‘Financial integration and inclusive development -
a view from the Mediterranean countries’

Banco de España, IEMed, OECD conference

Panel on ‘Central banks, financial integration and capital flows’

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It is a great pleasure to be here. The topic of this session is among the most challenging for central banks today.

My contribution will be in four parts. I shall start with some observations on monetary policy and financial spillovers in a financially interconnected world, before moving on to consider the role of the euro area, followed by the implications for the Southern Mediterranean countries. I shall conclude by discussing policy implications.

The debate on monetary and financial spillovers in a financially interconnected world

Global financial integration has been increasing rapidly over the last twenty years. Cross-border asset and liability positions have doubled as a share of global GDP since the Asian financial crisis of 1997-98. The pace of growth has been faster in advanced economies (AEs) – partly reflecting the disproportionate rise in the gross assets and liabilities of financial centres[1] – but it has also been remarkable in emerging economies (EMEs), where the average level of gross external assets and liabilities has reached 60 per cent of GDP, up from less than 40 per cent in 1997 (Fig. 1).

Greater financial interconnectedness allows for more risk sharing, increasing each economy's ability to absorb idiosyncratic shocks; however, it may also intensify the transmission of global shocks, especially those originating from core countries.

Capital flow volatility and the cross-border correlation of asset price movements and credit growth have increased in recent years, in connection with unconventional monetary policies put in place in major AEs and with the intensifying search for yield. This has revived the debate over the risks posed by international spillovers, not only to financial stability but also to monetary policy autonomy, particularly in EMEs with less developed domestic financial markets.

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[1] Lane, P.R. & Milesi-Ferretti, G.M. IMF Econ Rev (2018) 66: 189. https://doi.org/10.1057/s41308-017-0048-y.

The classical 'trilemma' of international macroeconomics has been called into question. According to this 'trilemma', to preserve monetary autonomy, more open capital accounts require more flexible exchange rates. In a well-known paper presented at Jackson Hole in 2013, Hélène Rey contested the validity of the 'trilemma'.[2] She argued that the existence of a global financial cycle, essentially driven by US monetary policy due to the dominance of the US dollar in the international monetary and financial system, has increasingly undermined the usefulness of flexible exchange rates for insulating an economy from external shocks. On the contrary, the financial implications of exchange rate changes may well dominate their real implications, so that exchange rate movements may even exacerbate spillovers (I shall come back to this issue later). According to the 'dilemma' view, the only way out is to resort to the management of capital flows, either through explicit controls or by means of macroprudential measures aimed at reducing boom and bust cycles of asset prices.

The debate is still very much alive today; indeed, this was one of the key topics at the 2019 Jackson Hole Economic Symposium.[3] The question then is which domestic policies and country fundamentals still matter, and how they can be used to tame the impact of volatile capital flows. On the one hand, the empirical literature has provided some evidence that capital controls, in combination with macroprudential regulations, can be effective in reducing the volatility of capital flows.[4] Furthermore, studies have found that capital inflows tend to be both larger and more stable in countries with sounder financial systems and better institutions.[5] On the other hand, recent research,[6] including some conducted by staff at the Bank of Italy,[7] has found that, in a more financially interconnected world, exchange rate flexibility helps in mitigating monetary and financial spillovers to EMEs, but it does not provide full insulation. This is true not only for small countries with weak economic fundamentals, but also for advanced economies and large monetary regions.

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2 H. Rey (2013), 'Dilemma not Trilemma: The global financial cycle and monetary policy independence'. Federal Reserve Bank of Kansas City Economic Policy Symposium.

3 https://www.kansascityfed.org/publications/research/escp/symposiums/escp-2019.

4 B. Erten, A. Korinek and J.A. Ocampo (2019), 'Capital controls: theory and evidence'. NBER Working Paper 26447.

5 I. Buono, F. Corneli and E. Di Stefano, 'Capital inflows to emerging countries and their sensitivity to the global financial cycle'. Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

6 M. Obstfeld (2015), 'Trilemmas and tradeoffs: Living with financial globalization'. In *Global Liquidity, Spillovers to Emerging Markets and Policy Responses*, edited by Claudio Raddatz, Diego Saravia, and Jaume Ventura, Santiago, Chile. Central Bank of Chile.

7 A. Ciarlone and D. Marconi, 'Financial spillovers to emerging economies: the role of exchange rates and domestic fundamentals'. Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

The euro area: a dual role

Turning to the euro area, let me focus briefly on the international transmission mechanism of monetary policy.

Despite being a large economic area, the euro zone is not immune to international spillovers. The relative importance of global versus local shocks is increasing as globalisation and financial markets' integration advances. US monetary policy, the key driver of the global financial cycle, also influences euro-area financing conditions.

At the same time, given that the euro is the second most important currency in the international monetary system, the ECB's monetary policy is itself potentially a source of spillovers (Fig. 2). In recent years, extraordinary monetary stimulus has also been provided through unconventional monetary policy measures; international spillovers have been sizeable.

Traditionally, monetary policy is thought to have cross-border effects mainly through the implied exchange-rate movements. Recent experience, however, has shown that the monetary policy international transmission mechanism may have several dimensions. The international environment is now much more deeply integrated; portfolio substitution by global asset managers acts as a powerful additional mechanism for transmitting financial shocks across monetary areas. Moreover, with policy rates close to their effective lower bound and the Eurosystem's balance sheet greatly expanded, the entire macro-financial environment has been transformed. Accordingly, the theoretical framework to study the international transmission of the ECB monetary policy stance has been enriched to take into account the role of the increased global integration of financial markets and the distinctive traits of non-standard measures.

Unconventional monetary policy can have significant effects abroad through two relatively new channels. The first is the so-called portfolio rebalancing channel of asset purchase programs, which is likely to impact financial conditions beyond currency area boundaries to the extent that domestic and foreign long-term bonds are substitutes. The second channel – the international bank lending channel – is likely to be even more important across the Mediterranean. The ECB's accommodative monetary measures, especially those aimed at making credit more

abundant, can spur the growth of euro-denominated loans outside the euro area, especially in economies with a significant presence of euro-area based banks.

Implications for the Southern Mediterranean countries

The issue is quite important for Southern Mediterranean countries. In fact, while capital controls are still stringent in many of them (Fig. 3), the region has become increasingly integrated into global financial markets. Gross external financing needs have grown fast, with few exceptions, and for some countries lie above the emerging and developing countries' average (Fig. 4).

Capital flows to the Southern Mediterranean countries have been quite resilient overall since the global financial crisis and the so called 'taper-tantrum' episode in 2013 (Fig. 5), helping to finance 'twin' (current account and fiscal) deficits in those countries (Tab. 1).

However, the more volatile components of capital inflows (portfolio and banking flows) have become larger than foreign direct investment (FDI). A sizeable share of these inflows has gone to financing the government sector's large fiscal deficits (Egypt, Lebanon, Jordan). At the same time, the reduction of FDI inflows in the region may also reflect weak fundamentals (feeble growth prospects and policy uncertainty, as well as geopolitical tensions).

Portfolio and banking flows are notoriously more volatile than FDI flows, as they are more sensitive to global push factors, such as global risk aversion and real interest rates in core countries, exposing recipient countries to sudden stops. A recent study conducted by the IMF shows that portfolio inflows to the Middle East and North Africa are almost twice as sensitive to changes in global uncertainty as those to other countries.[8]

Another worrisome feature concerns the currency composition of debt flows. Foreign currency debt has expanded rapidly in many countries over the past decade (Tab. 2), making the financial channel of the exchange rate especially important. For countries with sizeable net foreign currency liabilities, this channel will have

[8] IMF, 'Regional Economic Outlook: Middle East and Central Asia', October 2019.

the opposite sign to the traditional trade channel and may more than fully offset it (i.e. a devaluation can be contractionary).

Moreover, for many countries in the region trade integration is primarily with the euro area (Tab. 4) while exchange rates are mainly anchored to the US dollar (with the exception of Tunisia; Tab. 5). This creates potential currency mismatches, especially if export proceeds are mainly euro-denominated while debt obligations are in US dollars.

Policy implications

Given the interdependencies across the Mediterranean countries that I have just described and the ongoing integration with the euro area, it is natural to ask: how should policies be designed in order to promote sustainable capital flows in the Mediterranean area? The issue of how to deal with undesired spillovers from policies conducted in the euro area and in the US remains a controversial one. I would like to use the remainder of my time to discuss this question from three perspectives: that of the country (or area) generating the spillover effects ('originating country'), that of the country impacted and, finally, the multilateral approach.

Should the central banks in originating countries internalise the spillovers of their monetary policy to the rest of the world? The textbook answer to that question is that central banks pursue domestically-focused mandates: thus, they take into account the adverse effects of volatile capital flows only insofar as they negatively affect global financial stability, and through this channel may generate spillback effects to their domestic economy. Both conceptually and empirically, the measurement of these spillbacks is very challenging as they depend in part on the policy response of the countries affected.

However, central banks can limit adverse monetary policy spillovers, notably through transparency and clear communication of their monetary policy decisions and intentions. The 2013 'taper tantrum' episode exemplifies the potentially destabilising effects of policy communication mishaps. In addition, central banks can contribute to the resilience and soundness of their own financial systems with monetary policies designed to support economic activity and with macroprudential policies, as well as in their capacity as financial supervisors where

they have such responsibility. This, in turn, contributes to global financial stability, with favourable spillovers to the rest of the world.

From the perspective of the countries affected, the question is how can they shield their economies and financial systems from adverse spillovers? Experience shows that having strong domestic fundamentals and sound policy frameworks is essential. This usually includes sustainable budgetary positions; a business environment capable of stimulating investment and attracting FDI; a policy framework that ensures effective regulation and supervision of the financial sector; and the monitoring of private and public debt in foreign currency. Deep and developed domestic financial markets are a necessary condition for building up resilience to external shocks. The consensus nowadays is that exchange rate flexibility might help, but it is no silver bullet. Economies need to have good fundamentals and a comprehensive set of policy tools, including macroprudential and capital management measures, to protect themselves adequately from adverse spillovers.

Finally, from a multilateral perspective, it seems that the interdependencies between the policies of both the originator and destination countries call for enhanced cooperation. While formal monetary policy coordination would not be feasible in view of central bank mandates, there is scope for enhancing multilateral efforts to deal with adverse spillovers. Having a platform for the exchange of views is extremely valuable in this regard. I am thinking about this high-level policy dialogue between the Eurosystem and the Mediterranean countries' central banks. I believe that this is the right forum in which these issues can be framed and discussed on a regular basis.

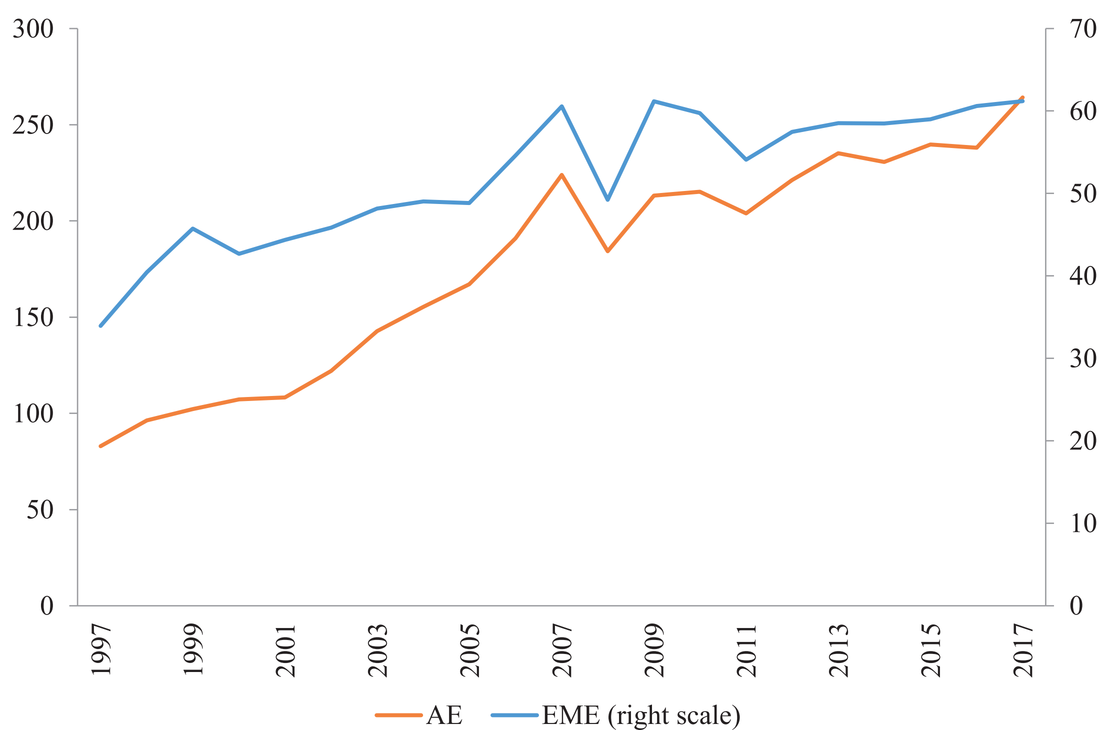
By sharing information and views on the global and domestic economic outlook and on the frameworks within which policy decisions are taken, central banks of the Eurosystem and the Southern and Eastern Mediterranean Countries can develop a better understanding of the respective monetary policies. Enhanced transparency makes policy actions more predictable and facilitates discussions on the mix of policy options to anticipate and address risks in the countries affected.

FIGURES AND TABLES

Figure 1

International financial integration: gross external assets and liabilities

(per cent of GDP)

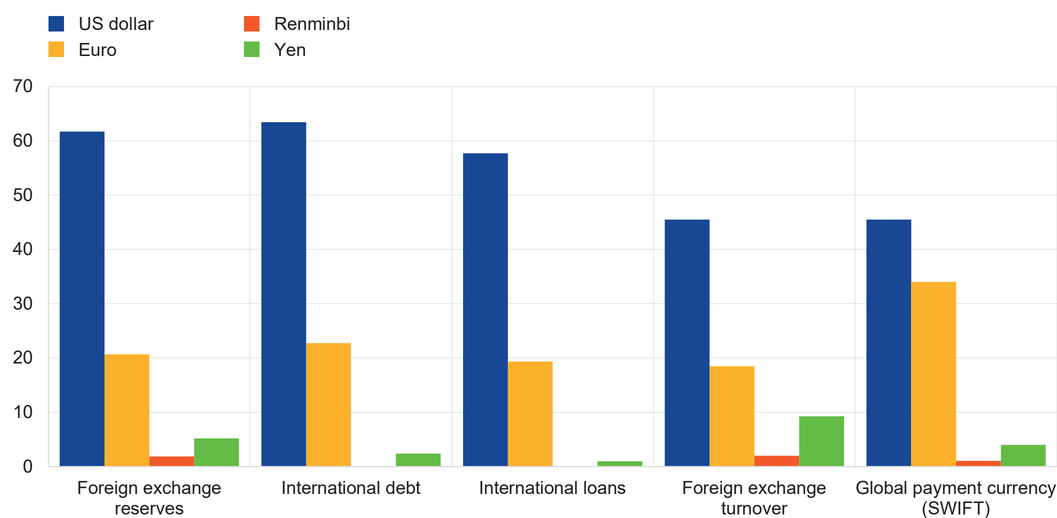


Sources: Lane and Milesi-Ferretti (2017) and IMF.

Figure 2

Snapshot of the international monetary system

(percentages; data at 2018 Q4 or the latest available)

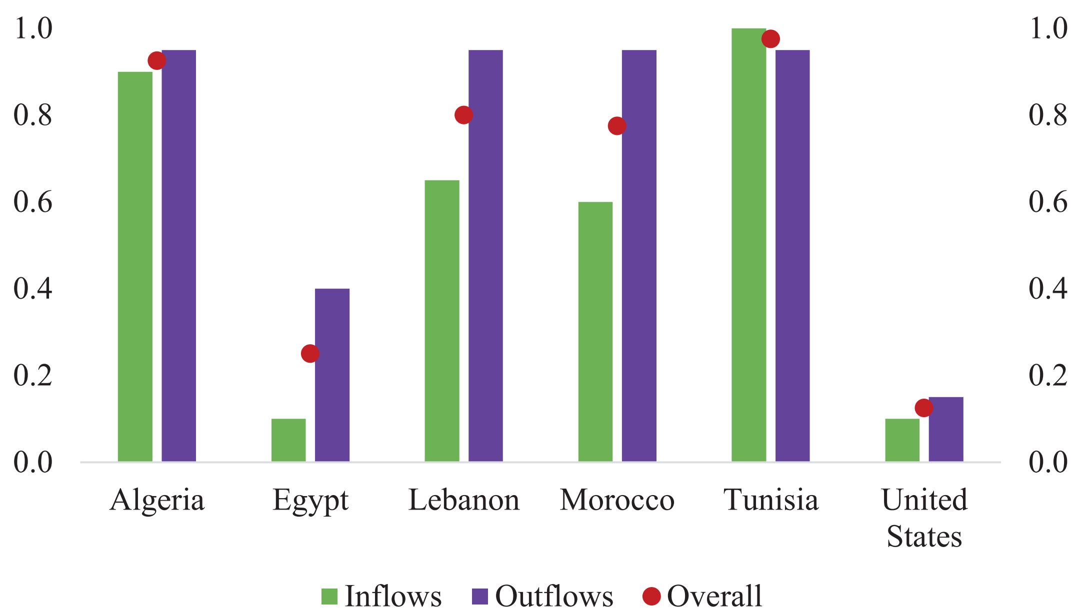


Source: ‘The international role of the euro’, ECB (2019).

Figure 3

Capital controls restriction index

(2017)

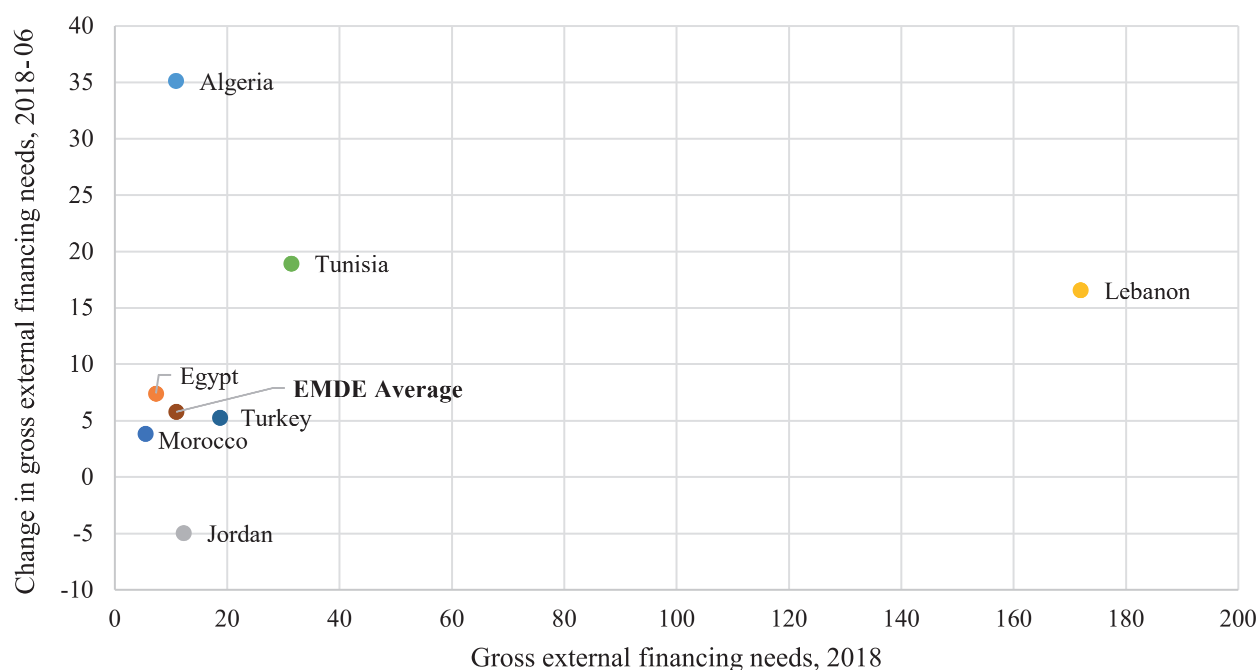


Source: Fernandez et al. (2016), update.
Note: The dataset considers capital control restrictions on both inflows and outflows of 10 categories of assets. It is based on the analysis of the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER). The index ranges between 0 (no restrictions) and 1 (total restriction).

Figure 4

Gross external financing needs

(per cent of GDP)

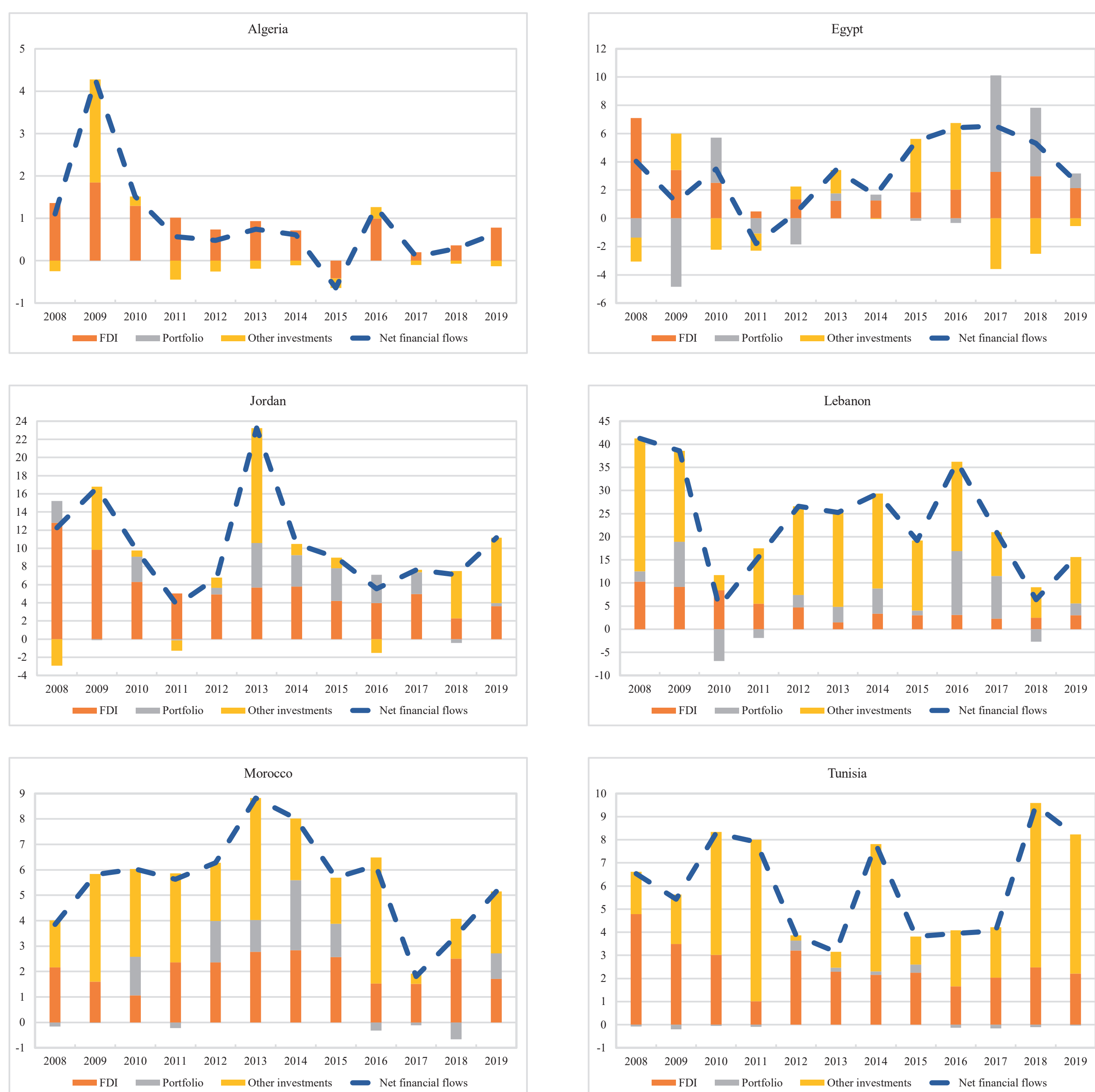


Source: IMF, *World Economic Outlook*, October 2019.
Note: Gross external financing needs= current account deficit plus short-term debt.

Figure 5

Net capital flows

(per cent of GDP)



Source: IMF, *World Economic Outlook*, October 2019.
Note: Net flows are given by inflows minus outflows.

Table 1

Current account balance and general government deficit

(per cent of GDP)

	Algeria		Egypt		Jordan		Lebanon		Morocco		Tunisia	
	Current account balance	General gov't deficit	Current account balance	General gov't deficit	Current account balance	General gov't deficit	Current account balance	General gov't deficit	Current account balance	General gov't deficit	Current account balance	General gov't deficit
2015	-16.4	-15.3	-3.7	-10.9	-9.0	-8.5	-19.3	-7.5	-2.1	-4.2	-9.7	-5.3
2016	-16.5	-13.1	-6.0	-12.5	-9.4	-3.7	-23.1	-8.9	-4.0	-4.5	-9.3	-6.2
2017	-13.2	-6.6	-6.1	-10.4	-10.6	-3.7	-25.9	-8.6	-3.4	-3.5	-10.2	-5.9
2018	-9.6	-4.8	-2.4	-9.4	-7.0	-4.8	-25.6	-11.0	-5.4	-3.7	-11.1	-4.6

Source: IMF, *World Economic Outlook*, October 2019.

Table 2

Current account position and foreign exchange debt exposure

	Current account % of GDP *(2018)*	Share of foreign currency debt* *(in %)*
Algeria	-9.6	n.a.
Egypt	-2.4	33.6
Jordan	-7.3	39.5
Lebanon	-25.6	n.a.
Morocco	-5.5	38.6
Tunisia	-11.1	40.5

Sources: IMF *External Sector Report*, July 2019 and *World Economic Outlook*, October 2019.
Note: *Foreign exchange weights on foreign liabilities.

Table 3

Destination of exports and origin of imports as a share of countries' total exports and imports

	Algeria	Egypt	Jordan	Lebanon	Morocco	Tunisia
			% share of exports to			
Euro Area	50.6	27.9	2.6	11.0	58.5	68.6
USA	9.4	8.5	26.4	1.9	5.5	2.8
China	1.3	1.3	1.6	3.1	0.9	0.7
Other	38.7	62.4	69.4	84.0	35.1	27.9
			% share of imports from			
Euro Area	27.7	19.7	16.8	34.2	47.0	48.8
USA	0.4	5.0	8.7	7.1	8.0	3.4
China	15.8	9.0	13.6	10.1	9.9	9.6
Other	56.1	66.3	60.8	48.5	35.1	38.3

Source: IMF, Direction of trade statistics.

Table 4

Exchange rate regimes and anchor currencies

	Exchange rate regime	**Anchor currency**	
	de facto	*de jure*	*de facto*
Algeria	Other managed arrangement	basket	USD (since 1999)
Egypt	Stabilised arrangement	USD	USD
Jordan	Peg	USD	USD
Lebanon	Stabilised arrangement	USD	USD
Morocco	Peg	basket	60% USD; 40% EUR
Tunisia	Crawl-like arrangement	EUR	EUR

Sources: IMF, AREAER 2018 and Ilzetzki, Reinhart and Rogoff (2016).