EUROPEAN CENTER

Newsletter 2001/2

Introduction

The European Center of the International Center for Economic Growth (ICEG) submits you its second Newsletter, in which we briefly report on our latest conference on *Managing Capital Flows in Eastern Europe*, present our new Annual Report on macroeconomic developments called *Macroeconomic Analysis and Forecast for Eastern Europe 2001-2002*, give and overview of the new working papers, draw readers' attention to the upcoming regional overview and report on inflation in Eastern Europe. More information about the activities, including most of the research output in downloadable format can be obtained from our web-site at www.icegec.org.

We would be pleased to receive comments on the newsletter, the web-site and especially on the programs and their outputs. In case you would like to write to us on these issues, please send the technical information to the web-master at webmaster@icegec.org, while the remarks, notes and questions to the office address at office@icegec.org.

Annual report on Macroeconomic Developments in Eastern Europe

The European Center has prepared its first review of macroeconomic developments in Eastern Europe under its Macroeconomic Monitoring program. The ***Macroeconomic Analysis and Forecast for Eastern Europe 2001-2002*** provides an overview assessment of the major macroeconomic developments in 14 Eastern and Central European economies and the whole region. The report gives an overview of growth, inflation unemployment, fiscal and monetary developments, evolution of trade, current and financial accounts as well as major vulnerability indicators of these economies.

The countries include Czech Republic, Hungary, Poland, Slovakia and Slovenia from Central Europe, Estonia, Latvia and Lithuania from the Baltics, Bulgaria, Croatia, Romania and Yugoslavia from South-Eastern-Europe and Russia and Ukraine from the CIS region.

Besides that a data based is attached to the report, which presents the major macroeconomic indicators for these economies for the period between 1996 and 2000.

The report in full and by sections can be downloaded from the Monitoring part of our web-site by clicking there at Macroeconomic Monitor and finding Annual Report.

Managing Capital Flows in Eastern Europe

Summary of the proceedings of the international conference

The European Center of the International Center for Economic Growth organized its final conference in the project “Managing Capital Flows in Eastern Europe” supported by the Ford Foundation in Budapest on October 19-20, 2001.

Attended by almost 70 international experts from academia, international financial institutions, central and private banks, the meeting offered an opportunity to discuss the final version of papers prepared within the project, and also to touch issues related to capital flows and financial vulnerability in emerging economies.

The participants of the meeting assessed the major issues related to the management of capital flows in transition economies based on the experiences of individual economies. The papers discussed the problems of capital flows in some advanced and less developed transition economies, allowing to compare the different country experiences, and to draw some tentative conclusions concerning the behavior of at least the more advanced economies.

Gábor Oblath (Kopint Datorg) and ***Gyula Barabás (National Bank of Hungary)*** described the case of Hungary with its crawling peg exchange rate regime. They pointed that while the emerging consensus on exchange rate regimes suggested that only “corner solutions” (either completely fixed or freely floating rates) were sustainable in a world of free capital movements, Hungary had fared relatively well with an intermediate solution in the period 1995-2000. The country maintained a quasi-fixed exchange rate regime and the significant widening of the band in May 2001 was a result of policy decision taken under calm conditions, rather than in a period of external or internal pressures.

According to the contributors, in spite of significant capital inflows between 1995 and 2000, the country not only succeeded in maintaining its exchange rate regime, but it was also successful in avoiding the potentially destabilizing (often disruptive) macroeconomic impacts. The current account was kept under control; excessive domestic credit booms, as well as the unwarranted fall in domestic savings could be avoided. While most of the negative effects could be avoided, the country was able to capture the positive effects of the inflows, in particular, those stemming from FDI.

The central bank’s response to inflows was sterilization: the large-scale sterilization of excess liquidity explains why the impact of capital inflows on (potentially effected) domestic macroeconomic variables (the money supply, interest rates, inflation and the current account) was limited. The authors quantified the macroeconomic costs of sterilization, which fluctuated between 0.2% and 0.5% of GDP since 1997. One unwelcome by-product of the management and macroeconomic policies was the slow progress with disinflation as the rate of inflation got stuck at around 10% in mid-1999.

Dariusz Rosati (Warsaw School of Economics and National Bank of Poland) started his presentation with the stages of evolution of capital flows to Poland from mid 1990-s, when the country returned back to the international capital markets. In his presentation he described the major structural changes in inflows, the impact of institutional and policy measures on the amount of net inflows. Mr. Rosati dealt both theoretically and empirically with the macroeconomic implications of capital flows and the measures adopted by the policy makers to manage inflows. He discussed the Impossible Trinity hypothesis, the impact of capital flows on the changes in the applied exchange rate arrangement and the sterilization problems. He mentioned the role of fiscal and exchange rate policies in the management of capital flows and presented evidence on the behavior of major monetary aggregates following the shift from exchange rate targeting to inflation targeting.

Zdenek Tuma (Czech National Bank) presenting his joint paper written with Tomas Holub (Czech National Bank) described the Czech experiences with capital inflows and their management, referring mostly to the period following the May 1997 currency crisis. He showed how the structure of inflows changed after the crisis and what have been the major concerns for monetary authorities in recent years. Mr. Tuma discussed the reason of the shift to inflation targeting in 1997 and then the changes from targeting core to headline inflation this year. His presentation reflected the importance of prudent fiscal policies and fiscal adjustment, as well as of sound financial sector in management of capital inflows.

Gonzalo Caprirolo (Institute of Economics) analyzed the case of an economy which has had a money targeting framework coupled with managed floating since the establishment of monetary independence. Although Slovenia has not been the economy attracting most of capital inflows, there were periods when sizeable inflows were recorded. The evidence suggested that domestic factors explained capital inflows to Slovenia as capital inflows were driven mainly by residents' borrowing abroad, and the positive domestic/foreign interest differential was one of the driving forces explaining capital inflows.

Mr. Caprirolo analyzed the dilemmas faced by monetary authorities in times of significant capital inflows which have however subsided in the recent years. The central banks' policy response to capital inflows indicated that it has occasionally followed alternative and conflicting objectives: lower inflation and stability of the real exchange rate. As a consequence, inflation inertia persisted but the real exchange rate has remained at its 1995 level, which was considered a success. The response of monetary authorities to foreign exchange inflows originating either in the current or capital account has been sterilized intervention by means of cumbersome instruments and, when confronting capital inflows, sterilization supplemented by capital controls. Both policy measures did not address the main cause of capital inflows, but gave time to the central bank to pursue its monetary policy at a lower cost.

Daniel Daianu (CEROP) described the performance of the Romanian economy and its experience with capital inflows. As the economy experienced repeated crisis and boom-and – bust cycles, capital inflows have been relatively insignificant. The presentation focused therefore more on the internal macroeconomic problems of the economy, pointing to the lack of fiscal prudence, low level of credibility of policy m makers, persistent and very unstable inflation. While these problems some times were aggravated by the inflow of mostly short-term, speculative capital, they served mostly as hindrance for more significant and long-term capital inflows.

The contribution emphasized that in Romania certain financial opening of the economy brought benefits and helped develop internal financial markets. The Romanian experience gives additional proof that, in transition economies, which are less integrated with the world economy, banking crises have, essentially, an internal origin. On the other hand according to the author while Romania got back on private capital markets in late 1995 and borrowed heavily in the following year, it kept its domestic money (capital markets) officially closed to foreign investors.

Boris Vujcic (National Bank of Croatia) analyzed the lessons learned by Croatia from the capital inflows and their management. After presenting a brief overview of the major macroeconomic developments in the economy- which can clearly be divided to the period before and after 1999 – the author analyzed the magnitude, structure of capital inflows to the economy. In his presentation Mr. Vujcic also discussed those instruments that were applied by the monetary authorities to mitigate the adverse impact of inflows, which have been relatively small compared to the average of transition economies.

Pekka Sutela (Bank of Finland) described in his presentation the experiences of the small Baltic's economies with managing capital inflows. He emphasized that the key role behind the success of these economies and their ability to avoid currency collapses and keep financial fragility within limits was played by the abolishment of markets, which disallowed the build-up of speculative pressures against the national currencies. Some market don't exist because of the favorable heritage and prudent policies, others because of the size of the economies (capital markets, money markets). Besides abolishing the markets, these economies made all efforts to integrate themselves to the more advanced Scandinavian economies and this resulted in their sizeable real and financial openness, but also protected them better from exogenous shocks.

Sergei Drobyshevsky (Institute of Transition) described the macroeconomic developments and capital flows in Russia, mentioning that time period of analysis was rather short compared with most of transition economies. His paper showed a picture for the Russian economy different from the most of transition economies, as it has been characterized more by capital outflows than inflows In Russia capital inflows through the current account are often of a greater importance than foreign investments through capital account. The problems with capital inflows to Russia are the low level of FDI, the modest role of foreign banks in the Russian banking system, the fact that most of inflows represent the return of the illegally exported Russian capital and that the legislative framework for capital flows management and in particular, legislation on capital movements is below requirements.

Macroeconomic policy to manage capital inflows in Russia was rather inconsistent, many important reforms (in particular, in fiscal, institutional and structural spheres) were not conducted until recently. Poor attention to capital flows management issues in monetary and exchange rate policy resulted in sterilization policy failures and shocks to financial sector. Administrative regulations of capital flows were widely applied by the Russian authorities after the August 1998 crisis, but the effectiveness of these measures was low. Liberalization of the domestic government debt market in 1996 through 1998 was conducted without taking into consideration financial markets conjuncture.

Alexander Mantchev (Center for Economic Development) paper was presented at the meeting, which described the experiences of Bulgaria with capital inflows, which have been relatively modest before the establishment of currency board in 1997 due to macroeconomic instability and slowness of structural reforms. Following the hyperinflation and currency crisis, the currency board brought deep changes in macroeconomic stability and this combined with accelerated structural reforms led to sizeable capital inflows. Although the economy has been hit by series of adverse exogenous shocks, the adherence to currency board and the tough fiscal and incomes policies helped in managing capital flows.

Presenting the joint paper written with Ralph Heinrich, ***Claudia Buch (Institute of World Economics, Kiel)*** described the microeconomic aspects of capital inflows. Giving a detailed theoretical overview of the banking sector developments, as well as of international capital flows, the author presented her views on the links between capital flows, financial vulnerability and currency issues. She stressed the role of sound financial sector, presence of appropriate regulatory and supervisory tools, the need to avoid the build-up of unsustainable net foreign positions. The authors described the special and different from other emerging regions features of capital inflows and net foreign asset position of advanced transition economies.

Claudia Buch emphasized that sustained integration into the international capital markets was among the major challenges facing advanced transition economies as global capital mobility remains imperfect but has risen substantially in recent decades. The transition economies described in her presentation have already reached degree of integration equal to the Southern members of the EU, and gross inflows have even exceeded the international averages significantly. The presenter emphasized at the same time that clear differences exist between advanced and middle income economies in the structure of inflows: the former economies have much higher foreign portfolio inflows, while in latter FDI dominates. In Eastern Europe the pattern is similar to other developing economies, although the share and amount of foreign portfolio inflows is increasing.

Claudia Buch stressed that while contagion is of increased concern nowadays, recent empirical and theoretical contributions have identified number of good pre-crisis forecast indicators. She also pointed to the role foreign banks could play in improving the efficiency of the domestic financial system.

Pál Gáspár (ICEG) presented the first ideas of the comparative paper which will be prepared based on the country contributions. In his presentation he showed first that the Central European pre-accession economies had to face sizable in international comparison with other emerging economies inflows. He argued that thee were common reasons explaining the amount and structure of capital inflows in pre-accession economies: the choice and evolution of the exchange rate arrangements, the rapid in international comparison liberalization of capital flows, the structural reforms with special role of privatization, the low level of national savings and reliance on net foreign savings and the presence of underdeveloped domestic financial sector. Turning to the macroeconomic consequences of capital inflows the contributor emphasized that capital inflows so far had positive growth effects on the major recipients, especially as they increased domestic investment rates, while on the other hand they have also contributed to worsening of current account imbalances.

Looking at the lessons with the management of inflows the presenter emphasized the reliance on sterilized interventions, the lack of appropriate fiscal adjustment, the changes in the applied exchange rate regime leading to their enhanced flexibility, the moderate reliance on capital controls and administrative measures. Finally, the presenter pointed to some issues which will affect capital flows in these economies and are raised by their expected accession to the EU: they include among others the impact of the Balassa-Samuelson effect, the increased exposure to global capital flows and financial volatility, the effect of ERM-II on the vulnerability of these economies to exogenous shocks.

Stephany Griffith-Jones (IDS) described the new financial architecture and the progress with financial reform. The presenter emphasized that a new global and regional architecture is required to achieve financial stability, as there is a growing body of literature showing a negative relationship between financial instability and macroeconomic volatility. But the reform process has asymmetries according to Mrs. Jones. First, far more progress has been made on the important measures taken by developing economies. Second, developing countries insufficiently participate in international institutions. Finally, most of the attention has been diverted to crisis prevention and management and less has been devoted to the provision of liquidity.

The contribution also stressed that there were three areas where the participation of developing economies in global financial governance is urgent: their incorporation to the Financial Stability Forum, their increased presence in the BIS, and their enhanced participation in the IMF Board.

Dubravko Mihajlek (BIS) presented the latest evidence in the changes and evolution of the composition of capital flows to the emerging markets and transition economies in particular. He described those factors that characterized and affected these developments since the end of the last year, pointing also to the economic and political shocks that have been present since early 2001. He briefly described the composition and amount of inflows faced by the Eastern European economies, mentioning some of the puzzles of their macroeconomic performance, including the still very robust increase of their exports.

Riccardo Ffrench-Davies (CEPAL) discussed the globalization of financial volatility and the challenges that are faced by emerging economies. In the beginning of his contribution he presented evidence on the growth of global capital flows, and their effects on the incidence of currency crises in several emerging market economies. While describing the evolution of economies under stress, he also showed the counterexamples of Chile and Taiwan.

In his presentation Mr. Ffrench-Davies argued that there were misleading recipes, including that the recovery from recent crises was rapid, that opening the capital account strengthened macroeconomic prudence, that external saving s complemented domestic ones and that only the corner solutions were appropriate for exchange rate regime. He suggested that several measures were needed to manage better increased volatility: sustainable volume and composition of capital flows should be maintained, outlier prices and ratios should be avoided, flexible and comprehensive macroeconomic regulation should be adapted, and the international financial architecture needs a reform.

The papers presented at the meeting can be downloaded from our web-site under at www.icegec.org/research/capitalflows.

New Working Papers from the European Center

The European Center has published some new working papers that have been prepared under its programs. The working papers cover broad issues, including country experiences with managing capital flows in Eastern Europe, the lessons with different exchange rate arrangement in these economies, the links between capital flows, monetary policy and the choice of exchange rate arrangement in transition economies, the lessons from the development of the Polish banking sector for less advanced Eastern European economies. The working papers can soon be soon downloaded from the web-site of the center at www.icegec.org./publications/workingpapers.html.

The new working papers are the following:

WP1. David Begg: Capital Inflows, Monetary Policy and the Exchange Rate Regime

WP 2. Claudia Buch- Ralph Heinrich: Capital Inflows, Financial Vulnerability and Currency Crisis

WP 3. Gonzalo Caprirolo and Vladimir Lavrač: Managing Capital Inflows in Slovenia Experiences and Options

WP 4. Urmas Sepp: Aspects of the Sustainability of CBA

WP 5. Miroslav Beblavy: Foreign Exchange Rate Policy and its Outcomes as an Element of Monetary Policy in four Advanced Transition Countries.

WP6. Ewa Balczerowitz – Andrzej Bratkowski: Restructuring and Development of the Banking Sector in Poland. Lessons to be Learnt by Less Advanced Transition Countries.

Trends in the Region

The European Center of the International Center for Economic Growth will prepare its first thematic report on macroeconomic developments in Eastern Europe during November. The first report in its ***„Trends in the Region"*** series will focus on the analysis of trends in inflation in the region and in the major economies. The report and other details will be available from late November at www.icegec.org/monitoring/macroeconomci monitor/trends in the region.html.