Press Points for Chapter 2: *Managing Capital Flows*

Spring 2010 Regional Economic Outlook: Europe

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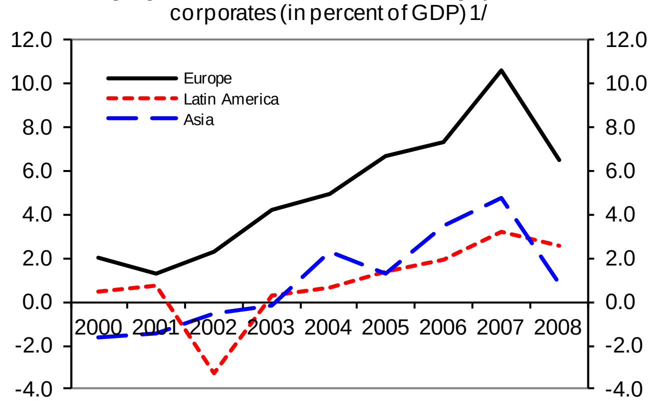
Key Points

- **Managing capital inflows is perhaps the greatest challenge facing Emerging Europe's policymakers in the post-crisis world. The three key questions are: how to attract a healthy level of foreign investment, how to prevent excessive capital inflows, and how to ensure the stability of an increasingly internationally integrated financial sector in light of these inflows.**

- **The lessons from the pattern of capital inflows before the crisis suggest that securing a healthy level of inflows requires structural reforms to ensure a balance between the nontradable and tradable sectors as sources of growth.**

- **Preventing and dealing with excessive inflows demands responsive macroeconomic policies and improving the financial sector's resilience through prudential policies and strengthening crossborder financial stability frameworks.**

Emerging economies: Overseas borrowing by banks and corporates (in percent of GDP) 1/



1/ Other investment liabilities (loans and currency & deposits of banks, and loans of nonbank private sector), net

Capital inflows were larger in Emerging Europe and fell more severely during the crisis than in other emerging economies. Prior to the crisis, crossborder loans from Western European parent banks to their emerging European affiliates accounted for most of the difference (figure). The large inflows created macroeconomic and financial sector vulnerabilities—larger current account deficits, rapid credit growth, worse fiscal positions, and heavier indebtedness (often in foreign currencies) of households in many countries in the region. These vulnerabilities and the fact that the externally-funded credit growth was susceptible to financing difficulties of parent banks when the crisis struck are reasons why Emerging Europe went through a deeper downturn than other emerging economies.

What motivated the inflows? Emerging Europe is the only region in which capital flowed "downhill," from richer European countries into fast-growing neighboring economies, and helped this region to close the income gap. A large part of the inflows before the crisis was motivated by prospects for higher returns in Emerging Europe than in home markets and was related to the level of income in recipient countries. FDI inflows were attracted by strong economic growth and urbanization but tended to slow as the country became richer. Crossborder loans to banks and corporates, on the other hand, speeded up as the economies matured, and was attracted by growing service sectors. As the economies liberalized with institutional and structural reforms, they pulled in even more inflows.

However, countries such as Estonia, Latvia, Bulgaria, Hungary and Ukraine saw inflows surging in excess of what can be explained by convergence factors. Our analysis shows that much of the exuberance was related to macroeconomic policies, exacerbated by excessive risk taking in the financial sector. Stable exchange rates in general, and slower nominal appreciation in non-pegged exchange rate regimes in particular, invited more bank-related and portfolio inflows. Countries with heavily managed or pegged exchange rates had the most rapid credit growth and received the largest volume of inflows. Seemingly solid government finances, supported by revenue booms driven by quickly heating-up economies, further attracted FDI inflows; where the improving government balances were associated with credit booms, bank-related inflows were the strongest. Expanding nontradables sector and its increasing relative price, the real exchange rate, attracted even larger inflows. Thus, the higher domestic demand, credit growth and capital inflows reinforced each other.

The impact of the macroeconomic policies on capital inflows was amplified by the persistently low country risk premia on interest rates. Investors seemed oblivious to the vulnerabilities in individual countries until the crisis hit. As a result, banks could borrow money overseas at very low interest rates. High profitability (due to low cost of funds and low provisioning for loan-losses during the boom) and capitalization provided comfortable indicators of stability and reinforced the sense that risks were manageable.

At the same time, policymakers, sought to influence the volume and composition of inflows through prudential policies to mitigate increasing macroeconomic and financial sector vulnerabilities. While country experiences varied, prudential tools seem to have been effective in temporarily slowing capital inflows into banks and changing the composition of inflows. In general, the impact of a specific type of prudential tool depended upon the monetary and exchange rate regime and the form of crossborder liabilities of the banks.

The crisis experience holds a number of crucial lessons for the challenges of managing capital inflows across the region. The policy implications differ across countries, with some waiting to rekindle and sustain inflows, while others already seeing a resumption of inflows. The key questions facing policy makers are: how to ensure a healthy level of foreign investment into emerging Europe, prevent excessive capital inflows, and improve the stability of an increasingly internationally integrated financial sector. The policy recommendations should be tailored to country-specific circumstances. In particular:

- For countries that are already seeing a resumption of inflows, responsive macroeconomic policies will be key to stem an excessive surge. For countries with pegged exchange rates, the best response to inflows in excess of those driven by structural factors is to tighten fiscal policies. For countries without pegged exchange rates, the most effective response could be to let the currency appreciate. A freely floating exchange rate is also helpful to prevent excessive inflows and a buildup of financial fragilities.

- These macroeconomic policies should be accompanied by improvements in the stability of the increasingly integrated financial system in the region. Prudential tools such as capital requirements on foreign borrowing help to lower excessive inflows and related risks in banks. Higher risk weights on loans to certain sectors help build buffers in the banking system and prevent overheating of certain sectors. To sustain the resilience of the financial system, these tools need supportive macroeconomic policies and effective cross-border financial supervision.

- Where capital inflows conducive to income convergence have yet to resume, policymakers will need to re-orient the sources of economic growth toward the tradable sector. While this transformation will take place in the private sector, support by policies to restore a balance between the nontradable and tradable sectors improve inter-sectoral labor mobility, lowering skill-mismatches, and addressing country-specific growth bottlenecks in infrastructure will be crucial.