Managing Large Foreign Exchange Inflows

Lessons From International Experiences

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Overview

- Large Foreign Exchange Inflows to CCA Countries offer benefits and challenges
- The CCA countries are not the first to see such inflows
- What can the policymakers here today learn from the experiences of other countries?

Organization

- Types of Inflows
- Policy for managing short-term inflows
- Policy for managing long-term inflows
- Policies to mitigate the risks related to possible sudden stops of the inflows
- Conclusions—lessons for the CCA countries

Characteristics of Different Types of Inflows

- Remittances—motivated by altruism, and likely to be long-term
- Capital Inflows—"push factors" could lead to short-term inflows, "pull factors" are more likely to lead to long-term inflows
- Oil revenues—term depends on oil volumes in the exporting country and movements in oil prices

Managing Short-Term Inflows--Sterilization

- Policies should focus on limiting exchange rate movements and preserving macroeconomic stability
- Central bank purchase the inflows, remove the domestic currency liquidity through sales of domestic securities, or shifting government deposits to the central bank

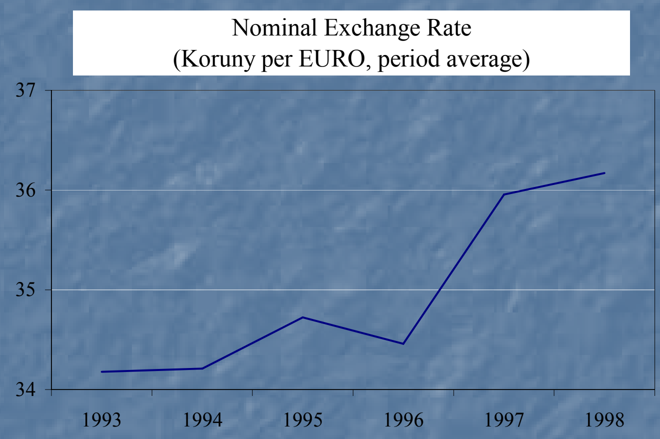
Sterilization is only Successful in the Short Run

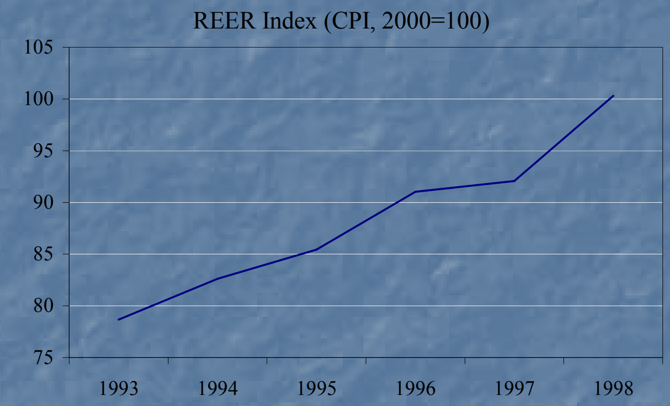
- If sterilization is used for too long:
  - The costs to the central bank (interest on the cds, etc.) will rise
  - Domestic interest rates will rise, stimulating more inflows

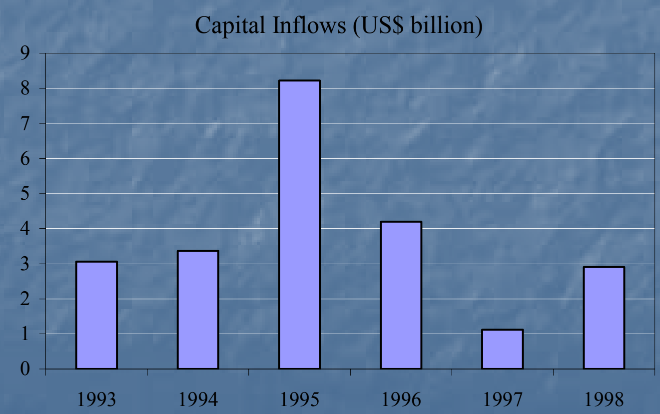
Czech Republic: Sterilization used too long

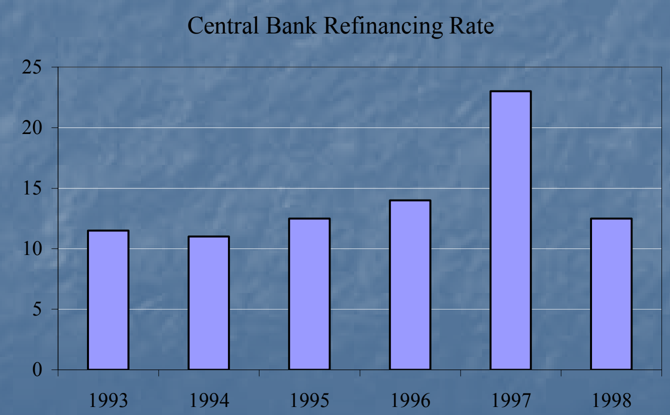
- 1993-1995, the Czech Republic received inflows of about 18% of GDP annually, due to its business environment and economic stability
- The central bank bought the inflows to prevent appreciation, sterilized by issuing central bank paper

Czech Republic: Results









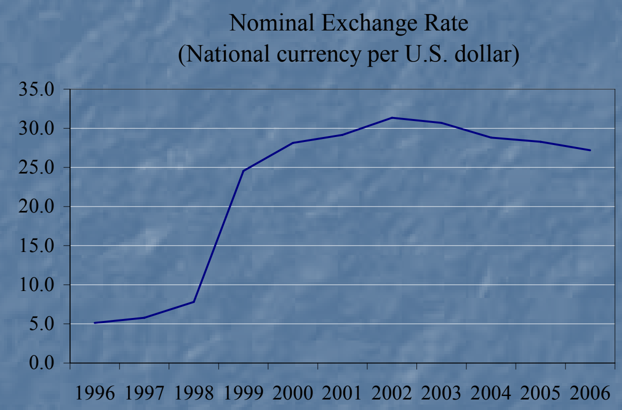
Strong Money Demand can Ease the Challenge

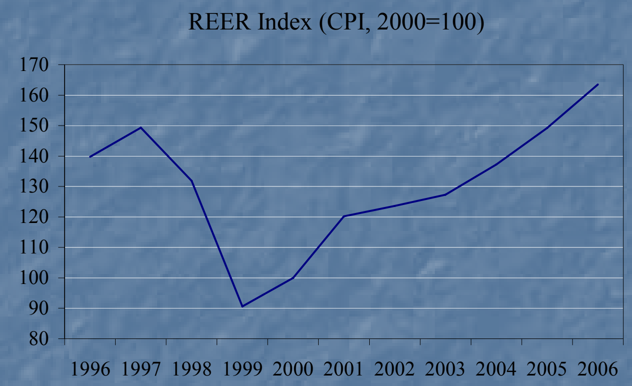
- If money demand is growing rapidly, central bank foreign exchange purchases may not require sterilization to avoid inflation
- But even in these cases, there is a limit to the amount of unsterilized interventions that are not inflationary

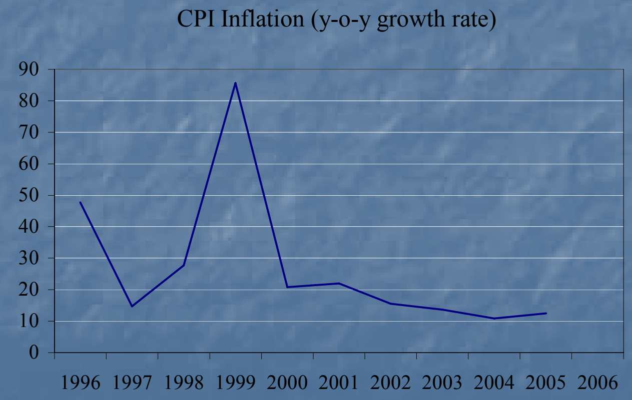
Russia: Successful Intervention with limited Sterilization

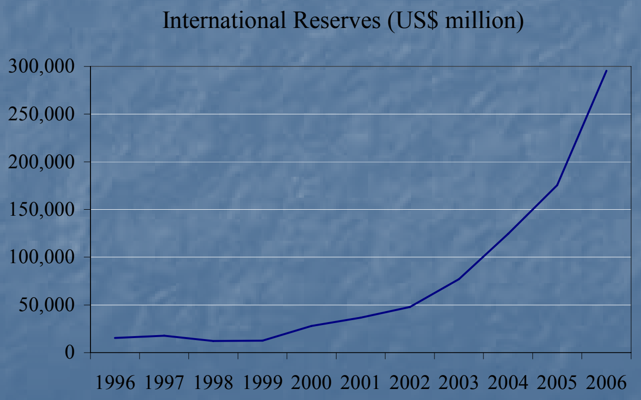
- In the early 2000s, Russia saw huge inflows in the form of rising oil revenue and capital inflows (mainly short term)
- The central bank intervened to prevent appreciation, but limited sterilization efforts for fear that rising interest rates would entice greater inflows

Russia Results









Managing Longer-Term Inflows

- In most CCA countries, the inflows appear to be longer-term
- That means interventions plus sterilization by the central bank will not work
- What are the policy options to contain both inflation and the real exchange rate?

Monetary Policy will not work

- If the central bank intervenes to prevent nominal appreciation, the result will be rising inflation, and real appreciation
- If the central bank does not intervene, they can keep inflation down, but nominal appreciation will cause real appreciation
- As the competitiveness results are the same, and inflation adversely effects growth, non-intervention is preferable

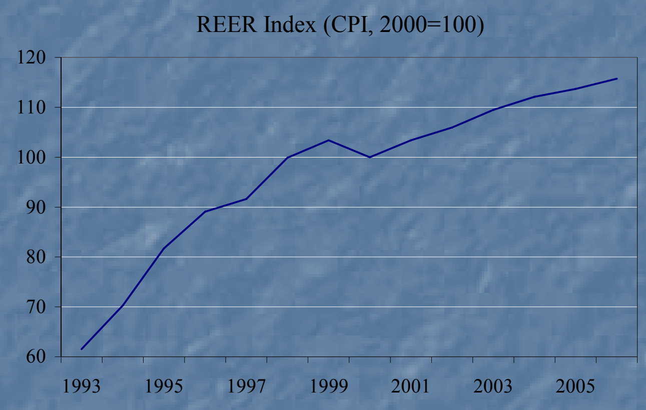
But Fiscal Policy can work

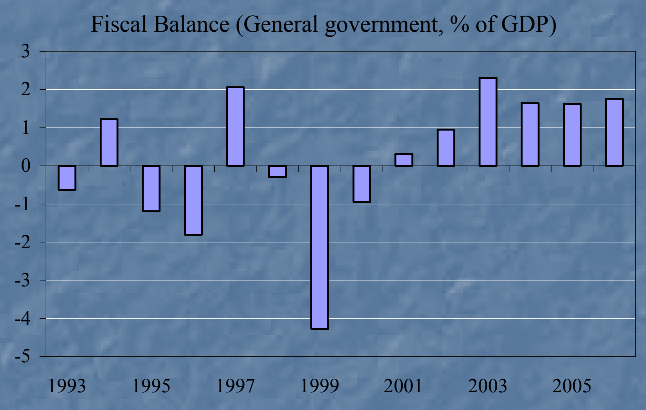
- If the central bank intervenes, and the budget is tightened by the same amount, the budget withdraws the injected liquidity
- If the central bank does not intervene, fiscal tightening can still prevent real appreciation
- By reducing domestic demand, fiscal tightening eases both inflation and nominal appreciation pressures, reducing real appreciation

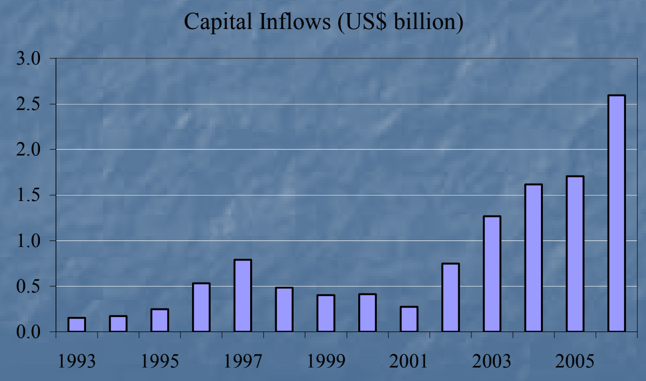
Estonia: Fiscal Policy as the Key to Managing Foreign Exchange Inflows

- Estonia's currency board forces all policy adjustment to be done by the budget
- Fiscal policy in Estonia has been very flexible, and generally tight
- When inflows rose, the fiscal surplus did as well
- The result has been modest inflation, modest real appreciation, and consistently strong growth

Estonia in Detail







If it is Politically Feasible

- Fiscal tightening can be hard to achieve, particularly in transition countries
- FDI inflows increase the demand for infrastructure; a tighter fiscal stance could limit the growth stimulus from the FDI
- In addition, public support for needed but difficult structural reforms often requires social spending that may be hard to reconcile with fiscal tightening

Structural Reforms can also help Maintain Competitiveness

- Structural reforms that help stimulate productivity growth can mitigate the effects of real appreciation on competitiveness
- Evidence shows that structural reforms in Asia resulted in inflows in the 1990’s being directed to investment, easing competiveness concerns, while in Latin America the lack of such reforms contributed to inflows financing consumption, not investment

Capital Controls as an Instrument to Manage Inflows

- There is debate over whether capital controls can effectively limit inflows, or change their nature
- A number of countries have tried them recently

International Experiences with Capital Controls--Chile

- Chile used capital controls in the 1990's (mandatory, unremunerated reserve requirements for one year on short term inflows).
- They managed to increase the maturity of inflows for a time.
- But markets eventually found ways around the controls
- And the cost was higher financing costs for small enterprises

International Experiences with Capital Controls—Malaysia and Thailand

- Malaysia introduced capital controls introduced in 1998 and found their impact small. They found that weak governance reduces the effectiveness of capital controls
- Thailand introduced capital controls in 2006, in the form of a 30% reserve requirement for one year on capital inflows. After a sharp drop in the stock market, the measure was no longer applied to equity inflows

International Experiences with Capital Controls—Bulgaria and Croatia

- High reserve requirements on foreign obligations of commercial banks in Croatia, and increased reserve requirements when credit grows too fast in Bulgaria, were attempts to restrict inflows
- Their effect was minimal, as markets found ways around them, such as direct loans to businesses from the foreign parent of a domestic bank, or lending through non-supervised financial institutions

Mitigating the Risk of a Currency Crisis

- Many countries have experienced sudden cessation, or even a reversal, of inflows
- Often these have been unrelated to events in the recipient country
- The result has often been a currency crisis, leading to a severe recession
- While this does not appear imminent today in the CCA, prudence dictates designing policies to reduce the risk of a halt to inflows, as well as to minimize the negative implications in the event of a halt

Mitigating the Risk of a Sudden Halt to Inflows

- Policies cannot prevent swings in capital flows driven by global developments
- Well-designed macroeconomic policies—low inflation, strong fiscal position, healthy reserves, sound banking system—combined with a good business environment, are a government’s only way to discourage a reversal of flows

Mitigating the Damage from a Sudden Halt to Inflows

- Reducing dependence on inflows will help reduce the damage should they stop
- Central bank purchases of the inflows can help prevent a widening of the current account deficit, easing vulnerability of the economy to a halt in flows financing that deficit
- These purchases also give the central bank greater reserves with which to finance the deficit itself, temporarily, if the flows halt

The Exchange Rate Regime Choice

- Examples of successful transition economies, that handled inflows well, include a wide range of exchange rate regimes:
  - Inflation targeting with a flexible exchange rate in Poland
  - A heavily managed float in Slovenia
  - A currency board in Estonia
- More important than the choice of the regime is the consistency of macroeconomic policies. The less flexible the exchange rate regime, the more flexible fiscal policy needs to be

Exchange Rate Regimes and Currency Crises

- But fixed exchange rate regimes are more prone to currency crises than flexible regimes
- In a flexible regime, the flexibility discourages wild swings in inflows, particularly short-term inflows
- Thus, for countries facing prolonged inflows, a gradual move to a more flexible exchange rate regime may be desirable

Mitigating Balance Sheet Risks

- Balance sheet risks refer to risks when assets and liabilities are in different currencies
- A sharp change in exchange rates in this situation can have a huge impact on net worth
- Balance sheet risks can effect government, corporations, the financial sector or households.

Public Sector Balance Sheet Risks: Ukraine

- For the public, the main risk stems from over-reliance on external debt
- The risk can be seen in the case of Ukraine, which relied heavily on foreign inflows to finance the fiscal deficit
- When foreign investors pulled out after the Asian and Russian crises, the government first borrowed heavily from the national bank
- But this was unsustainable; eventually the exchange rate was made more flexible, and fiscal policy had to be sharply tightened

Corporate Balance Sheet Risks

- Companies often borrow in foreign currency, even when they have only domestic currency income
- A shift in exchange rates can make the debt unmanageable
- This can trigger problems for the financial sector as well, as NPLs rise sharply
- The banking sector’s balance sheet risk means a currency crisis can trigger a financial crisis

Reducing Balance Sheet Risks

- Key is to prevent banks from engaging in excessively risky lending through prudential regulations, including
  - Enforcing strict limits on exposure to unhedged foreign currency loans and net open positions, and
  - Possibly risk-weighting foreign currency lending
- Develop markets for hedging exchange rate risks

Conclusions

In the face of large foreign exchange inflows, international experience gives the following lessons:

- Monetary policy should target low to moderate inflation;
- Real appreciation cannot be prevented over the longer term, except by fiscal tightening;
- Structural policies need to encourage inflows to be directed toward productivity-enhancing investments;

Conclusions Continued

- Capital controls and the use of prudential regulations to restrict inflows are unlikely to be successful;
- Central banks should seek to hold a substantial level of foreign exchange reserves, while ensuring that any accumulation is consistent with the inflation objective;
- Countries with significant short-term inflows should seek to make their exchange rates more flexible, and should strengthen prudential and other financial market regulations.