Marek Dabrowski

Managing capital flows in a globalized economy: the Ukrainian perspective

Presentation at the Annual Research Conference of the National Bank of Ukraine and National Bank of Poland on ‘Transformation of Central Banking’, Kyiv, May 19-20, 2016

Increasing integration of financial markets:

- development of world trade
- a progressing capital account liberalization;
- liberalization of the banking sector and other segments of financial market;
- transnational expansion of the large banks from developed countries;
- privatization of banks and other financial institutions in emerging-market and developing economies;
- technical progress in ICT;
- increasing level of general and economic education

Arguments in favor of full capital account liberalization:

- Import/ export of savings (saving-investment imbalance)
- Better resource allocation
- Deepening financial market and its disciplining role
- Limiting room for bad policies
- Difficulties in separating ‘good’ and ‘bad’ flows
- Technical difficulties in effective capital control
- Reputation problems
- EU accession requirements in the case of CEE countries

Arguments against full capital account liberalization

- Greater external vulnerability (exposure to various shocks)
- Fragile macroeconomic foundations (high inflation, high fiscal deficit, etc.)
- Limited microeconomic absorption (weak banking and corporate sectors)
- Regulatory problems, etc.

CASE

bruegel

ВЫСШАЯ ШКОЛА ЭКОНОМИКИ

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

Largely the past debate

- Most countries open to capital movement *de facto*; practical difficulties to reintroduce capital controls (even if desired)
- This also concerns Ukraine. However, Ukraine not only continues capital controls de jure but also reintroduced numerous current account convertibility restrictions in 2014

CASE

bruegel

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

Unrestricted capital movement: consequences for macroeconomic policy making

- Capital mobility and balance-of-payment management
- Capital mobility and monetary policy

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

BoP analysis: traditional (close economy) assumptions

- BoP and IIP are concepts based on residency; capital has its fixed residency (domicile)
- individual country gross national investment must be ultimately financed out of this country gross national saving (even if inter-temporal balance-of-payments imbalances are accepted) - echo of the Feldstein-Horioka (1980) ‘home country bias’

BoP analysis: the alternative (open economy) set of assumptions

- unrestricted cross-border capital mobility
- major sources of capital do not have country of origin (may change their domicile)
- private investors seek the highest rate of return disregarding country borders
- some countries may offer higher rate of return than others for a long period of time

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

BoP analysis: consequences of modified assumptions

- Country may become capital exporter or capital importer for a long period of time
- The expected rate of return determines the direction of capital movement
- In the case of capital outflow it also affects residents
- But current account imbalances still matter as long as country has its own currency (exchange rate risk)

CASE

bruegel

ВЫСШАЯ ШКОЛА ЭКОНОМИКИ

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

Current account vs. capital account

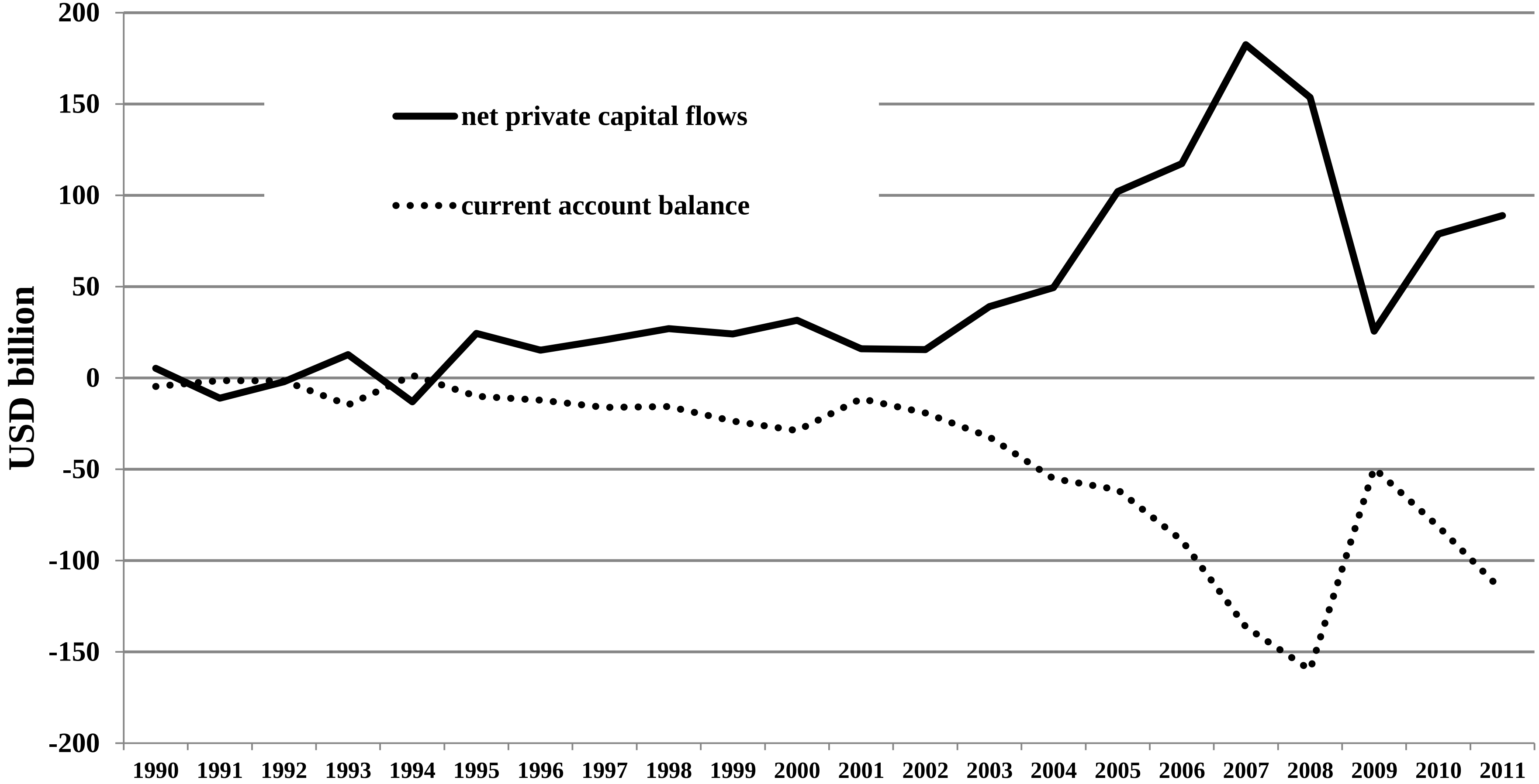
- Traditional approach (in the world of restricted capital mobility): domestic factors of competitiveness + trade policy + exchange rate policy ⇒ trade and current account balance ⇒ capital flows
- The reverse causality in the world of free capital mobility: net capital flows have exogenous character and current account balance adapts to changes in capital account (through changes in real exchange rates)
- Policy consequences: national macroeconomic policy has limited control over current account balance and real exchange rate (even if it controls nominal exchange rate)
- Criteria of assessment of current account: who is doing well, who is vulnerable

CASE

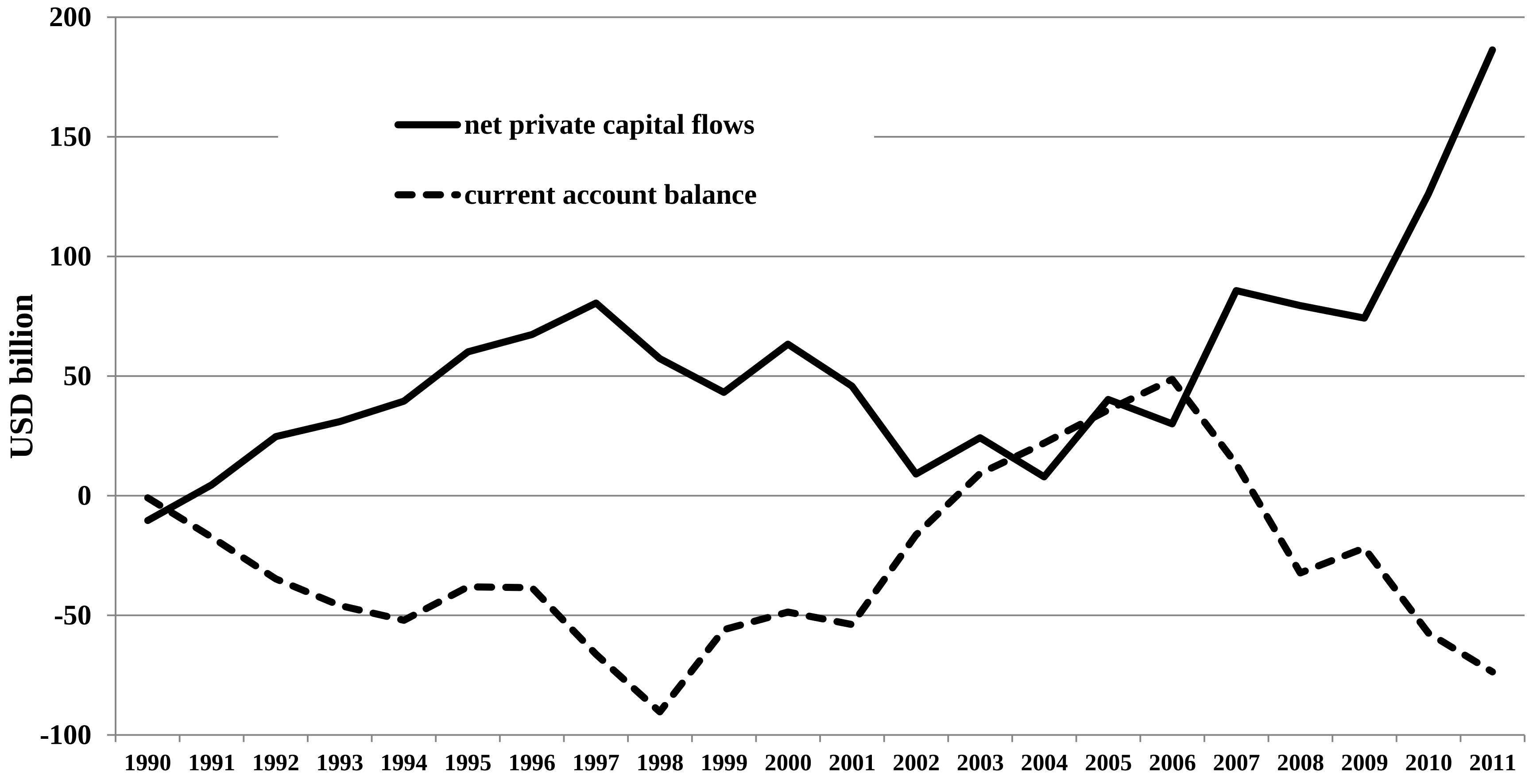
bruegel

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

CEE: capital vs. current account

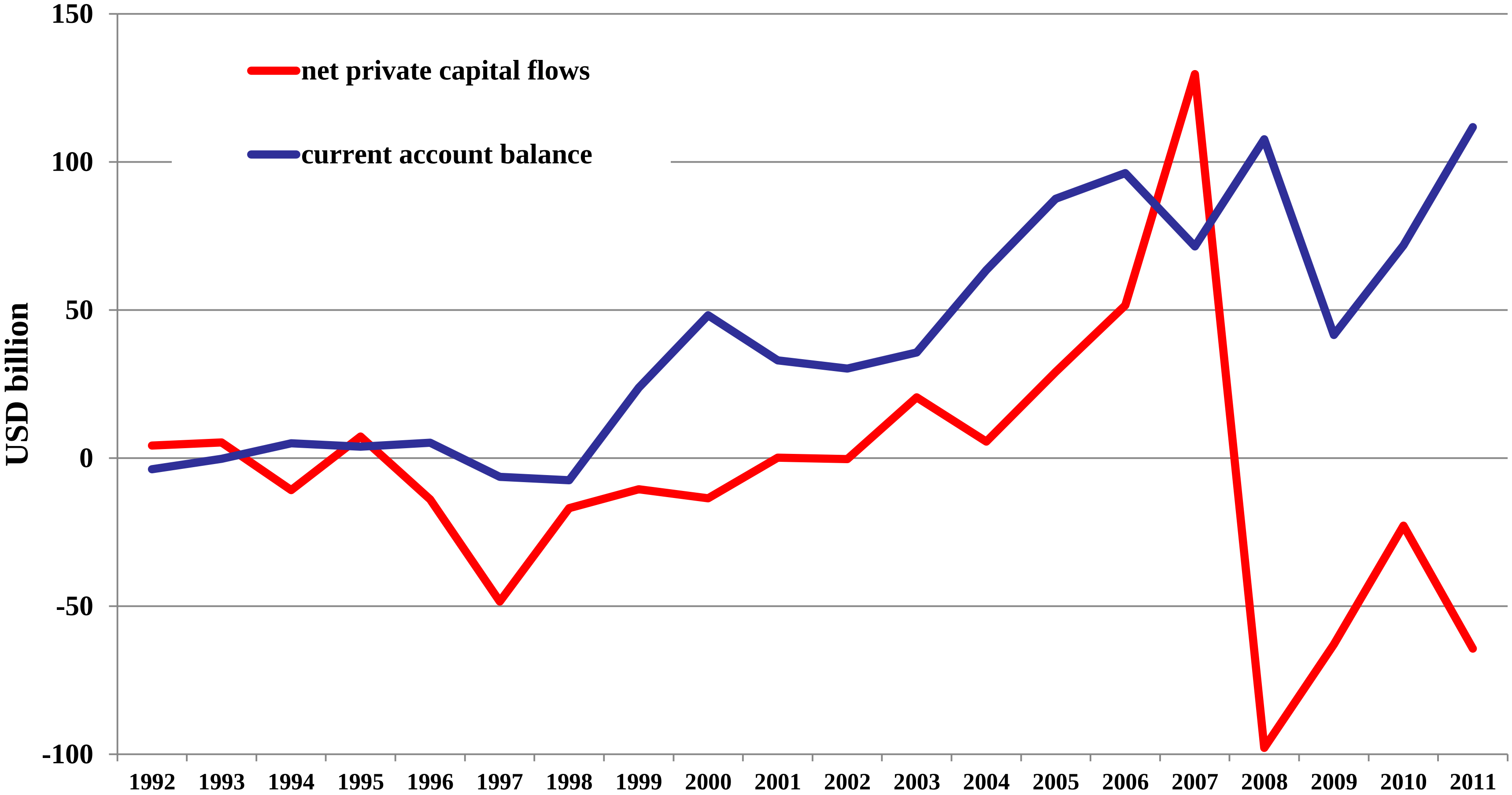


LAC: capital vs. current account



НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

FSU: capital vs. current account



CASE

bruegel

ВЫСШАЯ • ШКОЛА • ЭКОНОМИКИ •

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

Capital mobility and monetary policy (national perspective)

- Domestic money supply is largely exogenous as result of unrestricted capital flows.
- Even under the free floating exchange rate and inflation targeting limited room of maneuver (interest rate decisions must take into account international financial market trends, limits of currency appreciation/ depreciation).
- Consequences of monetary policies of major central banks (especially the US Fed) far beyond their formal jurisdictions $\Rightarrow$ major source of actual volatility in capital flows, export of inflation or deflation
- Others must follow decisions of major players (dealing with 'external' shocks produced by their decisions) but…

bruegel

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

Challenge of currency substitution

- Limited credibility of many emerging-market currencies
  - Memories of high inflation/ hyperinflation, past financial crises, confiscatory monetary reforms, currency restrictions, etc.
  - Insufficient political consensus on monetary stability and central bank independence; limited credibility of economic policy
  - Political instability
- High level of actual dollarization/ euroization
- Critical role of exchange rate
  - High inflation pass-through
  - Inflationary expectations anchored to exchange rate
  - Foreign-exchange denominated liabilities
  - Demand for domestic money dependent on exchange rate stability
  - $\Rightarrow$ 'Fear of floating'

CASE

bruegel

ВЫСШАЯ ШКОЛА ЭКОНОМИКИ

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ

Capital mobility and monetary policy (global perspective)

- Call for global monetary policy coordination – how much politically realistic???
- Worse, macroeconomic theory does not provide conceptual and analytical tools for such a coordination
  - How to define and measure a global money supply?
  - What factors and mechanisms determine changes in global money supply? (for example, the role of cross-country money multipliers under various exchange rate regimes)
  - All theoretical models of monetary policy (like the Taylor rule) analyze its determinants, tools and consequences within a single national economy (no global monetary model or even sufficient external spillovers in national models)

НАЦИОНАЛЬНЫЙ ИССЛЕДОВАТЕЛЬСКИЙ УНИВЕРСИТЕТ