Prospects and challenges to recovery and growth – a central banker's perspective

Presentation at CFA Forecast Dinner "Romania's Competitiveness and Post Crisis Fiscal Adjustment", organized by CFA Romania

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I. The philosophy behind capital account openness

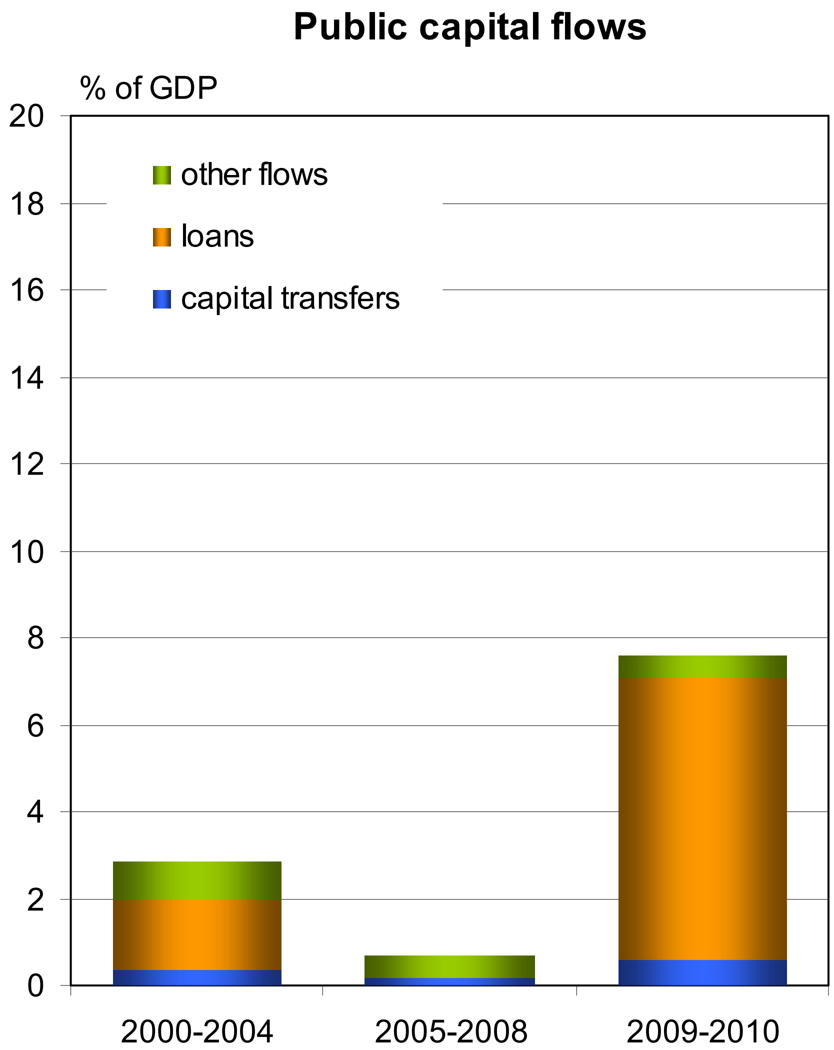
- Capital inflows fill the domestic savings' deficit, and promote economic growth and development. This is why policymakers try to attract capital inflows (Dornbush, 1998).
- Is this really true? Not always! Evidence is mixed.
- We think that *moderate capital inflows help*, but capital flow bonanza may create problems
- The "transfer problem":
  - ✓ Balance sheet currency mismatches in the private sector (banks, households and non-financial firms)
  - ✓ Asset price bubbles
  - ✓ Excessive exchange rate appreciation
  - ✓ Credit boom

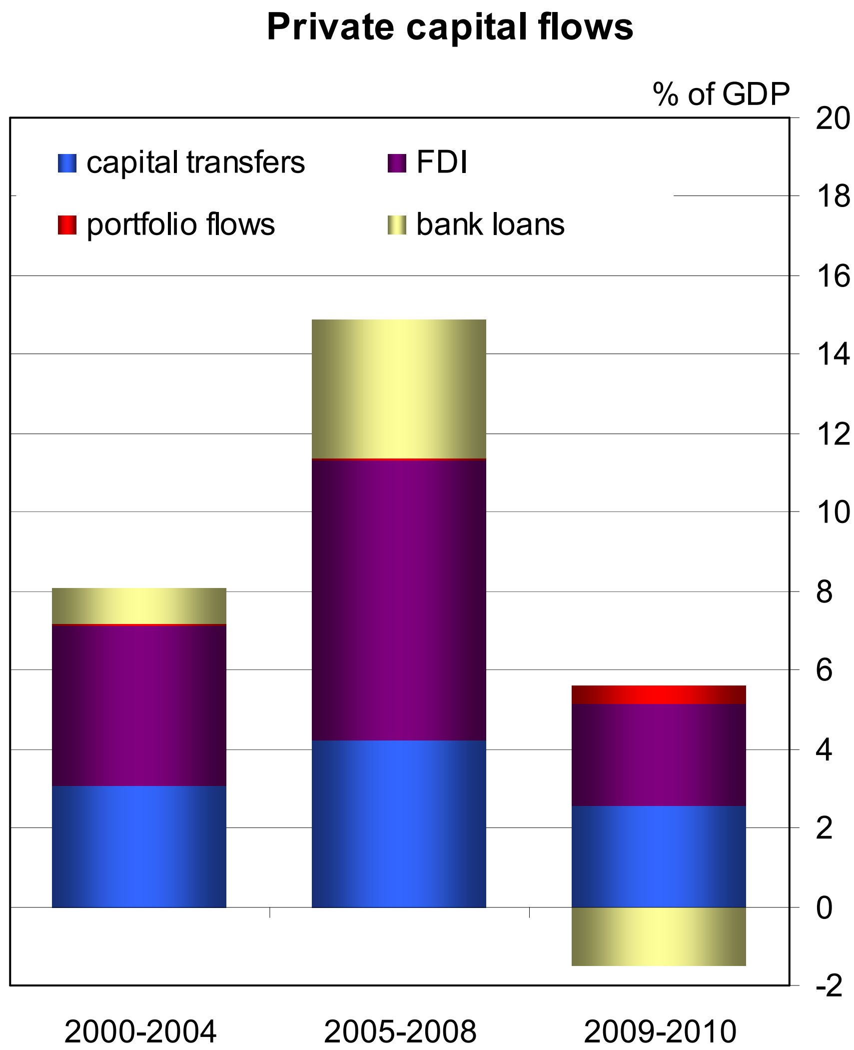
II. Romania's experience

Perioada	Average growth rate	Cumulated growth over the period	Comments
1990-1992	-9.1	-25.0*	low private capital inflows
1993-1996	3.9	16.6	low private capital inflows
1997-1999	-2.5	-7.3	low private capital inflows
2000-2004	5.4	29.8**	moderate private capital inflows
2005-2008	6.4	28.2	high private capital inflows
2009-2010	-4.2	-8.3	high public capital inflows
*3 years			
**5years			

- Significant economic growth in the absence of private capital inflows achieved through interest rate and exchange rate implicit subsidies (we were fiscally and monetary undisciplined: red means do not repeat the exercise)
- High private capital inflows (we were not lucky) during 2005-08 led to large imbalances and mismatches (we were fiscally undisciplined)
- Green means that we were disciplined (implemented the IMF program) and lucky (moderate capital inflows) during 2000-04

Romania: Capital flows before and after the crisis





Note: values are annual averages

Source: NBR

What should we expect concerning capital inflows to Romania?

- Something similar to what is already happening to other EMs
- Developments in EMs might provide a hint

III. Right now the transfer problem is growing in EMs

- **Capital inflows to emerging markets seem to rebound**

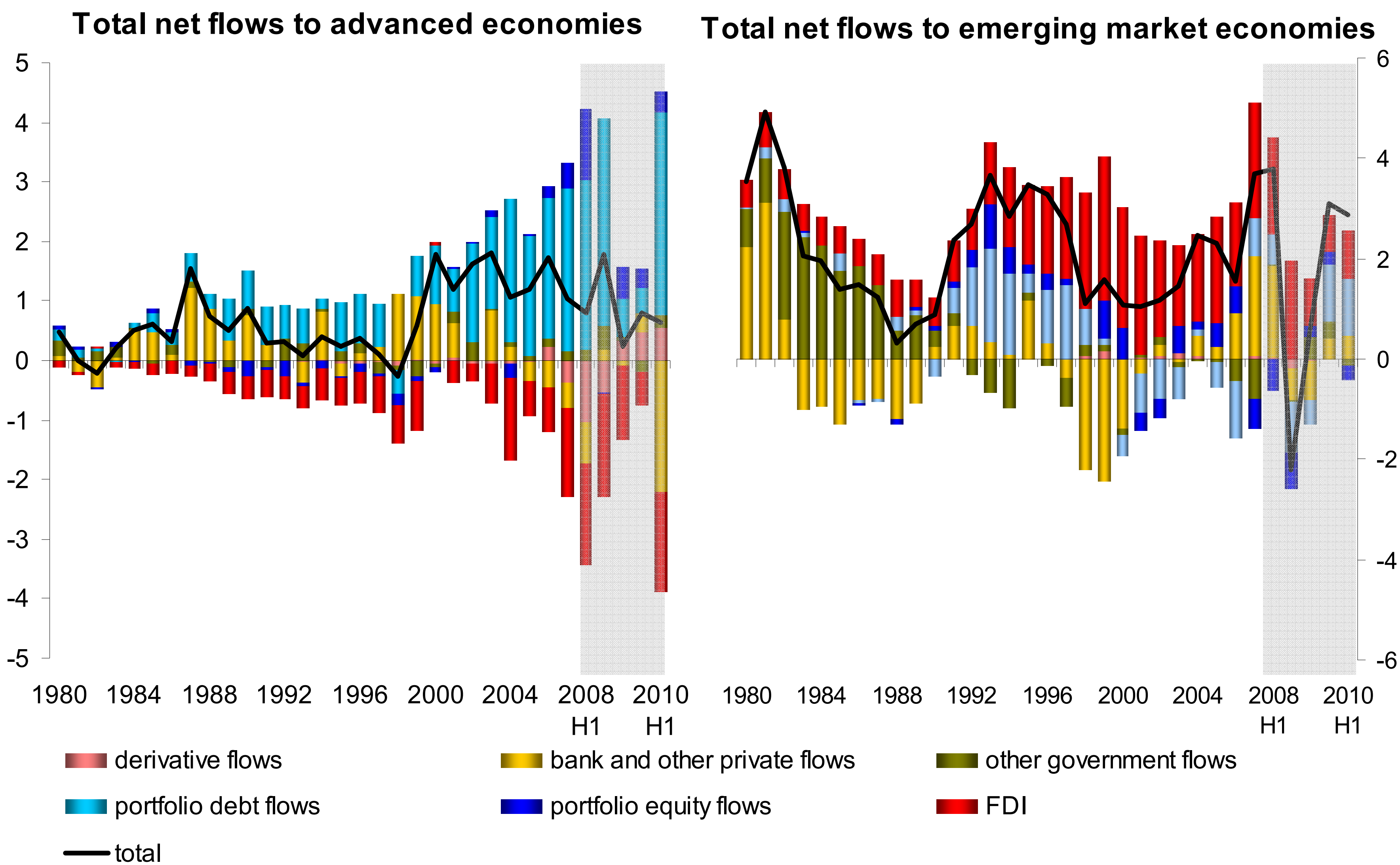
  Massive financial account movements given **widening interest rate differentials between DM and EM** although Japanese retail investment abroad is being repatriated back to Japan and China's current account surplus is narrowing rapidly

- **Increase inflationary pressures**

  DM headline consumer price expected to be 2.8% yoy in 4Q11 (1.6% in 4Q10). EM headline consumer price forecast at 6.2% yoy in 4Q11 (5.6% in 4Q10). It has been problematic in India, China, Indonesia, Korea, Brazil, Mexico, Egypt, Russia, parts of Eastern Europe and Sub-Saharan Africa.

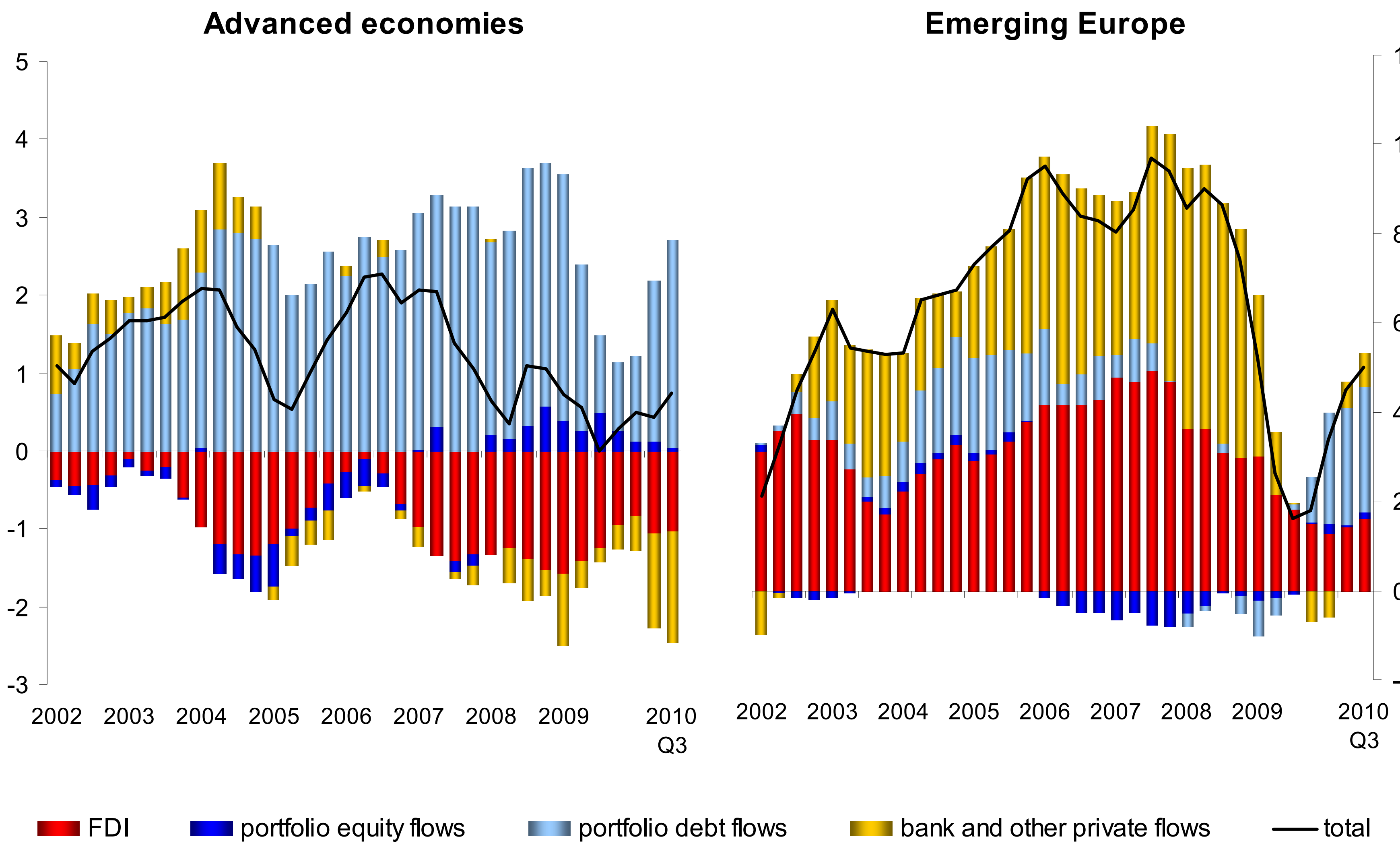
  - On one side, capital inflows lead to nominal appreciation, eroding countries' competitiveness
  - On the other side, the contribution of imported inflation to the headline inflation is increasing

Resurgence of capital inflows towards emerging economies



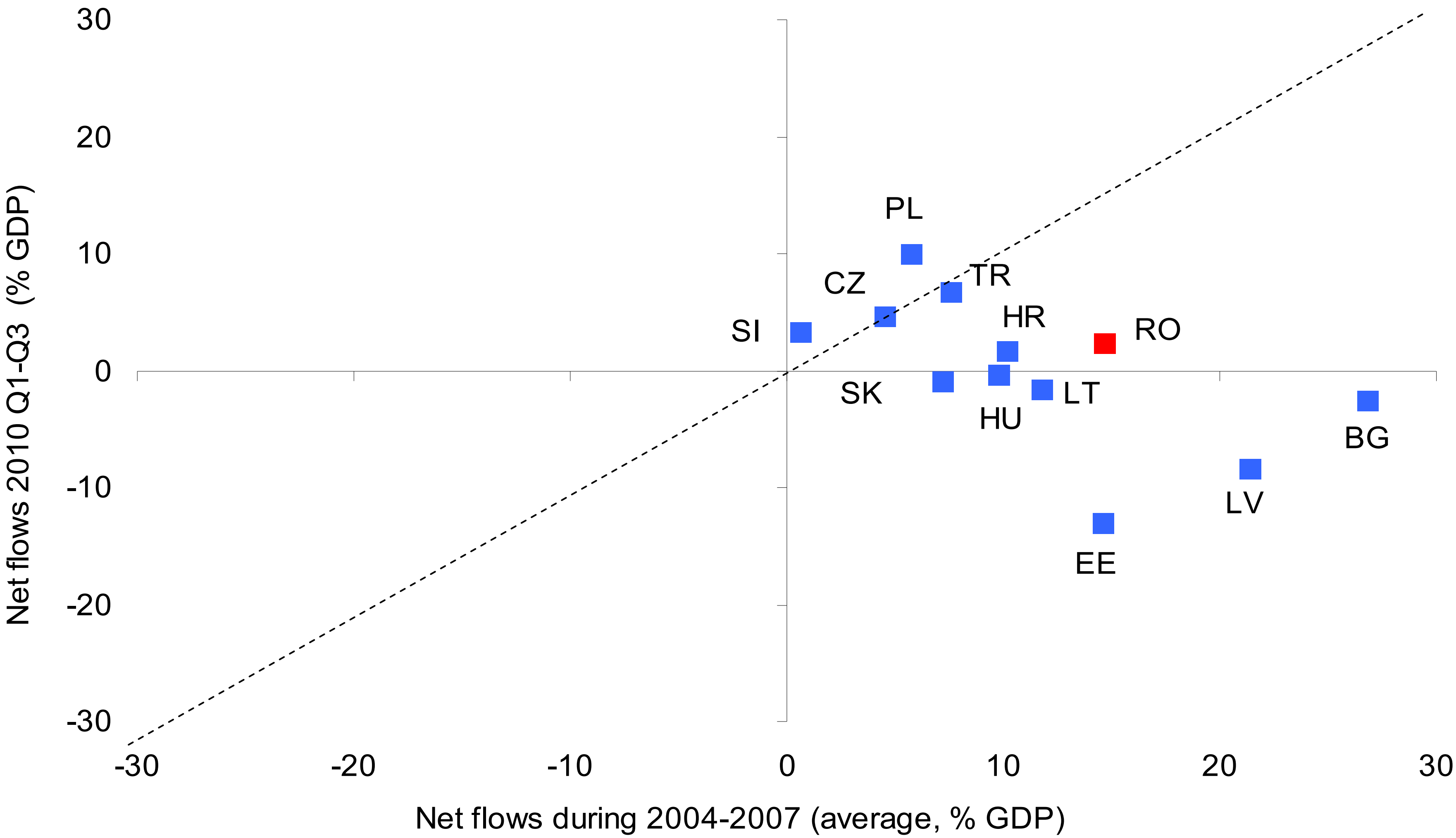
Source: IMF

Significant change in the composition of capital flows to emerging economies as compared to the pre-crises period...



Source: IMF

Despite their recent increase, capital flows have not reached yet their pre-crisis levels in the majority of European emerging countries



Source: IMF

IV. Policy responses in emerging markets so far

- A shift in focus to inflation
  - ✓ **Increased tolerance for nominal appreciation** and therefore less FX interventions (see China, Peru, Israel, Korea, Taiwan, Indonesia, Brazil, Turkey, South Africa, Mexico, India)
    - ✓ Also eases the burden on FX mortgage holders
    - ✓ and reduces debt-to-GDP ratios
  - ✓ **Monetary policy tightening** in much of EM Asia (including China), Brazil, Chile, Peru, Israel, Turkey, Serbia and Georgia, caused by asset price inflation and/or excessive credit extension to the private sector
  - ✓ **Increased resort to macroprudential measures** in order to manage capital inflows
- Such a policy mix may materialise into lower growth

Appreciation versus US dollar

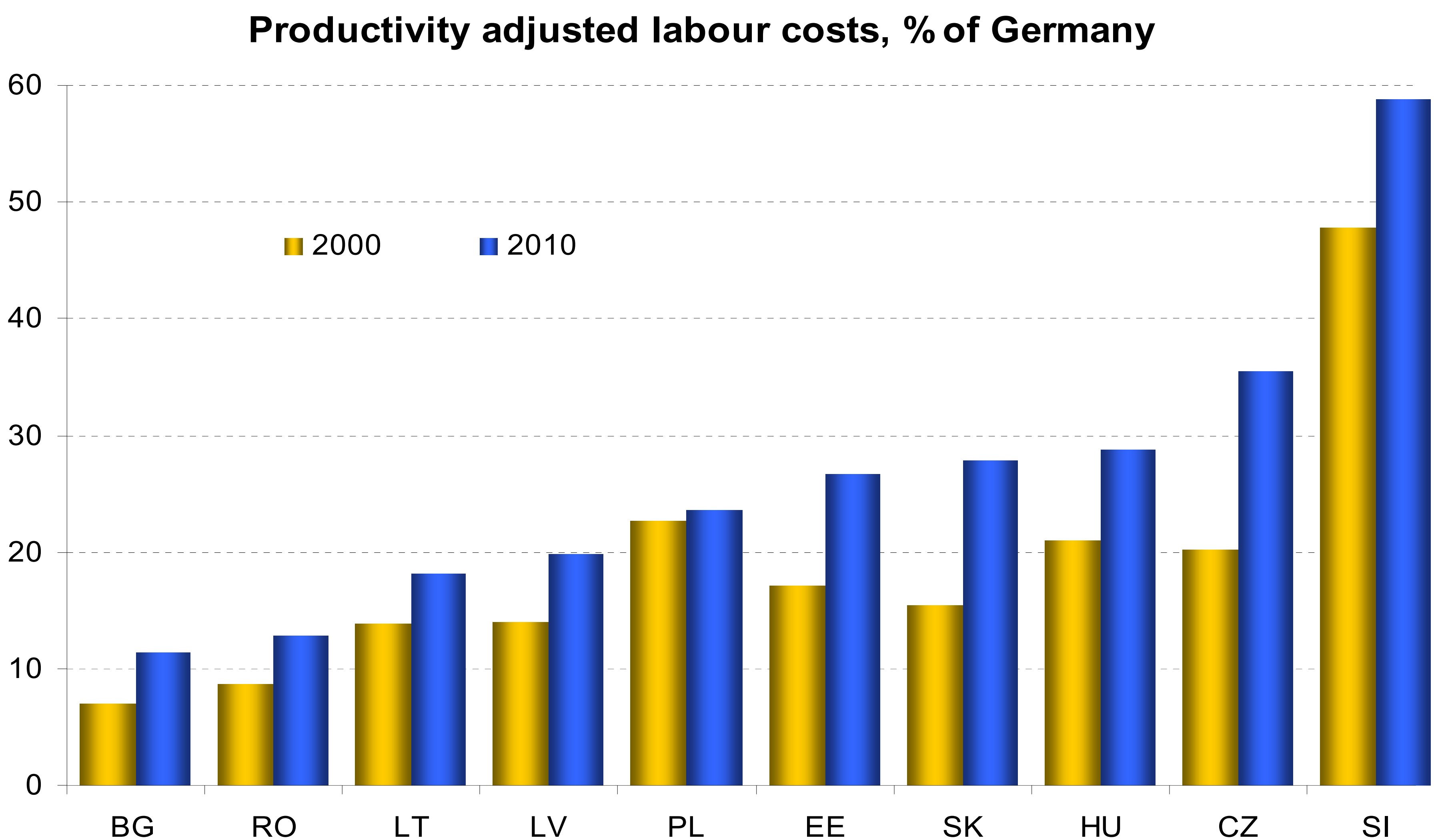
V. Is this policy mix sustainable?

- **Probably NOT!**
  - ✓ Prudent macroeconomic policies and macroprudential measures increase the odds for long-term macroeconomic and financial stability
  - ✓ This in turn attracts ***more capital inflows*** and increases appreciation pressure
  - ✓ More interventions would be needed to tame appreciation
- This potential change in policy would be more expansionary
- The focus might change to competitiveness later
- Is a shift in focus to competitiveness sustainable?
- **Probably NOT!**
- More interventions by accumulating more reserves translate into more inflation without sterilization. But a systematic **sterilization policy is not sustainable** since it may result in higher interest rates (the Peril of Sterilization, G.A.Calvo, Staff Papers vol. 38, No. 4,1991) and quasifiscal losses of the central bank

VI. A changing focus from inflation to competitivenes reises some challenges for monetary policy...

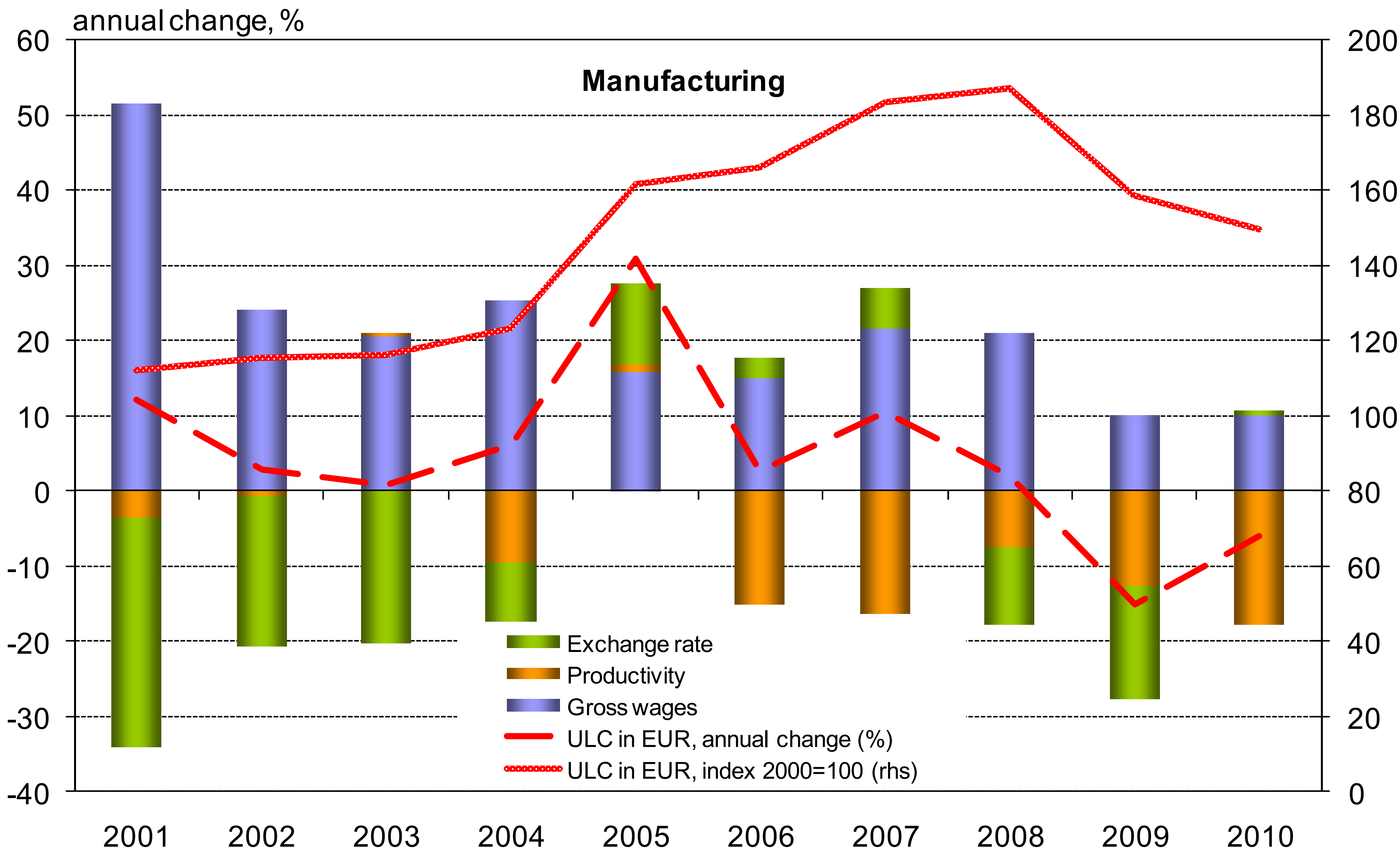
- The main challenge: to reach inflation target in 2012 while maintaining the financial stability of the system
- Specific challenges to liquidity management:
  - ✓ Increased role for interest rates in taming capital inflows since a reversal in minimum reserve requirements is not acceptable
  - ✓ More capital inflows mean more money. This means more sterilisation efforts and hence losses for the NBR. More losses mean higher inflation
  - ✓ Increased reserve accumulation if capital inflows are not tamed by interest rate cuts
  - ✓ More capital inflows: the NBR a net debtor again
  - ✓ An increased coordination effort with the fiscal policy, since a slippage in the fiscal area might amplify the interest rate dilemma

...and bring to the attention the non-price competitiveness issue. Labor costs in Romania remain among the lowest in the region…



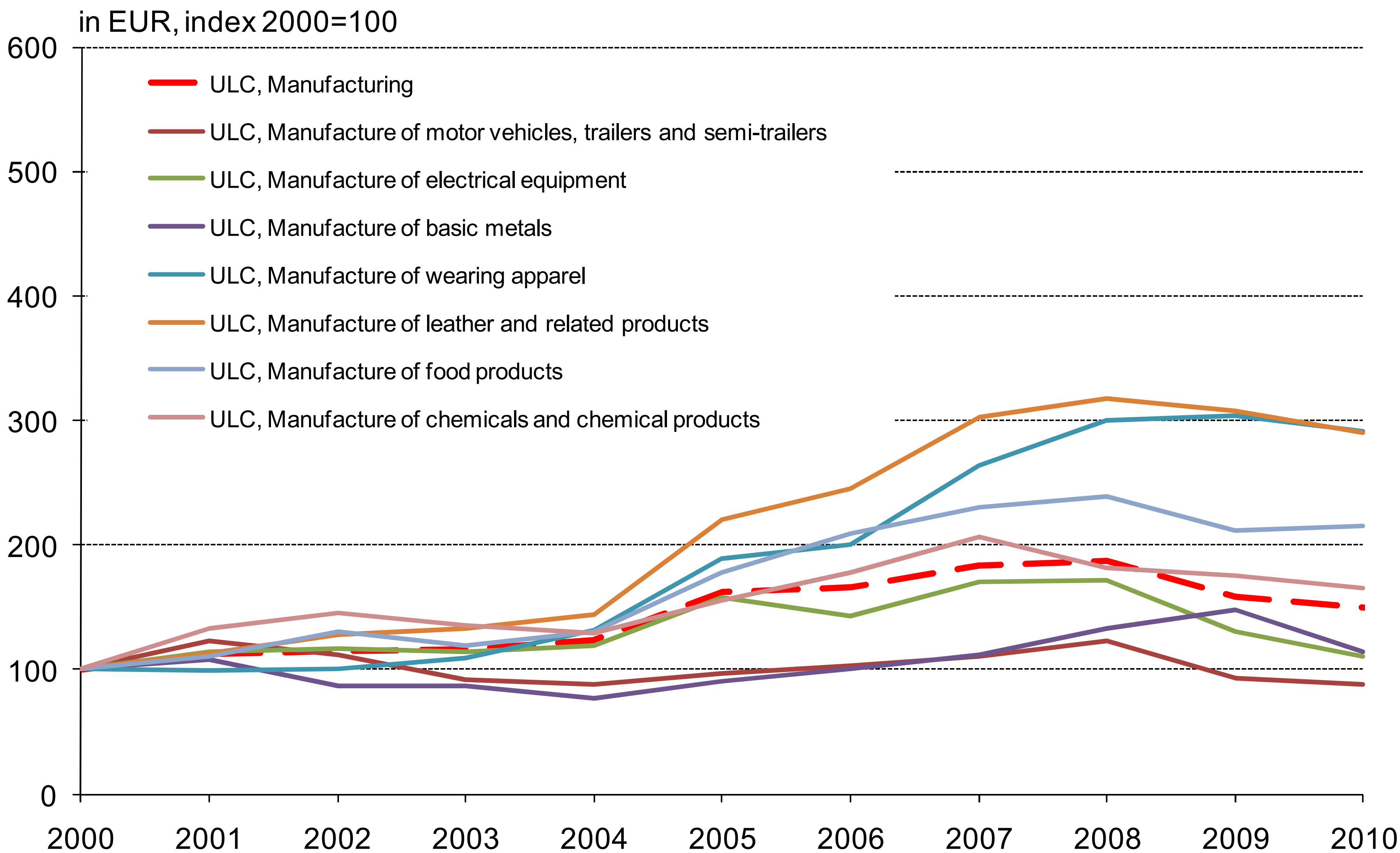
Source:Eurostat, AMECO

…with developments during the last 2 years partly undoing the erosion in competitiveness that occurred in the boom period



Source: NIS, NBR

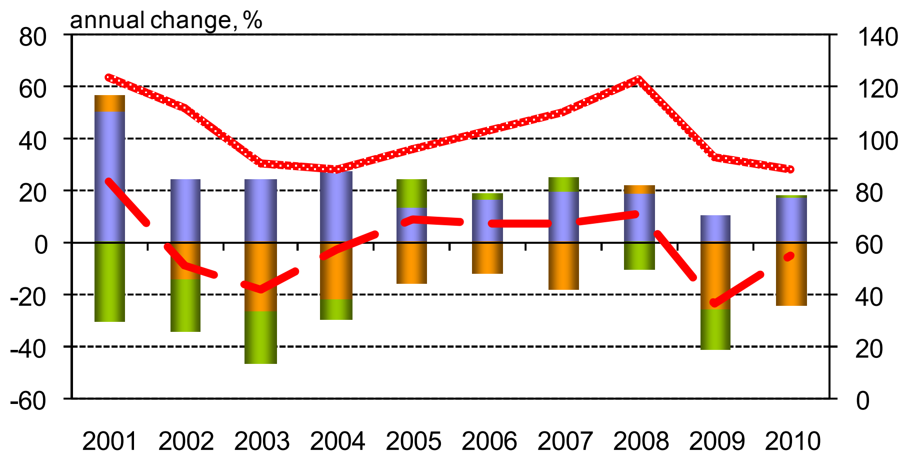
Wide spectrum of ULC developments across the main industrial sectors…



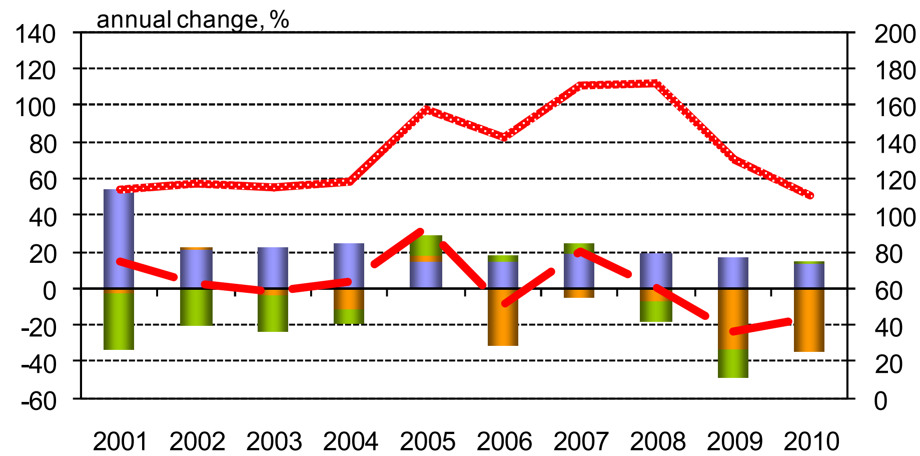
Source: NIS

…with the automotive industry and the electrical equipment sectors appearing as particularly labor-cost efficient

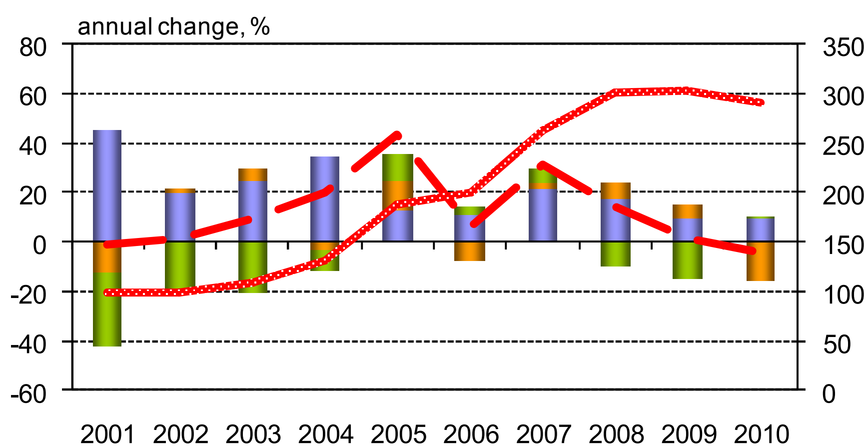
Manufacture of motor vehicles



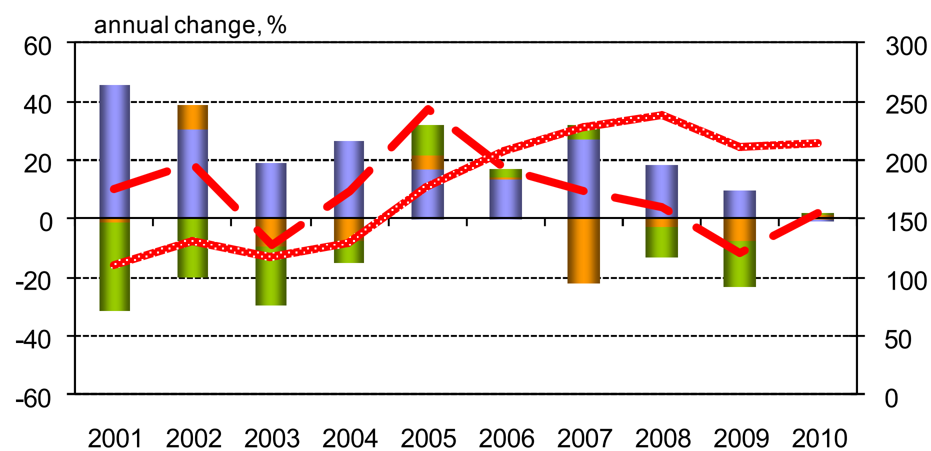
Manufacture of electrical equipment



Manufacture of wearing apparel



Manufacture of food products

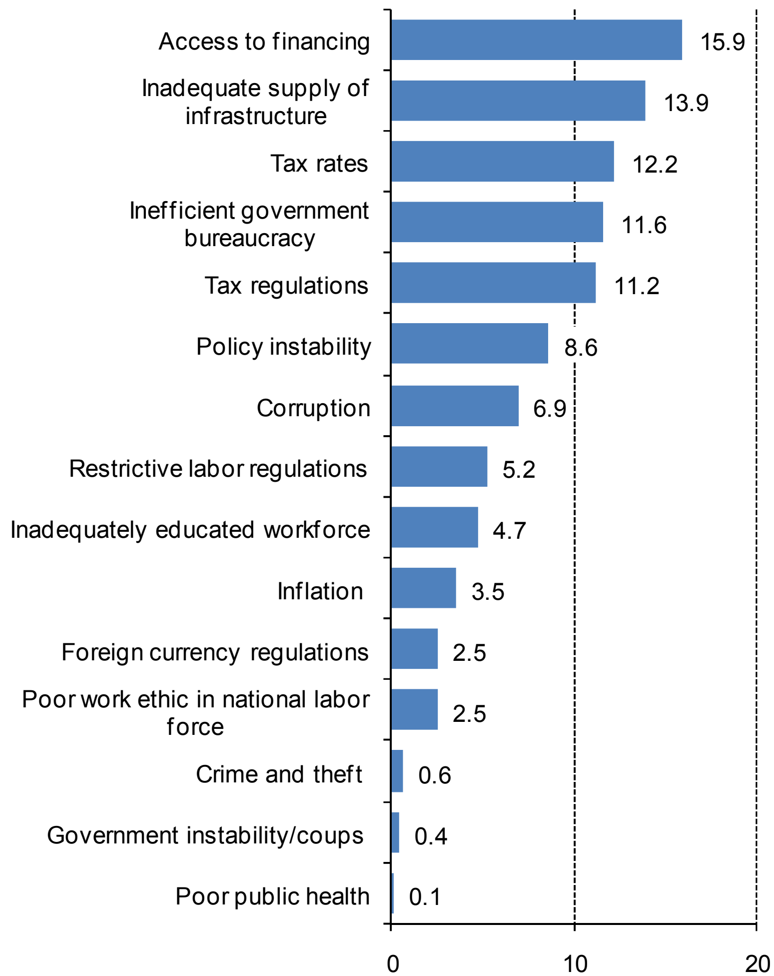


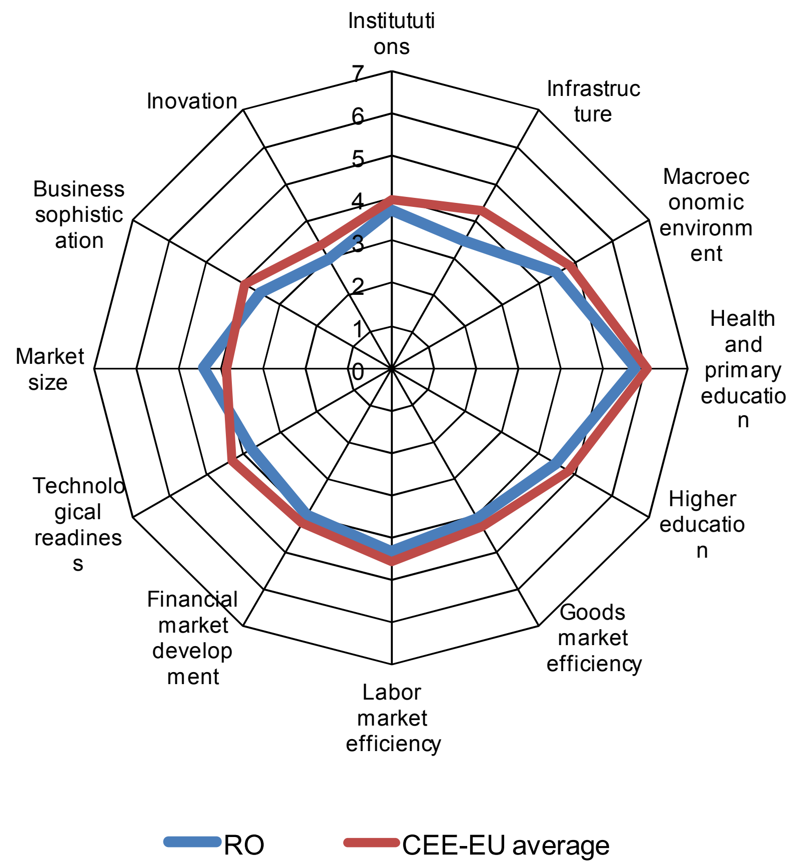
Gross wages
Exchange rate
ULC in EUR, index 2000=100 (rhs)
Productivity
ULC in EUR, annual change (%)

Source: NIS, NBR

Romania scores systematically below the regional average in terms of non-price competitiveness, with the widest gap located at the level of the infrastructure indicator

The most problematic factors for doing business





Source: World Economic Forum

VII. What are the prospects at the global level?

- **Global growth to slow in 2011** due to: high energy prices; the supply shortages (Japan earthquake and Tsunami); fiscal consolidation among some DM countries; and globally tighter monetary policy (with the US an exception)
- **Time mismatches for closing the output gaps in EM**. The **Asian EM**' output gaps mostly closed by mid-2010; In most **Latin America' s countries** output gap will disappear in 2011 (Argentina's output gap closed before 2009; Brazil's closed in early 2010). Many EMEA EM countries will still have slack throughout 2011 (not Israel (closed last year), Poland (closed end 1Q11), Turkey (to close this year) and Russia (to close late 2011)
- **The need for prolonged DM fiscal consolidation** is likely to constrain DM growth this year and beyond. The export contribution to growth likely to moderate in Romania
- **Global imbalances have become less of a problem**: China's CA surplus is narrowing rapidly and the US's CA deficit is expected to remain below 4 percent over the next 2 years. This is going to weaken capital inflows movements. A higher chance for moderate capital inflows to Romania

VIII. Romania might face again challenges similar to those of the period 2005-2008

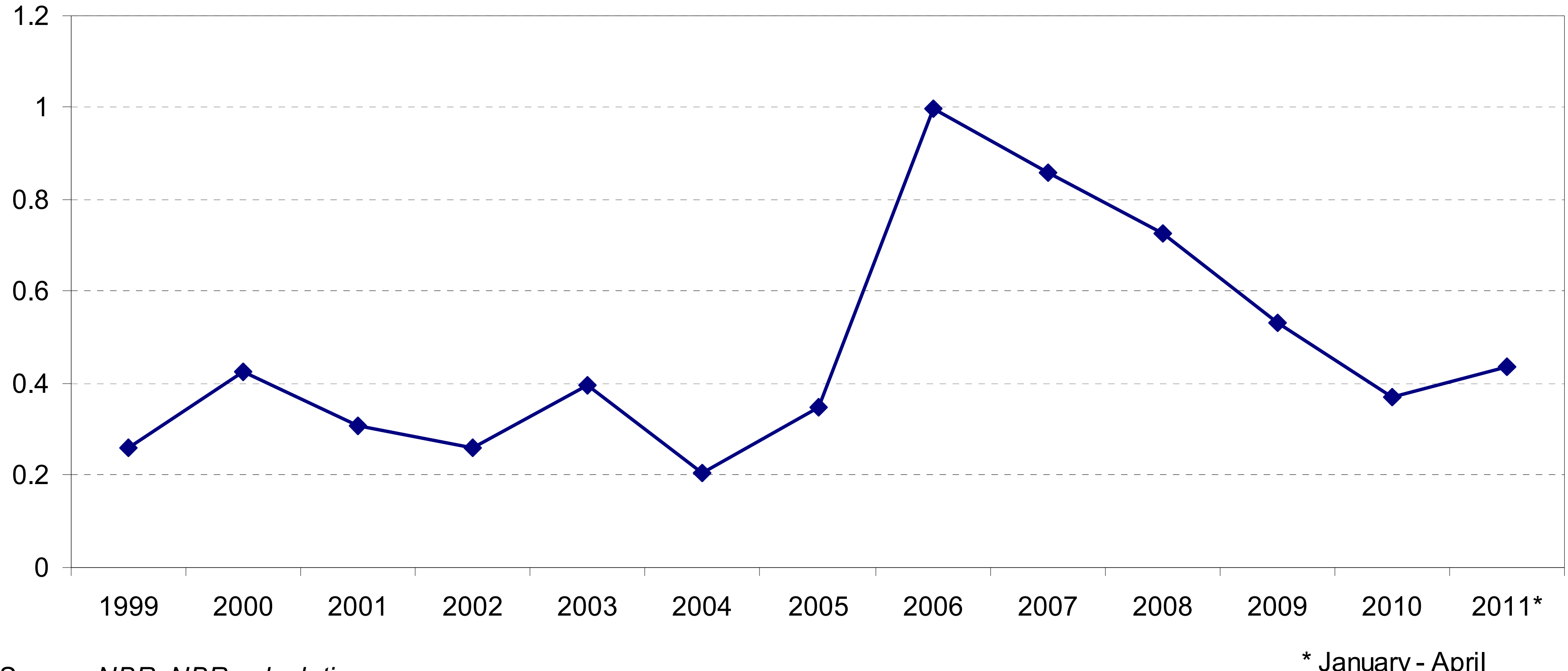
- In terms of developments:
  - ✓ Increased capital inflows
  - ✓ More portfolio investment since flows from North Africa look for new destinations. Low positive impact on growth but strong impact on appreciation
  - ✓ Credit and asset prices booms
  - ✓ External imbalances
- In terms of policies:
  - ✓ Policy interest rate dilemma – to manage domestic inflation
  - ✓ FX interventions dilemma – competitiveness vs. quasifiscal costs of the central bank
  - ✓ Macroprudential measures – interfere with FX interventions

IX. Conclusions: we can have a different approach this time

- When capital flows flood an economy:
  - ✓ There is little to be done to protect price competitiveness via FX interventions. A relatively flexible exchange rate helps dampen real effective exchange rate appreciation
  - ✓ High non-price competitiveness helps
  - ✓ High non-price competitiveness requires strong competition
  - ✓ **Structural reforms have to aim at enforcing competition**

- To help dampen external imbalances accumulation, **the public sector has to make room for the private sector**
  - ✓ On the ascending phase of the economic cycle, decreasing fiscal deficits or increasing surpluses are consistent with higher public expenditure in real terms
  - ✓ Would be capital controls a solution? NO. Capital flows always find a way out to intended destinations. There would be more distortions and less efficiency.

Degree of exhange rate flexibility in Romania



Source: NBR, NBR calculations

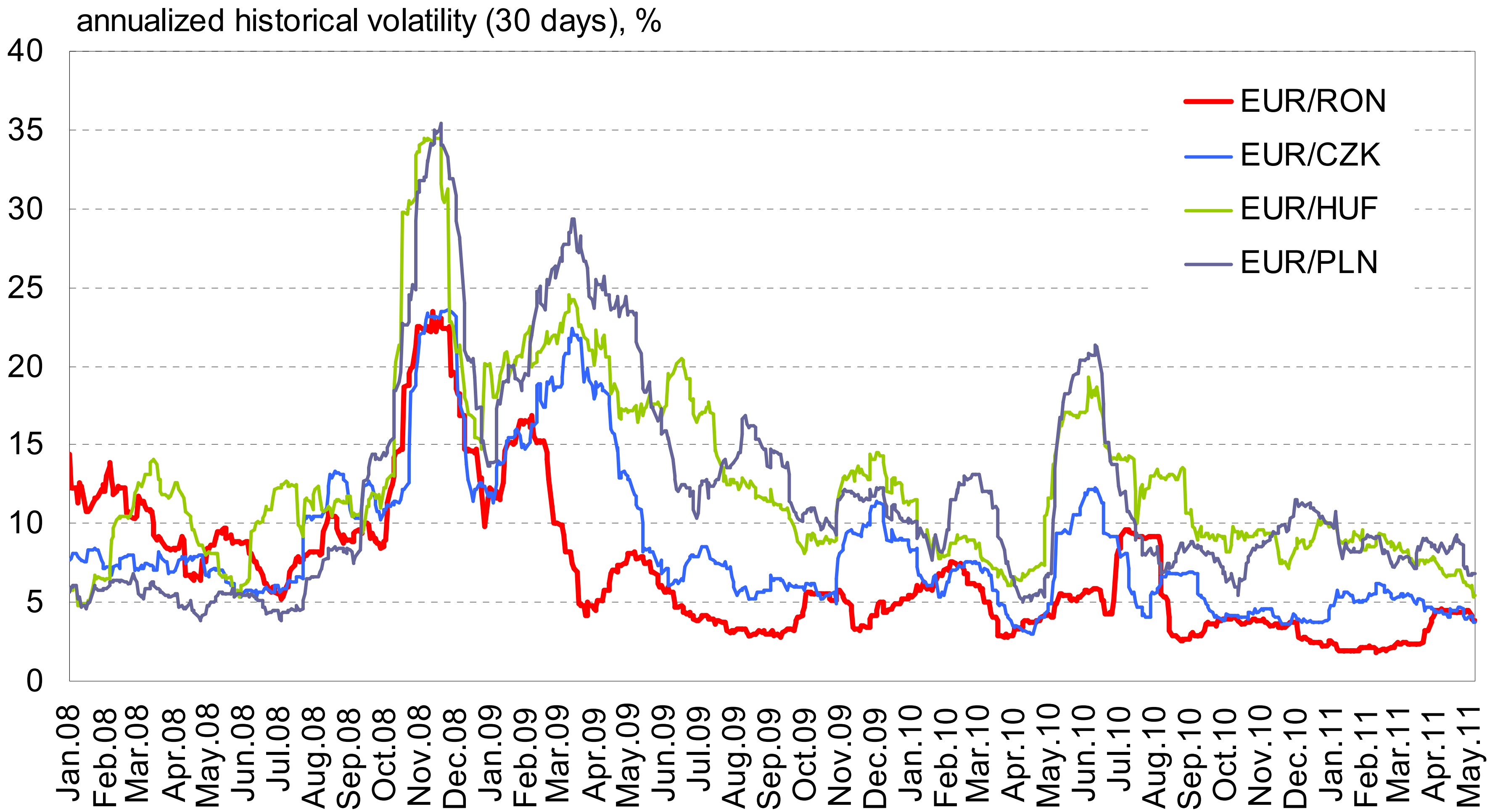
$$\left(\frac{\left|s_t - s_{t-1}\right|}{s_{t-1}}\right) \Big/ \left(\frac{\left|s_t - s_{t-1}\right|}{s_{t-1}} + \frac{\left|Int_{t/t-1}\right|}{BM_{t-1}}\right)$$

where: s_t = average nominal exchange rate in year *t*,

Int_t = purchases foreign exchange / sales

BM_t = monetary base

Following the speculative attack in 2008, central bank intervention lowered exchange rate volatility, which remained below that of other currencies in the region throughout the period



Source: Bloomberg