Regulatory reforms and credit supply

- CEE faces a particular problem:
  - regulatory reforms could limit credit supply
  - bank based, foreign-owned banking systems, high exposure
- **Liquidity**:
  - greater emphasis on local deposit gathering;
  - centralising wholesale funding on the parent level
- **Capital**:
  - major EU banking groups active in CEE
  - local banking systems relatively well capitalised
- Remaining concern about parent banks:
  - could change credit policies;
  - turn to CEE subsidiaries for help with capital;
  - dispose some units

3. Implications for CEE monetary policy & financial stability

- External financing conditions:
  - Low global interest rates
  - Regulatory reforms – some tightening of external credit possible
- Domestic monetary policy environment:
  - Slow recovery, weak post-crisis credit demand, low inflation
  - Low domestic interest rates
  - Banks consolidating operations, repairing balance sheets
  - Central banks assessing how policy frameworks performed

3. Implications for monetary policy and financial stability

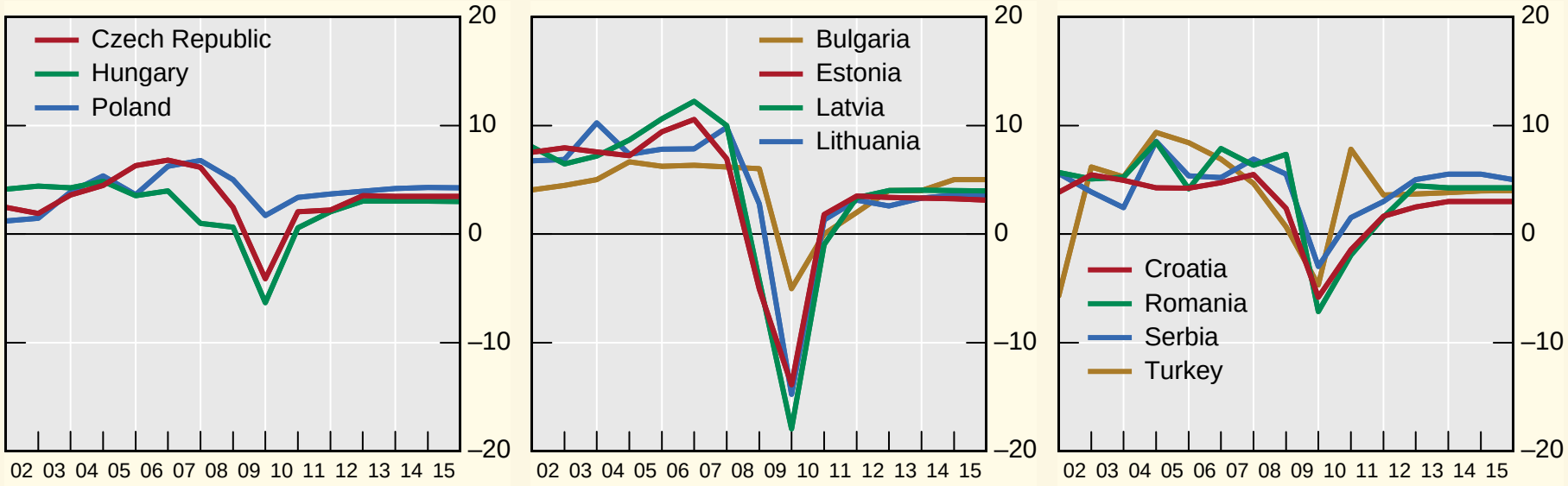
- Monetary policy in transition
- Existing policy frameworks performed relatively well during the crisis: currency collapses and banking crises avoided
- Extensive use of macro-prudential tools in region
- However, monetary policy will again need to address:
  - capital inflows,
  - asset prices,
  - catching-up issues

CEE is destined to grow faster than the euro area

2011-15 projections cluster around 3-5% p.a.

Real GDP growth

Annual percentage changes



Source: World Economic Outlook (September 2010).

Diversification motives, high long-term rates attract inflows

Long term interest rates[1]

BG = Bulgaria; CZ = Czech Republic; HR = Croatia; HU = Hungary; LT = Lithuania; LV = Latvia; PL = Poland; SK = Slovakia.

[1] Long-term domestic currency government bonds; the horizontal line refers to the 10-year German benchmark bond; in per cent.

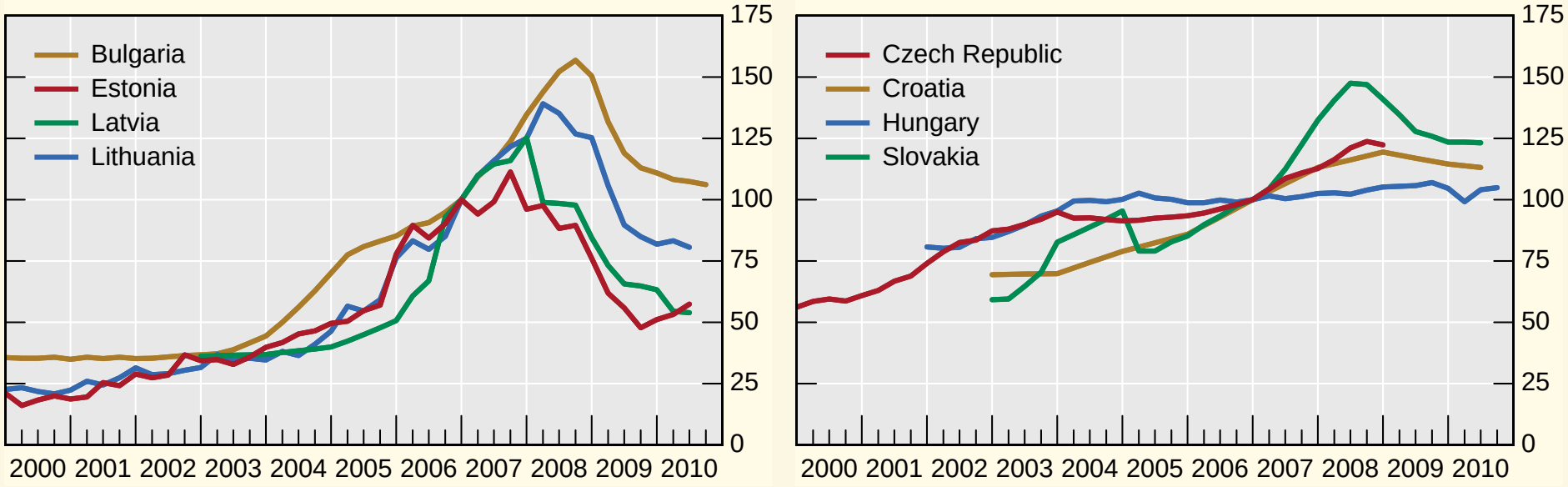
Sources: ECB; Datastream; national data.

Capital flows unlikely to return to the real estate sector

It will take years for household debt overhang and excess supply of housing and commercial property to normalise

House prices

End-2006 = 100



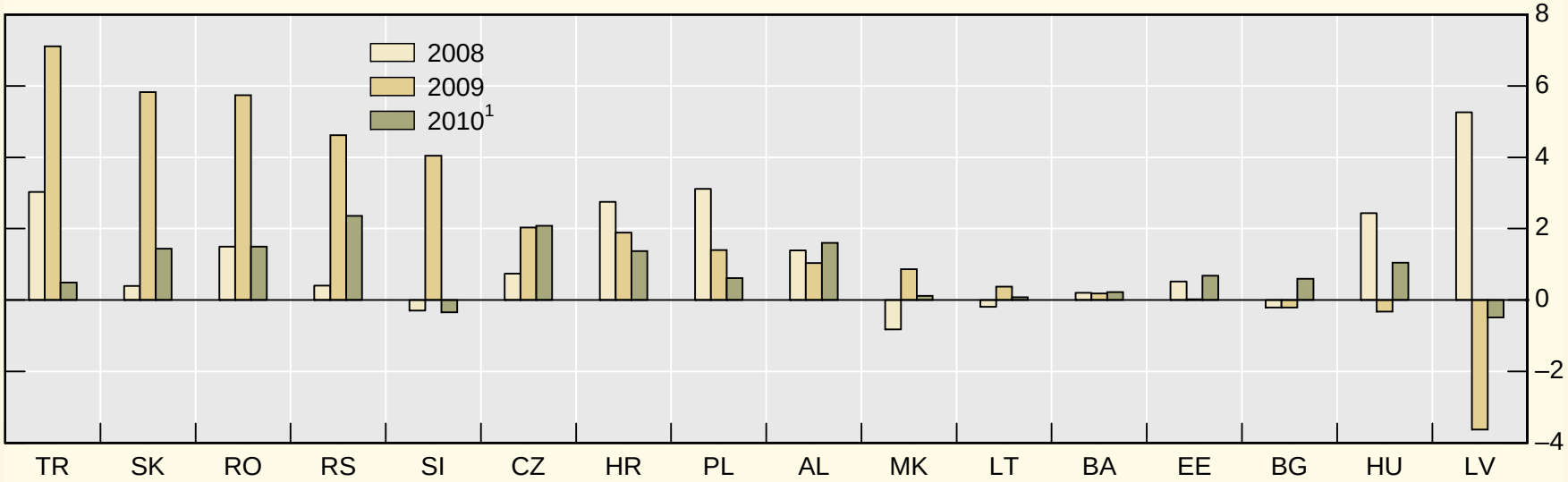
Source: BIS; central banks.

Some inflows could be channelled to public sector

Crowding-out private sector, weakening incentives for fiscal consolidation

Bank credit to the government

Annual changes, as a percentage of 2008 GDP



AL = Albania; BA = Bosnia-Herzegovina; BG = Bulgaria; CZ = the Czech Republic; EE = Estonia; HR = Croatia; HU = Hungary; LT = Lithuania; LV = Latvia; MK = Macedonia; PL = Poland; RO = Romania; RS = Serbia; SI = Slovenia; SK = Slovakia; TR = Turkey.

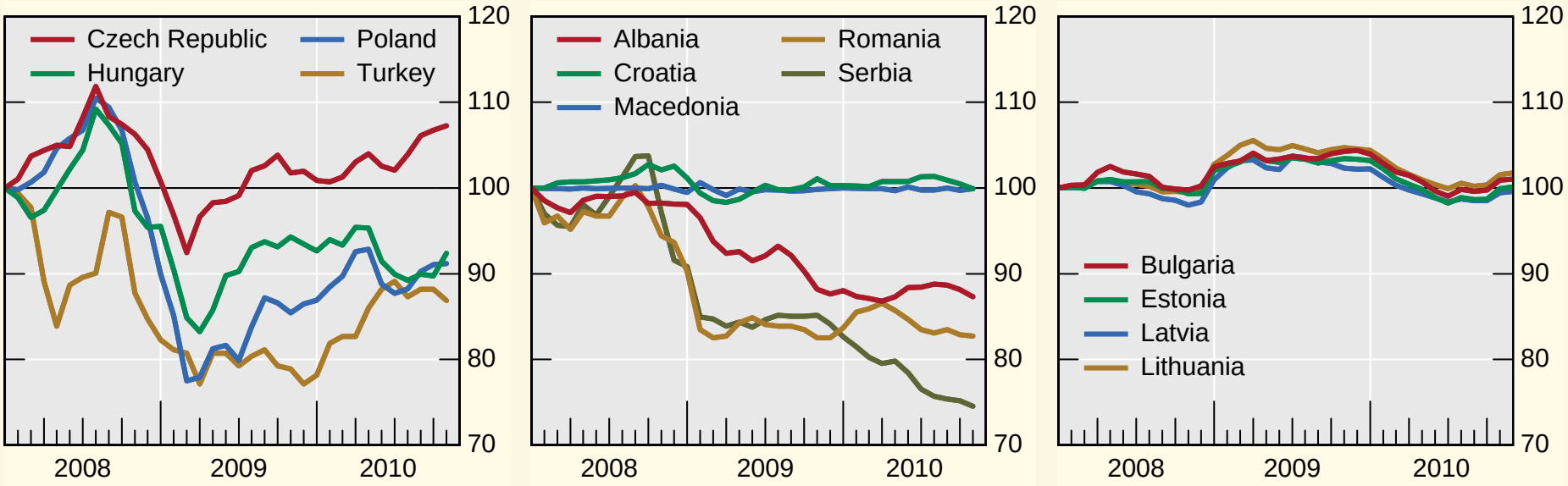
[1] Latest available.

Sources: IMF; national data.

Exchange rates could become volatile again

Exchange rate flexibility has served CEE countries well
As has labour market flexibility in countries with fixed exchange rates

Exchange rates[1]



[1] December 2007 = 100; euro per unit of local currency (nominal effective exchange rates for Bulgaria, Estonia, Latvia and Lithuania). An increase indicates an appreciation; monthly averages.

Sources: ECB; Datastream; national data; BIS.

Conclusion

- Monetary policy is in transition period
- Existing policy frameworks performed relatively well during the crisis
- Central banks have experience with the use of macroprudential tools → "Inflation targeting 2.0" should not be a major novelty
- Be ready to face capital inflows, asset prices, catching-up issues
- Resist spillovers from policies of other EMEs:
  - let exchange rates adjust,
  - avoid capital controls,
  - avoid interventions in credit allocation,
  - avoid a return to financial repression