10th ESCB Emerging Markets Workshop[1]

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On October 4 and 5, 2012, the OeNB hosted the 10th ESCB workshop on emerging markets. This workshop series, launched by the ESCB in 2003, provides researchers with a platform for disseminating relevant research conducted on macroeconomic and financial issues in emerging economies. Nowadays, invitations to the workshop are also extended to non-ESCB central banks. Therefore, with more than 40 – mostly excellent – submissions from over 20 countries including e.g. Russia, Kosovo and many Latin American countries, the jury was truly spoiled for choice this year. Within the course of 1.5 days, the program organizers accommodated two stimulating keynote speeches and 13 papers. Moreover, the exchange of views benefited considerably from discussants' contributions as well as questions and comments raised by the large audience, which provided highly positive feedback.

The first session was chaired by *Peter Mooslechner,* Director of the OeNB's Economic Analysis and Research Department. In the introductory statement, he pointed to the growing economic and political importance of emerging markets for the global economy in general and for Austria in particular. One of the main driving forces behind the success story of emerging markets – and also one of its major consequences – is increasing economic and financial integration. It manifests itself, inter alia, in new and deepening trade linkages, rising cross-border capital flows and FDI investments. Every coin has two sides, however. Intensifying real and financial integration with emerging markets and their rise on the global scene – while being instrumental in spurring economic growth and welfare – also hold risks and imply new big challenges for monetary, regulatory, fiscal and supervisory authorities in both advanced and emerging economies. Against this backdrop, Mooslechner closed by highlighting the aim of the ESCB workshop on emerging markets: to unveil these risks, challenges and vulnerabilities and to help resolve them.

Macroprudential Policy: Expanding Central Banks' Countercyclical Arsenal

In the first keynote address, *Andrzej Sławinski,* General Director of the Economic Institute of Narodowy Bank Polski, emphasized – against the background of the genesis of the current crisis – the crucial role of macroprudential instruments as a second weapon of central banks' countercyclical policy, i.e. besides monetary policy tools. In particular, the recent economic and financial crisis calls for macroeconomic stability to be set as a direct target for macroprudential policy to facilitate a timely reaction to macroeconomic imbalances resulting from excessive credit growth. So far macroprudential policy has been used as a countercyclical tool most actively in emerging economies due to their exposure to the destabilizing impact of short-term interbank funding. According to Sławinski, the merits of such an approach are so obvious that it is set to be adopted in an increasing number of countries, particularly under the framework of the planned banking union in the European Union.

[1] *The presentations and workshop program are available at http://ceec.oenb.at (Events).*

Monetary Policy and Capital Flow Issues in Emerging Markets

Addressing the risks and challenges emanating from emerging markets' strengthening role on the global stage, the presented papers broadly centered on (1) monetary policy and capital flows, (2) financial and fiscal stability, and (3) real economy issues. To ensure focused discussions, each of the three sessions was divided into two blocks. The morning part of the first session, chaired by *Peter Backé,* Deputy Head of the OeNB's Foreign Research Division, revolved around time-varying components of inflation paths and capital flows.

With the paper "Changes in Inflation Dynamics under Inflation Targeting? Evidence from Central European Countries" (coauthors: Jaromír Baxa and Miroslav Plašil), *Bořek Vašíček* of Česká národní banka presented a novel look at the evolution of inflation dynamics in the Czech Republic, Hungary and Poland. Using a time-varying New Keynesian Phillips Curve framework with stochastic volatility estimated by means of Bayesian techniques, the authors analyzed the evolution in inflation dynamics in response to changes in the economy and economic policy. The results point to rather heterogeneous inflation paths in the region: While inflation persistence has almost disappeared in the Czech Republic, it remains rather high in Hungary and Poland. Moreover, the volatility of inflation shocks decreased relatively quickly after the adoption of inflation targeting in the Czech Republic and Poland, whereas it remains rather unchanged in Hungary even after a decade of inflation targeting. Vašíček thus concluded that different practical implementations of inflation targeting may impact inflation dynamics.

In the presentation of the paper "Modelling the Time Varying Determinants of Portfolio Flows to Emerging Markets," *Marco Lo Duca* of the ECB addressed the question on how drivers of portfolio flows develop over time by employing a model allowing for continuous endogenous changes in regression coefficients. Apart from facilitating a precise calculation of the contribution of different factors to capital flows, this approach enables an endogenous detection of periods in which the relative importance of these drivers changes. Lo Duca's empirical analysis of daily equity portfolio flows to emerging markets over five years prior to March 2012 unveiled a substantial time variation in regression coefficients. Major changes in the importance of the factors driving the flows coincided with important market events. Overall, investors tended to pay more attention to regional developments in emerging markets in periods when market tensions were elevated. However, according to Lo Duca's analysis, extreme tensions generated panics, i.e. periods in which flows were driven by changes in uncertainty and risk aversion, while regional developments played only a marginal role.

In the second block of the morning session, chaired by OeNB senior expert *Thomas Reininger,* the focus shifted from determinants of capital flows to drivers of exchange rates and macroeconomic forecasts. The analytical work presented in this subsession essentially boiled down to the question: Do central banks have the power to influence exchange rates and public expectations? *Emanuel Kohlscheen* of the Banco Central do Brasil presented his paper titled "What Drives Emerging Market Currencies?" where he investigated the impact of monetary policy shocks on the exchange rates (effective or vis-à-vis the U.S. dollar) of the Brazilian real and the Mexican and the Chilean peso. He found that even a focus on one-day exchange rate changes following policy events – which reduces the potential for reverse causality considerably – fails to lend support to the conventional view that associates unexpected interest rate hikes with appreciations. This lack of empirical backing for standard open economy models withstood a whole plethora of different model and variable specifications and other robustness checks. According to Kohlscheen, the policy implication to be drawn from these findings is that if policymakers want to impact the exchange rate, they should not tinker with the interest rate but rather intervene directly.

In a similar vein, central banks' effective power to influence macroeconomic variables – or, more precisely, the expectation thereof – played a key role also in the contribution of *Michael Pedersen* from the Banco Central de Chile. In his paper "What Affects the Predictions of Professional Forecasters? The Role of Central Bank Forecasts," Pedersen analyzed the drivers of professional forecasters' expectations and, particularly, whether they are affected by central bank forecasts. Controlling for other relevant factors such as central bank credibility or surprises in published data, he compared professional forecasters' inflation and growth predictions before and after the publication of the forecast of the Banco Central de Chile. His results were mixed. They suggested that central bank predictions indeed affect inflation expectations in the short run, i.e. for the current year. In the medium term, however, inflation expectations depend mainly on changes in short-run forecasts, while oil price expectations also seem to matter. For GDP growth expectations, central bank forecasts do not play a role, however. Such expectations are driven only by surprises in the monthly indicator of economic activity in the short run and exchange rate expectations in the medium term.

Challenges to Financial and Fiscal Stability

The first part of the afternoon discussion featuring financial and fiscal stability was moderated by *Laura Solanko,* adviser at the Bank of Finland Institute for Economies in Transition (BOFIT). It centered on the effect of different exchange rate arrangements on real economic developments during the current crisis. In her paper, *Livia Chiţu* of the ECB raised the question "Was Unofficial Dollarisation/Euroisation an Amplifier of the 'Great Contraction' of 2007–09 in Emerging Economies?" Building on a novel dataset on unofficial dollarization/euroization covering a cross-section of around 60 emerging market economies, she tested whether informal currency substitution contributed to the growth collapse in 2007–09. According to Chiţu, both OLS as well as Bayesian techniques suggest that unofficial dollarization/euroization indeed contributed to the severity of the recession, once other growth determinants well established in the literature are controlled for. Moreover, she found that the adverse impact on the real economy was transmitted through currency mismatches, reduced monetary policy autonomy and the limited lender of last resort ability. Hence, all traditional channels highlighted in the literature became a more binding constraint in the wake of the crisis.

Michał Brzoza Brzezina of Narodowy Bank Polski shed some light on a similar issue – but from a different perspective. In his contribution "Would It Have Paid to Be in the Euro Area?" he presented an analytical project that he had coauthored (with Krzysztof Makarski and Grzegorz Wesołowski), which aimed to assess by means of a DSGE model whether Poland's joining of the euro area would have been beneficial in terms of providing more macroeconomic stability. Apart from standard frictions present in new Keynesian models, the authors also included financial frictions as well as stochastic interest rate spreads in their model. Such an approach ensured that financial shocks, particularly the current crisis, were better accounted for. Counterfactual simulations suggested that the volatility of the Polish economy would have increased substantially if Poland had joined the euro area in 2007. Especially GDP would have featured a strong boom after accession, followed by a recession during the global crisis. Against this background, Brzoza Brzezina concluded that independent monetary policy, most importantly the flexible exchange rate, played an important stabilizing role for the Polish economy.

The second afternoon subsession, chaired by *Enrique Alberola Ila,* executive coordinator at the Banco de España, zeroed in on fiscal sustainability issues, bank failures and the interlinkages of the two. *Irina Balteanu* from the Banco de España presented a paper titled "Bank Crises and Sovereign Defaults: Exploring the Links." She and her coauthor used a large sample of emerging economies over three decades to study, in a systematic way, the mechanisms through which sovereign and bank problems feed into each other. While they found that there are many systematic differences between single and twin crises, the key distinctive characteristic of the latter – which typically have more severe consequences for the real economy – is the existence of large and increasing balance sheet interrelations between banks and the public sector. Moreover, banking crisis episodes that compound into twin events feature a late policy response by the central bank and the government. Then, *Jarmila Urvová* of the OeNB led the discussion from fiscal stability to fiscal sustainability. A condensed version of her joint paper with Markus Eller – "How Sustainable Are Public Debt Levels in Emerging Europe?" – is published in this issue.

Returning to the issue of bank failures, *Zuzana Fungáčová* of Suomen Pankki – Finlands Bank closed the first day. The paper "Does Excessive Liquidity Creation Trigger Bank Failures?" (coauthors: Rima Turk Ariss and Laurent Weill) proposed the so-called excessive liquidity creation hypothesis: Proliferation in the core liquidity creation of banks increases the probability of their failure. This hypothesis withstood an empirical test involving the Russian banking sector, which was used as a natural field experiment given the large number of bank collapses in the last decade. Against this background, regulatory authorities are advised, by Fungáčová and her coauthors, to identify excessive liquidity creators early on and monitor them closely.

Real Economy Issues and Challenges

The second day of the workshop was devoted to real economy topics ranging from measurement problems for macroeconomic variables to sources of growth, wealth and competitiveness. OeNB expert – and chair of the first part of the morning session – *Julia Wörz* opened the day by introducing *Marcelo Delajara* from the Banco de México. In his contribution titled "Weekday with Low Prices: Evidence on Daily Seasonality of Foods, Beverages and Tobacco Prices," Delajara presented evidence of daily seasonality he and his coauthor (José Antonio Murillo) had found in weekly price variations of certain product categories in the consumer basket in the Metropolitan Area of Mexico City. The researchers were able to identify the weekday with the lowest weekly price variation, which, however, differs across products, types of commercial establishment and supermarket chains. According to Delajara, this "day-of-the-week effect" should be taken into account when preparing calendars for CPI data collection.

Subsequently, *Alessio Ciarlone* of the Banca d'Italia presented his paper on "Wealth Effects in Emerging Economies" featuring estimations of the impact of changes in real and financial wealth on private consumption for a panel of emerging economies in Asia and Central and Eastern Europe. He found that both house and stock market prices affect household consumption positively in the long run. As this long-run impact is generally greater in Central and Eastern Europe, the emerging countries in that region are more vulnerable to adverse developments in the housing market.

After the coffee break, *Doris Ritzberger-Grünwald,* Head of the OeNB's Foreign Research Division, took over the chair, welcoming *Laurent Weill,* Professor at Strasbourg University, as the second keynote speaker of the workshop. In his speech titled "Corruption and Bank Lending," Weill started out by presenting some stylized facts on corruption in CESEE, which is still comparably high, and – contrary to expectations – has not eased in line with rising wealth. He then went on to stress that corruption had a detrimental impact on growth through various channels, inter alia through hampered or distorted bank lending, which was the focus of his lecture. In fact, many empirical studies – partly (co)authored by Weill – confirm that corruption per se has a harmful effect on bank lending both in quantitative and qualitative terms at the macro and micro level. Corruption thus not only reduces the bank lending volume but also favors bad loans. However, the quantitative detrimental impact of corruption on bank lending falls with banks' rising risk aversion, and if the risk aversion is sufficiently high, corruption may even increase bank lending volumes. Since greater risk aversion translates into more rejected loan applications, incentives for borrowers to bribe increase in order to obtain bank credit. Weill wrapped up by stressing that the impact of corruption on bank lending should not be underestimated, especially given the key role of banks in economic development.

After this stimulating food for thought, Ritzberger-Grünwald opened the last subsession, handing over the floor to *Sokol Havolli* from the Central Bank of the Republic of Kosovo. He presented a paper, coauthored with Bostjan Jazbec, on "Migrants' Investments, Remittances, and Foreign Direct Investments in the Balkans: The Case of Kosovo." In their empirical analysis, the authors found that one of the most important factors in determining migrants' investments is their perception of the home country's business environment. Moreover, emigrants with higher income levels and those who send remittances tend to invest more in their home country. The migrants' age is also an important determinant of their investments. According to Havolli, these findings suggest that it is crucial for emerging market economies in the Balkans to set up an attractive investment environment to attract foreign investments, particularly emigrants' capital.

The final contribution to the workshop came from *Konstantins Benkovskis* of Latvijas Banka. He presented a joint paper with Julia Wörz (OeNB) on "Nonprice Competitiveness of Exports from Emerging Countries," follow-up research to a study published in FEEI Q3/12. In this paper, the authors applied their previously developed export price index to nine emerging economies for the period from 1999 to 2010. Unlike studies that use a CPI-based real effective exchange rate, their method highlights notable differences in nonprice competitiveness across markets. Among other things, China shows a huge gain in international competitiveness due to nonprice factors, which implies that China's critics may be over-stressing the role of renminbi undervaluation. Benkovskis moreover pointed out that oil exports account for substantial improvements in nonprice competitiveness in the case of Russia, while they brought about modest losses of competitiveness for Argentina and Indonesia.