Monetary policy and financial stability: what's ahead for central and eastern Europe

Stephen G Cecchetti[1]

Economic Adviser and Head of Monetary and Economic Department
Bank for International Settlements

Remarks prepared for the Oesterreichische Nationalbank
Conference on European Economic Integration
Vienna, 15 November 2010

Good afternoon. I would like to thank Governor Nowotny for his kind words of introduction and for inviting me to make this presentation at the Oesterreichische Nationalbank's Conference on European Economic Integration. Today I will speak about the monetary policy and financial stability challenges facing central and eastern Europe *after* the crisis.

In my presentation this afternoon, I will begin with a description of the current global monetary policy environment and its effects on emerging market economies. Following this, I will very briefly comment on the ongoing regulatory reforms and their potential impact on credit supply. And finally, I will turn to what this all means for monetary policy and financial stability in central and eastern Europe.

My main message is that monetary policy in this region is in a period of transition. Existing policy frameworks have performed relatively well during the crisis. Contrary to widespread expectations, there have been no currency collapses and no banking crises. And, as I stand here today, there is a gradual recovery with low inflation.

That said, the landscape for monetary policy and financial stability in EMEs outside of central and eastern Europe has changed considerably over the past few years. Having weathered the severe financial stress and the impact of a steep decline in global demand, emerging markets in Asia and Latin America are once again confronting issues similar to those they faced before the bankruptcy of Lehman Brothers in September 2008. Capital flows are back and policymakers are focusing on managing the consequences of these inflows – as well as the inflows themselves.

Although the challenges faced by Brazil, Korea or Thailand may seem remote, I will argue that policymakers in the CEE region need to prepare as their turn will likely come. And, when capital inflows return, it will be important that authorities be able to rely on existing monetary policy frameworks to manage the consequences. This will mean resisting spillovers from policies pursued by other emerging market economies, while fighting the tendency toward distorting policies such as foreign exchange intervention and capital controls.

With that as a preamble, let me now turn to describing briefly the current global monetary environment. Over the past few months it has become clear that the growth performance in the global economy is diverging.

[1] I would like to thank Dubravko Mihaljek and Agne Subelyte for their assistance. The views expressed here are those of the author and do not necessarily reflect those of the BIS.

The US and the Japanese economies have weakened, with growth rates in the US falling from 2.7% on average in the first half of this year to 2.0% in the third quarter (advance estimate); and in Japan from 4.2% to 3.9% over the same period. Meanwhile, many euro area and emerging market countries continued to expand, albeit at a slower pace than earlier this year. For instance, growth in Germany slowed from 6.0% in the first half of 2010 to 2.8% this past quarter, while in the BRICs and Korea growth has fallen from a rate in excess of 8% to an average of around 6½%.

In response, as everyone here knows, the United States and Japan recently embarked on another round of monetary easing. The Federal Reserve announced additional measures of quantitative easing, buying a further $600 billion of assets through June 2011. Meanwhile the Bank of Japan has entered into what they have labelled comprehensive monetary easing, which includes the establishment of an asset purchase program and a commitment to keep the call rate between zero and 0.1% until price stability is in sight.

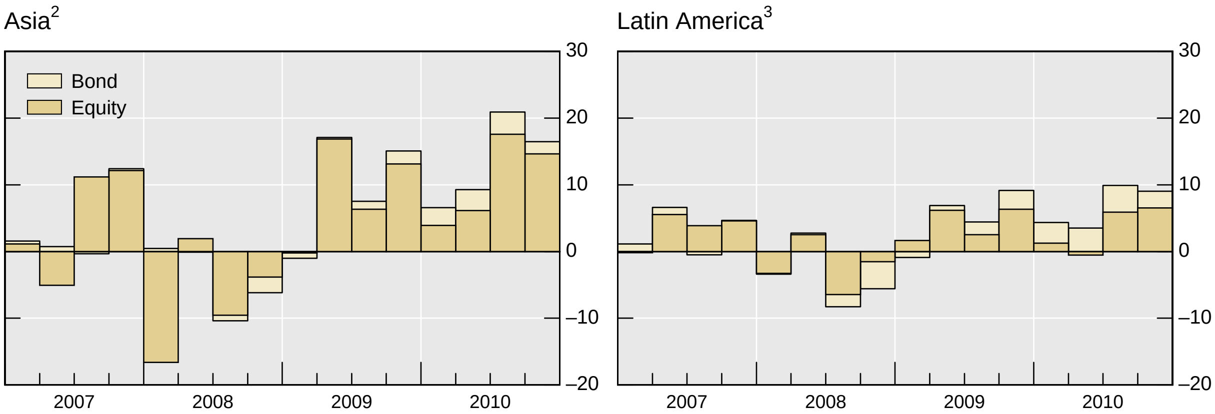
In anticipation of these moves, long-term bond yields in the G3 economies declined. In the United States, for instance, the 10-year Treasury rate fell by 25 basis points between mid-September and early October, before returning recently back to its early August level; and in Japan the 10-year JGB rate is off about 25 basis points in the two months since early September.

The combination of high growth in the emerging markets and further easing of monetary policy in the advanced economies has reinforced what were already strong portfolio investment flows. Looking at Graph 1, we see that flows to emerging Asia, in the left-hand panel, strengthened to over $20 billion in the third quarter and about $17 billion in just six weeks of the current quarter (that is, through 10 November). The bulk of these inflows went to Asian equity funds. At the same time, net portfolio flows to Latin America, in the right-hand panel, have increased to nearly $10 billion per quarter in the third quarter and so far in the fourth quarter.

Graph 1

Net flows into emerging market equity and bond funds[1]

In billions of US dollars



[1] Sums of weekly data up to 10 November, 2010; sums across economies listed. [2] China, Chinese Taipei, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.

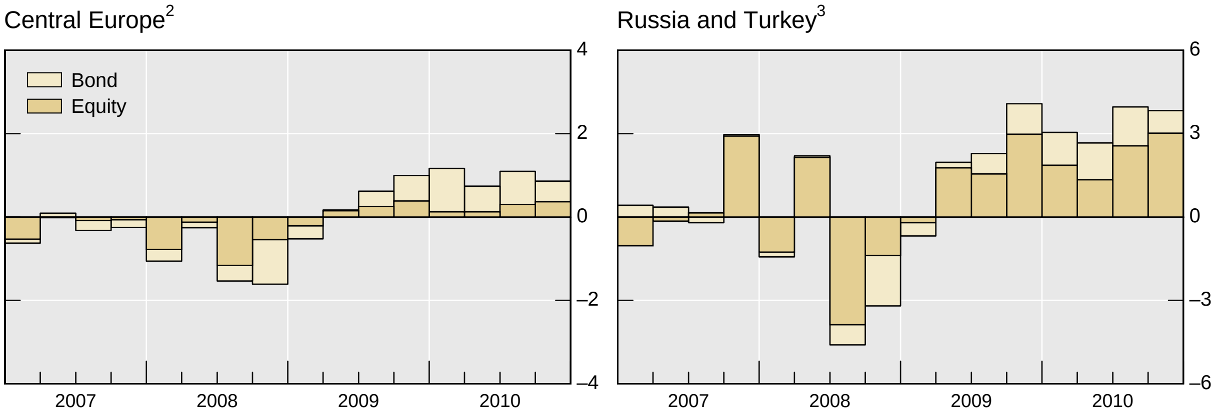
Source: EPFR.

Interestingly, this same phenomenon has not manifested itself in central and eastern Europe; at least, not yet. In the left-hand panel of Graph 2 we see that the Czech Republic, Hungary and Poland have together received less than $2 billion in portfolio inflows since September. Russia and Turkey, in the right-hand panel, are exceptions, having received over $4 billion in the third quarter and another $4 billion in just six weeks of the current quarter.

Graph 2

Net flows into CEE equity and bond funds[1]

In billions of US dollars



[1] Sums of weekly data up to 10 November, 2010; sums across economies listed. [2] Czech Republic, Hungary and Poland.

Source: EPFR.

In trying to assess the desirability and appropriateness of these flows, it is important to keep in mind that interest rate differentials are normally a symptom of strong economic fundamentals. For instance, with nominal policy rates between 6 and 11%, and inflation between 4 and 6%, real policy rates in Brazil, China and Russia are currently between 1 and 6%, compared with negative policy rates in the United States and the euro area. As I noted at the outset, these countries have very high growth rates, projected at 5–10% this year and only slightly lower next year. We would expect the neutral real interest rate in a country – the policy rate that equates aggregate demand with potential output – to be roughly in line with the growth rate of per capita output. So, higher growth means higher real interest rates. And higher real interest rates translate into higher capital inflows.

We can see this in the cross-border lending data as well. Looking at the BIS data in Table 1, note that cross-border bank lending to emerging Asia, adjusted for exchange rate changes, was $120 billion in the first half of 2010 – that's the sum of the two numbers in the far right columns of the second row of Table 1. This was higher than the $111 billion in the whole of 2007, itself a historical peak for external bank lending to the emerging markets. Cross-border bank lending to Latin America has also returned to the peak levels seen in 2007 – $32 billion in the first half of 2010 versus $61 billion for the whole of 2007. Finally, after declining steadily for over two years, cross-border bank lending to central and eastern Europe is now steady.

Table 1

Cross-border bank lending to emerging market economies[1]

In billions of US dollars

	2007	2008	2009	2009 Q3	2009 Q4	2010 Q1	2010 Q2
Total EMEs	512	128	–149	–62	68	116	95
Asia[2]	111	–59	11	8	47	72	48
Hong Kong and Singapore	140	42	–48	–35	32	40	40
Latin America[3]	61	22	–19	–7	6	17	15
CEE[4]	125	107	–39	–8	–2	–9	0
CIS[5]	75	16	–53	–20	–14	–4	–8

[1] External loans of BIS reporting banks (on the residence basis) vis-à-vis individual emerging market economies; exchange rate adjusted changes in gross amounts outstanding. Does not include changes in reporting banks' holdings of emerging market securities. [2] China, Chinese Taipei, India, Indonesia, Korea, Malaysia, the Philippines and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] Total of 10 new EU member states from central and eastern Europe, southeastern Europe (including Turkey). [5] Russia, Ukraine and Kazakhstan.

Source: BIS, locational banking statistics.

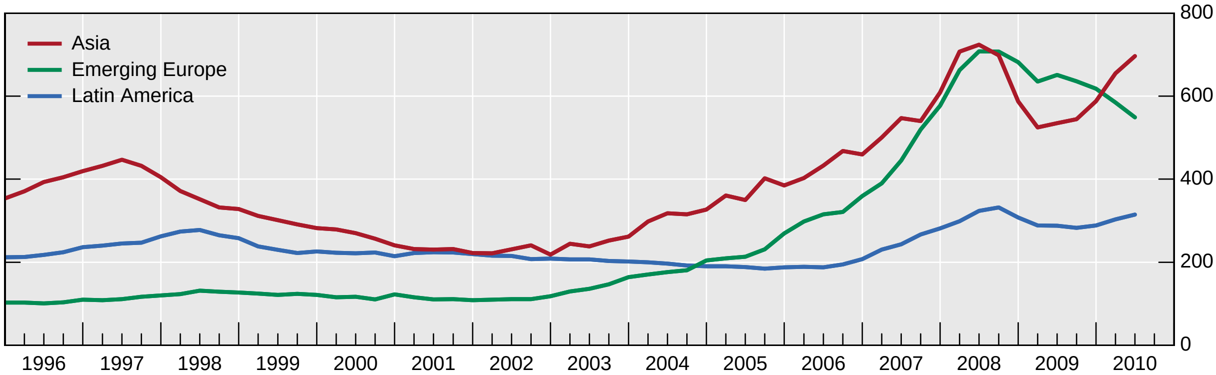
Turning from flows to stocks of external financing, Graph 3 shows that emerging Asia, the red line, and Latin America, the blue line, have nearly returned to their pre-crisis peaks of $725 billion and $330 billion, respectively. Looking at the green line in Graph 3, we can see that the exposure of advanced economies' banks to CEE countries has fallen by $160 billion since its pre-crisis peak, and seems unlikely to increase any time soon.

While you may find the rough equality of the Asian and CEE lines in Graph 3 surprising (I did), the rationale is simply that Asians have developed local currency bond markets, reducing their overall demand for bank loans, while corporates in this part of the world have not.

Graph 3

External loans of BIS reporting banks vis-à-vis emerging market regions

Amounts outstanding at end-of-quarter, in billions of US dollars



Source: BIS, locational banking statistics.

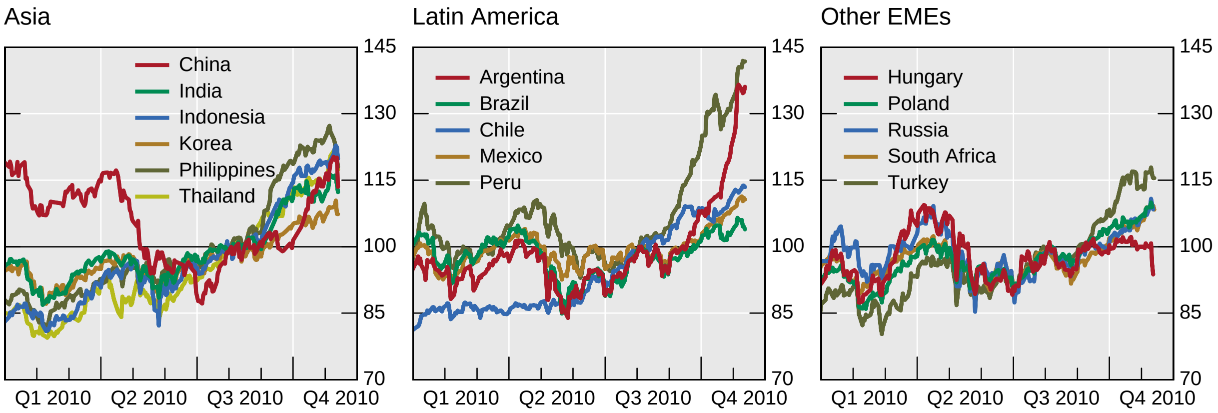
Needless to say, these large capital inflows create a number of challenges for policymakers. To see these, we can look, in turn, at equity prices, bond yields, and exchange rates.

Starting with equity prices, we can see in Graph 4 that in eight of the 16 cases plotted here equity prices are up by 15–30% in the past three months! To see this, note that the data in the lines in Graph 4 are all normalised at 100 on 2 August 2010.

Graph 4

Equity prices[1]

2 August 2010 = 100



[1] In local currency.

Sources: Bloomberg; Datastream.

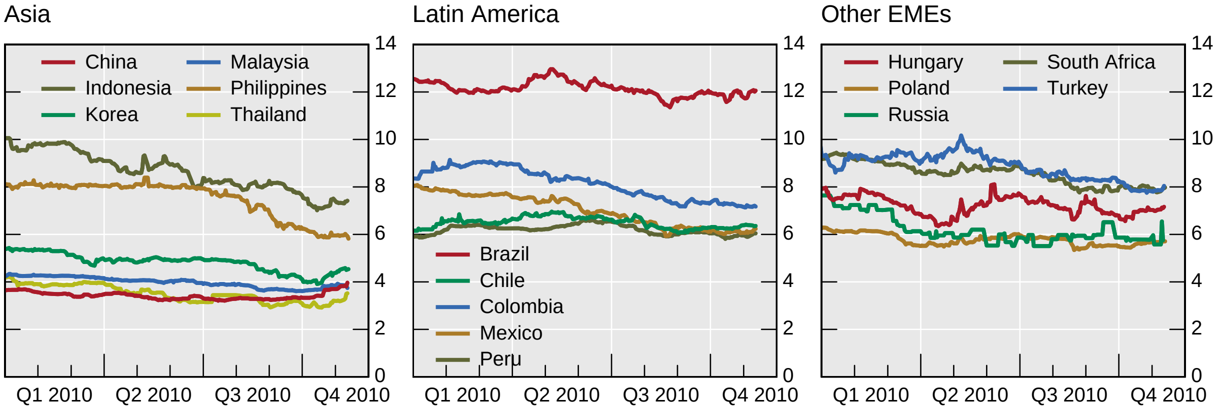
Given the limited supply of domestic equities in most of these countries, and the generally underdeveloped financial markets in many EMEs, strong increases in foreign demand have given rise to concerns that stock price bubbles are developing. And, rising equity prices are putting strong pressures on aggregate demand and consumer prices in a number of Asian and Latin American countries, as well as in Turkey.

Turning to bond yields, capital inflows are driving up prices of fixed income instruments. So, long-term domestic bond yields are falling in many EMEs. While more pronounced in some countries than in others, the trend is definitely evident in Graph 5. Analysts' commentaries have linked these developments more or less directly to foreign investors' demand for emerging market local currency bonds. For instance, at the end of July 2010, foreign investors held 27% of Indonesia's local currency government debt, compared with 16% a year earlier.

Graph 5

Local currency bond yields[1]

In percent



[1] Ten-year government bonds; for Brazil, three-year; for Chile, nine-year; for Turkey, two-year.

Sources: Bloomberg; national data.

It is worth noting that in some countries – including Brazil, Korea, Malaysia, Peru, the Philippines and Thailand – local currency *long-term* bond yields declined despite increases in *short-term* policy rates; a phenomenon that is eerily similar to what happened in the United States in the early part of the last decade.

Turning to exchange rates, capital inflows have been, unsurprisingly, accompanied by currency appreciations. And, given the importance of exports as a source of growth in many EMEs, this has created concerns.

At an abstract level, currency appreciation is what we should expect. And, it shouldn't really be a problem. Solid economic fundamentals ought to be reflected in strong and appreciating exchange rates. And, to the extent that neighbouring countries' exchange rates – those of export competitors – are appreciating as well, the effect of dollar depreciation should be less of an issue.

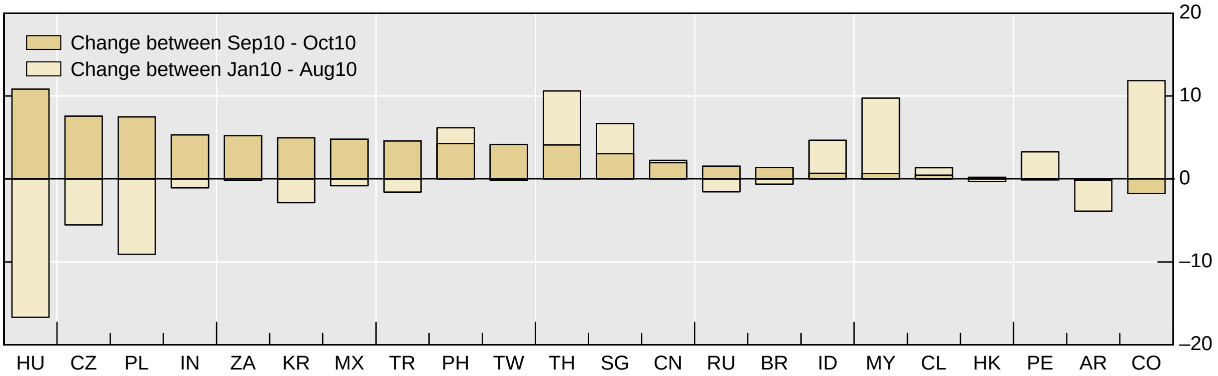
In practice, however, concerns about exchange rate volatility induced by the inflows and the loss of export revenues at a time when the outlook for growth in major advanced economies is uncertain have led policymakers in many EMEs to resist exchange rate appreciation for both political and economic reasons.

That said, we can see in Graph 6, on the left-hand side, that the CEE countries, following their strong free-market instincts, have let their exchange rates adjust much more – both up and down – than other EMEs.

Graph 6

Changes in nominal exchange rates[1]

In percent



[1] US dollars per unit of local currency; an increase indicates appreciation of local currency.

AR = Argentina; BR = Brazil; CL = Chile; CN = China; CO = Colombia; CZ = Czech Republic; HK = Hong Kong SAR; HU = Hungary; ID = Indonesia; IN = India; KR = Korea; MX = Mexico; MY = Malaysia; PE = Peru; PH = Philippines; PL = Poland; RU = Russia; SG = Singapore; TH = Thailand; TR = Turkey; TW = Chinese Taipei; ZA = South Africa.

Sources: Bloomberg; Datastream; national data.

Turning to the specific policy responses to the capital inflows, EMEs have raised interest rates, albeit cautiously; intervened in the foreign exchange markets, sometimes substantially; employed macroprudential tools in an effort to address the perceived build-up of asset price bubbles; and in some cases instituted outright capital controls.

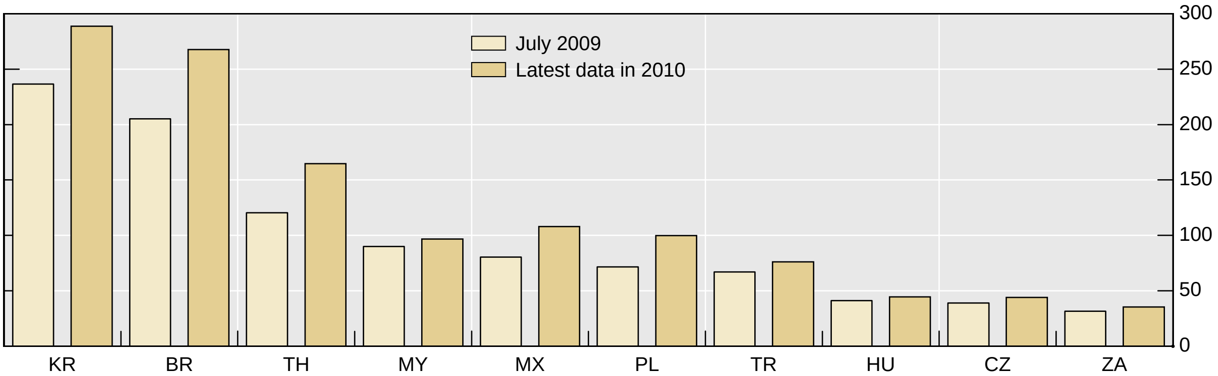
Starting with the first, we have seen interest rates rise by a quarter to half a percentage point in Southeast Asia since the start of the year; to 2½ percentage points in India; to 1¼–2 percentage points in Latin America.

Next, there is foreign exchange intervention. Graph 7 compares the most recent data with those in July 2009. Increases in Korea, Brazil, Thailand and Mexico are significant – more than $50 billion in some cases – increases on the order of $1 billion per week!

Graph 7

Reserve accumulation

In billions of US dollars



Sources: CEIC; Datastream; IMF, *International Financial Statistics*; national banks.

That said, reserve accumulation in Asia and Latin America has clearly been much more substantial than that in CEE (or South Africa). Looking at something like this, one is immediately drawn to asking how long it can continue.

Regardless, we can see that policymakers are in a real bind. Even if foreign exchange intervention and capital controls limit the pace and extent of currency appreciation, they cannot alleviate the inflationary pressures arising from the expansion of banking sector balance sheets. The natural response is to raise interest rates, but this will tend to attract additional inflows, making the problem worse. The pressure for adjustment of the macroeconomic policy mix is increasing.

I would be remiss if I neglected to mention the implications of regulatory reform in this context. For emerging Europe, the impact could be limited credit supply as foreign-owned banks adjust. Given the changes that are being put in place, these banks are reconsidering their business models after years of extremely rapid credit growth in this region.

How are the new liquidity and capital standards likely to affect international banks active in CEE? Regarding liquidity, banks have already put greater emphasis on local deposit gathering. One can also discern a trend toward centralising wholesale funding activities on the parent level.

Regarding capital adequacy, major European banking groups active in CEE had relatively high capitalisation levels before the crisis. Banking systems in CEE are also generally well capitalised, with levels well above those mandated by the new Basel III standards.

Some banks could nevertheless change their credit policies; turn to their well capitalised subsidiaries in CEE for help in meeting the new requirements; or dispose of some business units in CEE.

Against this background, what are the implications for monetary policy in CEE of an extended period of low global interest rates and the gradual transition of parent banks to new regulatory requirements? Currently, most CEE countries are experiencing a gradual recovery, with low inflation, weak credit demand and therefore low domestic policy rates. Unlike their peers in emerging Asia and Latin America, CEE countries have lowered their policy rates by 25–100 basis points since the beginning of this year.

Banks are consolidating their operations and repairing their balance sheets – in fact, peak levels of non-performing loans are expected in 2011. At the same time, central banks in the region are assessing how their monetary policy frameworks performed during the crisis, and how to adjust these frameworks in the future, with a view to combining monetary policy and financial stability objectives. As a consequence, monetary policy in the region is simply waiting to see what happens next.

Looking at policy frameworks, there is a clear sense that they served countries well during the crisis. Both inflation targeting central banks and those operating fixed exchange rate regimes avoided currency collapses and banking crises. In both groups, central banks attributed good performance in large measure to the combination of sound banking systems and the presence of non-standard elements in their frameworks, including various macroprudential tools.

The Vienna Initiative was, of course, instrumental in protecting several CEE economies from currency crises. The few near misses have also highlighted the need to elaborate better contingency plans for emergency foreign currency liquidity provision in the future and to reduce the vulnerabilities that have led to currency mismatches in private sector balance sheets in the first place.

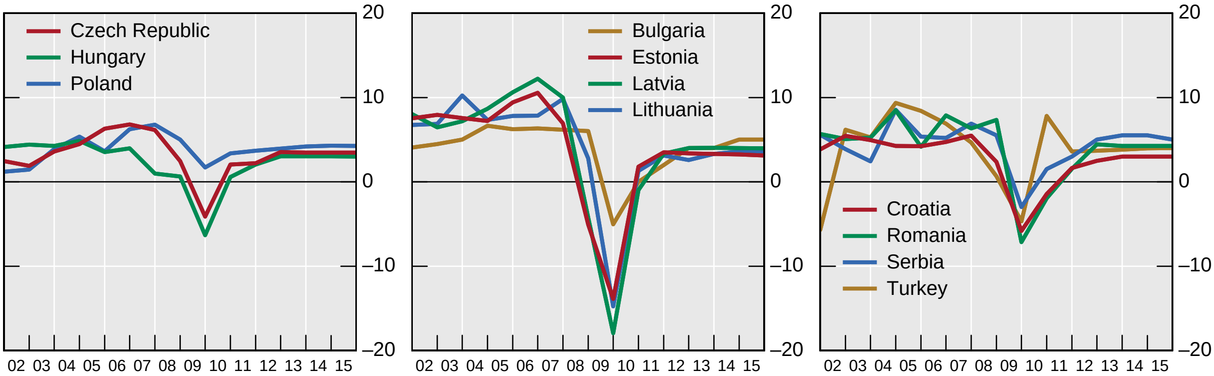
However, rather than just looking backward, monetary policy must concentrate on the challenges ahead. Here that means focusing on the familiar issues of capital inflows, asset price increases and catching-up.

In particular, CEE is destined to grow faster than the euro area. Looking at Graph 8, we see that current projections are for slower growth than before the crisis, mostly in the range of 3–5% per year for the next five years. But "slower than before" for this region is still 2–3 percentage points faster than growth is expected to be in the euro area. Moreover, this more modest pace is likely to be more sustainable than what was happening before the crisis.

Graph 8

Real GDP growth

Annual percentage changes

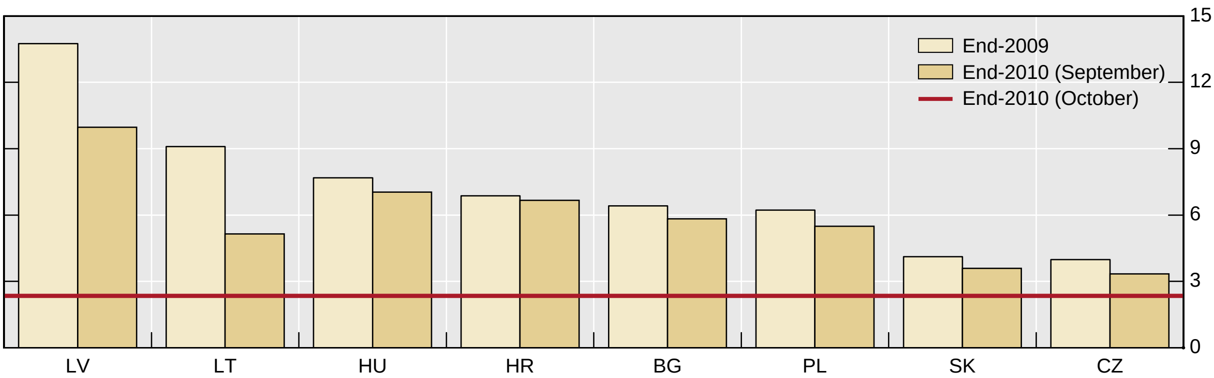


Source: World Economic Outlook (September 2010).

That's the silver lining. The cloud is that with positive growth differentials come interest rate differentials, as shown in Graph 9. And these interest rate differentials are destined to attract capital. As we have seen, such inflows have already returned to Russia, Turkey and, to a lesser extent, Poland.

Graph 9

Long-term interest rates[1]



BG = Bulgaria; CZ = Czech Republic; HR = Croatia; HU = Hungary; LT = Lithuania; LV = Latvia; PL = Poland; SK = Slovakia.

[1] Long-term domestic currency government bonds; the horizontal line refers to the 10-year German benchmark bond; in per cent.

Sources: ECB; Datastream; national data.

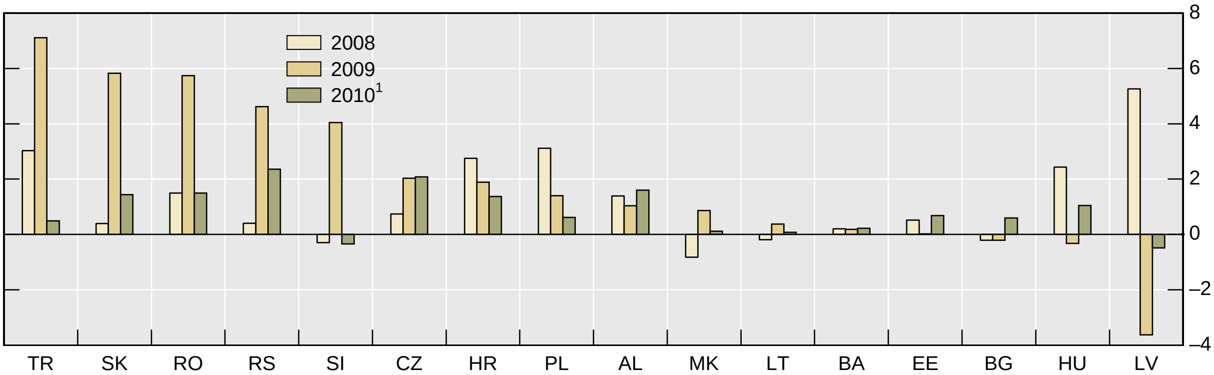
It seems unlikely that this inevitable new round of capital inflows will create a new round of real estate price appreciation. While that is surely a good thing, the reason is not. Many households in CEE are saddled with high mortgage debt, and countless apartments and commercial properties remain unsold. We know from numerous property busts in the past that it takes years before the real estate demand and supply normalise around longer-term trends.

Instead, given the large financing needs of the public sector, a high share of the inflows could end up in sovereign bonds and bank credit to the government. As Graph 10 shows, as local banks became more risk-averse, we have already seen a big increase in bank lending to these governments.

Graph 10

Bank credit to the government

Annual changes, as a percentage of 2008 GDP



AL = Albania; BA = Bosnia-Herzegovina; BG = Bulgaria; CZ = the Czech Republic; EE = Estonia; HR = Croatia; HU = Hungary; LT = Lithuania; LV = Latvia; MK = Macedonia; PL = Poland; RO = Romania; RS = Serbia; SI = Slovenia; SK = Slovakia; TR = Turkey.

[1] Latest available.

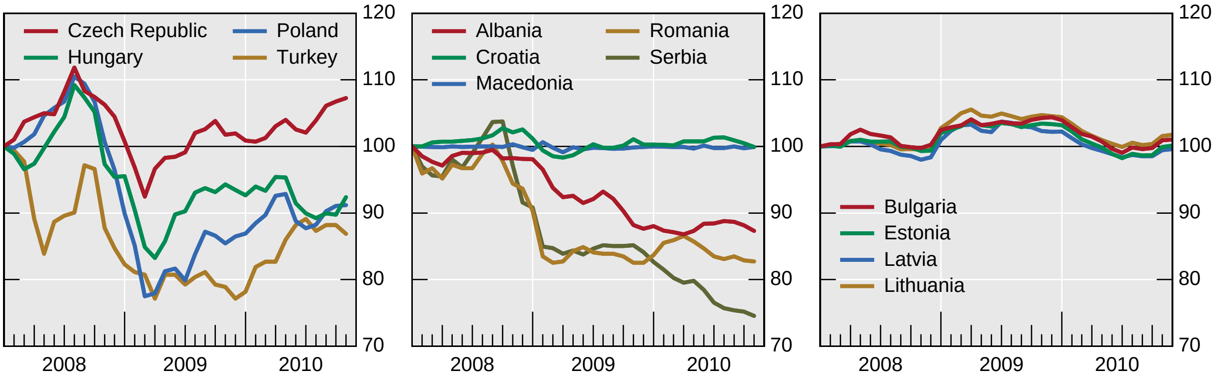
Sources: IMF; national data.

The problem with such inflows is that easy access to credit weakens the incentives of governments to implement structural fiscal reforms; something that is sorely needed in most CEE countries. Not only that, but in these circumstances large public sector borrowing requirements are particularly prone to crowd out investment in the non-financial corporate sector; something that is surely not good for long-term growth.

Finally there is the risk that capital inflows could lead to a rise in equity prices and a fall in domestic bond yields that are disconnected from underlying fundamentals. The exchange rates could also start appreciating – as happened before the crisis (Graph 11) – reducing the debt burden on households that borrowed in euros or Swiss francs, and increasing the incentives for new borrowing in foreign currencies. This would undermine the ongoing efforts of several central banks and institutions such as the EBRD to develop local currency capital markets. But, at the same time, allowing exchange rates to appreciate would avoid the problems that other emerging market countries resisting this trend are currently facing.

Graph 11

Exchange rates[1]



[1] December 2007 = 100; euro per unit of local currency (nominal effective exchange rates for Bulgaria, Estonia, Latvia and Lithuania). An increase indicates an appreciation; monthly averages.

Sources: ECB; Datastream; national data; BIS.

In conclusion, monetary policy in central and eastern Europe finds itself at a transition point. And, it is at times like this that there is the greatest potential for errors.

Existing monetary policy frameworks served countries in the region well during the crisis, and do not seem to require significant modification to incorporate required financial stability objectives. And, since central banks in this region in fact have considerable experience with the use of macroprudential tools, incorporating them into a new inflation targeting framework should be more or less straightforward.

At the same time, however, central banks need to be prepared to confront the challenges created by capital inflows, asset price inflation and catching-up issues. In doing this, it will be essential to retain focus on traditional monetary policy and financial stability objectives, resisting spillovers from policies pursued by other EMEs. Maintaining exchange rate flexibility – or, in countries with fixed exchange rates, labour market flexibility – will be of key importance.

Furthermore, CEE countries need to be encouraged to maintain free capital flows and to continue to pursue domestic financial liberalisation, avoiding a return to financial repression. These policies have been instrumental in the rapid financial and economic convergence accomplished thus far, and should not be abandoned under pressure from short-sighted populist policies.

Thank you for your attention.