Taming capital flow cycle in CESEE

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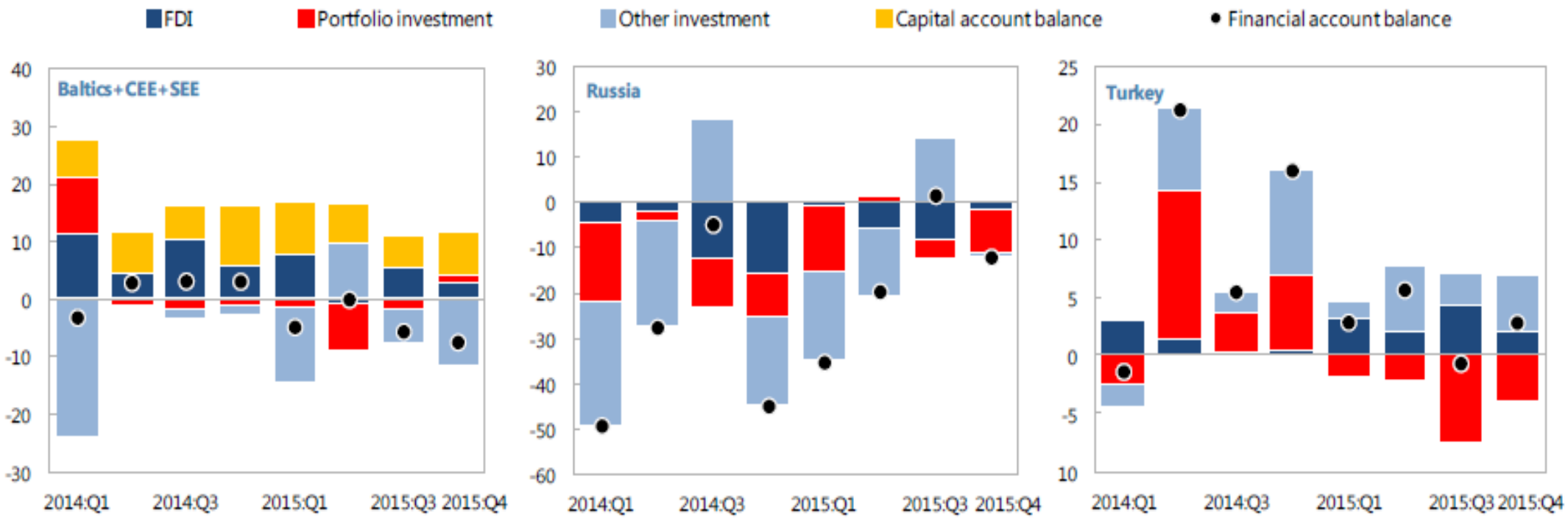
Outline

- ❖Overview of recent developments
- ❖Which policy tools seem to be suitable?
- ❖Evidence from CESEE so far & the case of the Czech Republic

Recent developments (IMF, 2016)

- Growth: Central, Southeastern Europe, Turkey exhibit solid growth, CIS lags behind
- Inflation: very low in C, SE, the Baltics
- Downside risks have become more pronounced recently
  - Weak growth in Euro area, weak performance of emerging markets, increased global uncertainty (Brexit)
- Slower rate of convergence towards Western Europe than in the years prior to the global financial crisis (GFC)
  - Structural reforms needed to address this issue

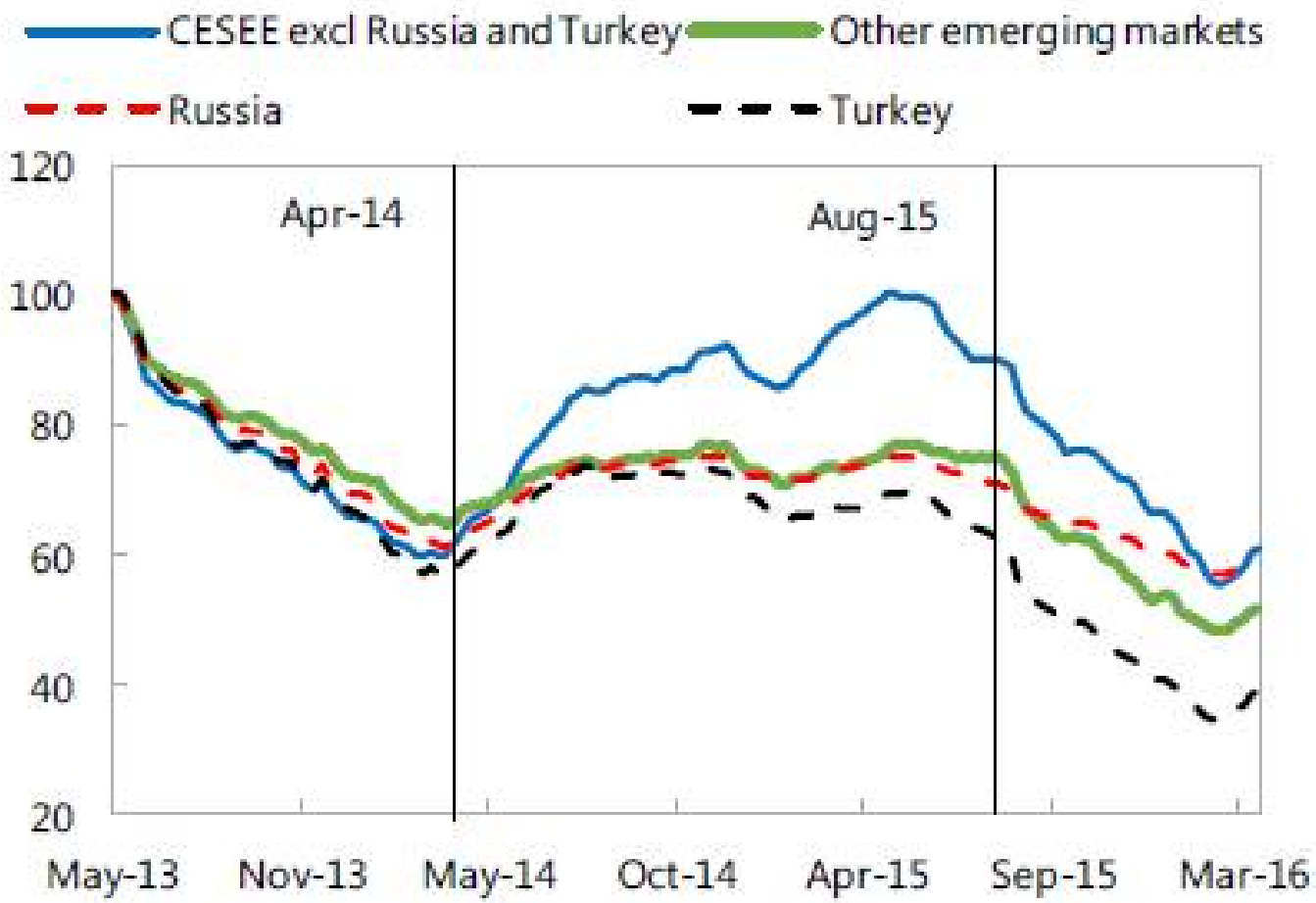
Recent balance of payments capital inflows



(Billions of US dollars)

Source: IMF (2016)

Recent cumulative (EPFR) flows into bond funds



(May 2013=100)
EPFR = Emerging Portfolio Fund Research

Source: IMF (2016)

Capital outflows dominated in 2015

- Two key factors (IMF, 2016):
  - Shrinking portfolio flows in the second part of 2015 (Russia, Turkey), recent improvement in 1Q of 2016
  - Ongoing deleveraging by Western European banks which own three-quarters of CESEE banking systems
    - Do foreign-owned banks in CESEE act as shock absorbers or shock transmitters?
      - Research leaning mainly towards the shock absorber characteristic (Vogel and Winkler, 2012; De Haas and Van Horen, 2013; Clarke et al., 2012)
- FDI flows remain largely positive, except for Russia

Why to tame the capital flow cycle?

- Financial openness can be “too much of a good thing” as it can increase vulnerability to external macroeconomic shocks
  - Excessive credit growth, possibly fuelled by foreign-denominated loans, followed by a sudden bust (Hungary, Poland before the GFC)
  - Sizable capital outflows may lead to a significant spike in inflation via currency depreciation (Ukraine, Russia recently)
  - Temporary restrictions on capital flows may be necessary to stabilize balance of payments (Ukraine recently)

Possible domestic policies

- Improvement of institutional setting & structural reforms
- Flexible exchange rate
- Capital flow management
- Counter-cyclical fiscal policies
- Macroprudential policies

FDI and portfolio flows w.r.t. production

- Fidrmuc and Martin (2011)
  - Focus on interlinkages between capital flows, exports and industrial production in CESEE
  - Main results and policy implications:
    - The stock of FDI positively related to industrial production and thus economic growth -> increase attractiveness for FDI
      - The effect of the foreign ownership on the efficiency of Czech firms is strongest when foreign owners control firms with less than majority of voting power (Hanousek and Kočenda, 2016)
    - On the contrary, portfolio investment seems to be only weakly related to the industrial growth performance of the CESEE countries -> should not be of the primary concern to policymakers

Internationally coordinated polices

- Need to be considered as well as capital flows are most likely to be driven by global factors
- Spillovers from decisions of the most important central banks (FED, ECB, BoJ)
  - Can the monetary policy of “less important” countries thus still be autonomous in such circumstances?
  - Plus asymmetries in forex volatility spillovers in general (Barunik et al. 2016) and stronger impact of ECB (than Fed) on CEE forex in particular (Kočenda and Moravcová, 2016)
- Hardly imaginable nowadays (very complex trade-offs included)

Suitability of possible policy tools

- Improvement of institutional setting & structural reforms
  - Benefits: Long-term benefits, a positive signal for investors
  - Limits: Political will, short-term costs
- Flexible exchange rate
  - B: Can help to alleviate the impact of capital flow volatility on the real economy
  - L: “Not for everyone” (the CESEE without it - Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia - have a good reason for doing so)

Suitability of possible policy tools

- Capital flow management
  - B: Useful in extreme circumstances (Ukraine)
  - L: Danger that its may delay implementation of serious reforms
- Counter-cyclical fiscal policies
  - B: Can help out monetary policy when inflation is high
  - L: Unsuitable to react to sudden capital inflows
- Macroprudential policies
  - B: Tools to limit excessive credit growth, enhancing financial stability
  - L: Still relatively new and unproven, question about their efficacy

A possible mix?

- Between international policy coordination (IPC), capital flow management measures (CFMs) and macroprudential measures (MPMs)?
  - IPC: Arguably the more, the better, but unfeasible due to conflicting objectives of institutions in various countries
  - CFMs: Use them only when necessary, can create substantial distortions
  - MPMs: They should be put to work constantly as their main aim – to contain the build-up of systemic financial risks – is “timeless”; however, questions remain about their interaction with other policy tools

Evidence from CESEE so far (IMF, 2016)

- CIS recently: tighter fiscal policies, greater exchange rate flexibility, interventions in the FX market
  - Improved trade balance, price competitiveness but also a surge in inflation
- Turkey: relaxing macroprudential policies but also stronger domestic demand at the same time
- Stable exchange rates against the euro in countries outside the CIS may suggest that the current policies do not harm at worst
  - A reason could also be improved fundamentals compared to the pre-crisis years
    - Average regional current account deficit was at 12 percent of GDP in 2008, compared to 2 percent in 2015

The case of the Czech Republic

- Exchange rate management since November 2013
  - The floor of 27 CZK/EUR should provide a clear signal to speculators
  - However, there in a non-negligible uncertainty about the exit strategy
- The Czech National Bank (CNB) actively uses and promotes macroprudential measures
  - The countercyclical capital, the systemic risk, the capital conservation buffer among others
- Fiscal policies rather pro-cyclical

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