Foreword

Jaime Caruana

The seminar aimed to expand and complement the G20 discussions on topics related to capital flows, which are particularly important for central banks. Chairman Ignatiev and Governor Nabiullina from the Bank of Russia took great personal interest in the seminar and shaped the topics to address key emerging market issues.

We addressed three broad topics: The first was how best to respond to volatile capital flows. The second topic is what can be done to finance long-term projects; and the third one how to develop domestic capital markets in emerging economies. In order to motivate the discussion, we asked academic experts to prepare short papers on each topic, and we publish them in this volume. The central bank Governors and Deputy Governors had lively discussions on each subject.

The first session highlighted that the capital flows we see differ in many respects from the idealised textbook case. The main risk is, however, the sudden reversal of capital flows. This risk can be mitigated in three ways. One, solid macroeconomic policies, most importantly sustainable fiscal positions and low inflation, are the basis for ensuring proper capital allocation. Exchange rate flexibility is also part of such a macroeconomic policy mix. Two, to strengthen the resilience of the financial system active macroprudential policies might also be necessary. Three, to enhance fundamentals structural reforms that increase productivity and reduce distortions may be needed. These three main elements may not be enough on some occasions; therefore it is worthwhile to discuss in what extraordinary circumstances and for how long direct capital flow management may be necessary.

The second discussion examined the links between the current regulatory reforms and sustainable long-term finance. Of course, short-run difficulties may arise. For instance, there seems to be pressure in the banking industry to achieve Basel III capital ratios faster than the official timetable – and there has been some concern that this might reduce the supply of bank lending in certain areas. However, the main lesson from the financial crisis is that only well capitalised banks are able to provide lending on a sustainable basis.

The third and final topic considered developing capital markets in emerging markets. The development of local capital markets depends on many other policies, and often depends on the development of an efficient local banking industry. Indeed, there seem to be synergies between capital markets and banks.

Discussions at the seminar illustrated well the interdependence of economic policies. Monetary policy is but one of these policies. While central banks can play a highly useful role in managing capital flows, at the same time governments must implement the regulatory reform, undertake structural reforms and vigorously maintain fiscal sustainability to enable stable long-term growth. Currently, the main risk seems to be overburdening central banks: the success in controlling inflation should not mean that central banks have the magic solution to meet all policy objectives.