Capital Flows:
Prospects and Risks for the Region

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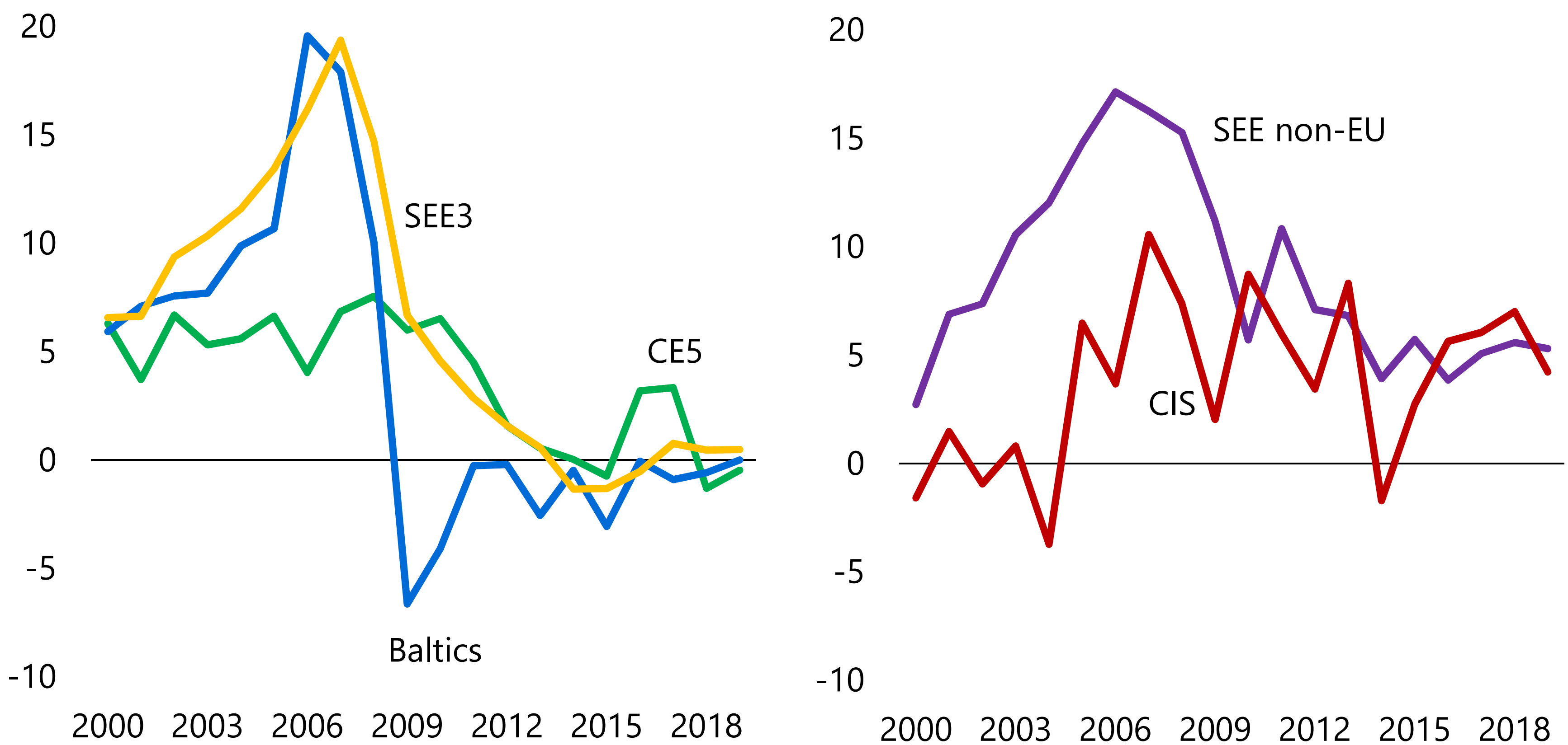
CAPITAL INFLOWS IN RECENT YEARS

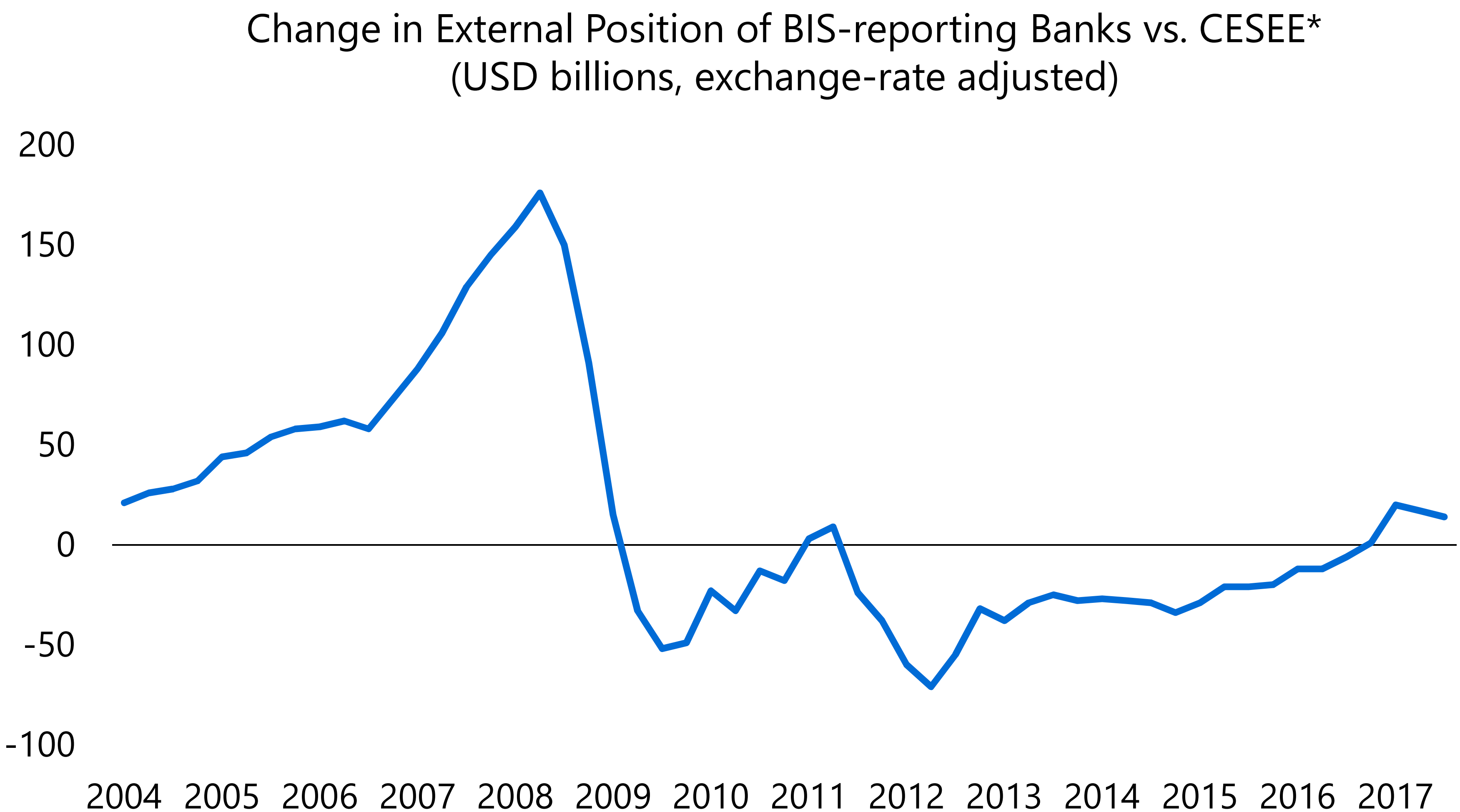
Net capital inflows in CESEE have been fairly modest in recent years

Capital flows to CESEE*
(percent of GDP)



*Excluding Russia and Turkey.

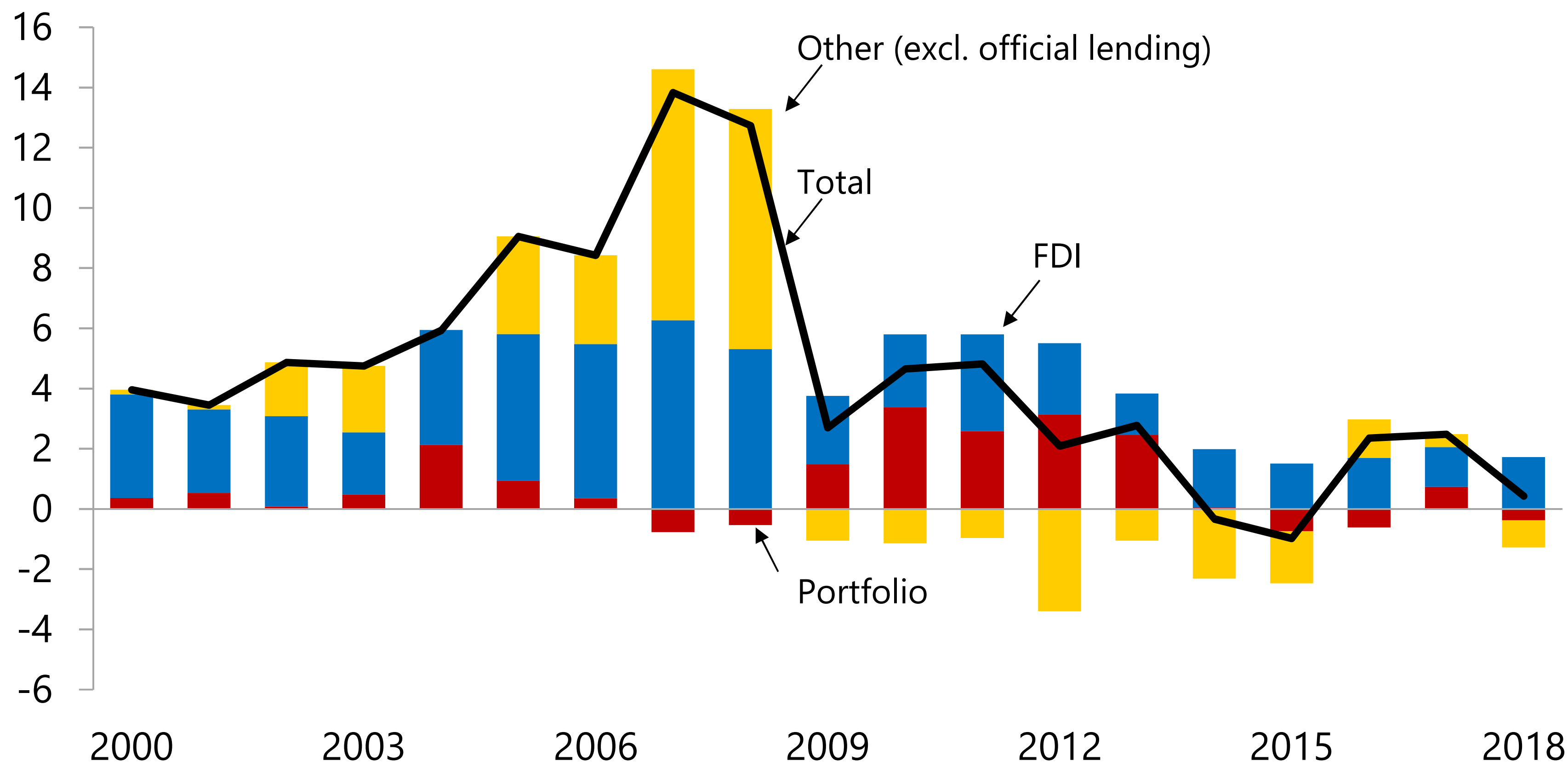
Banks have been deleveraging



*Excluding Russia and Turkey.

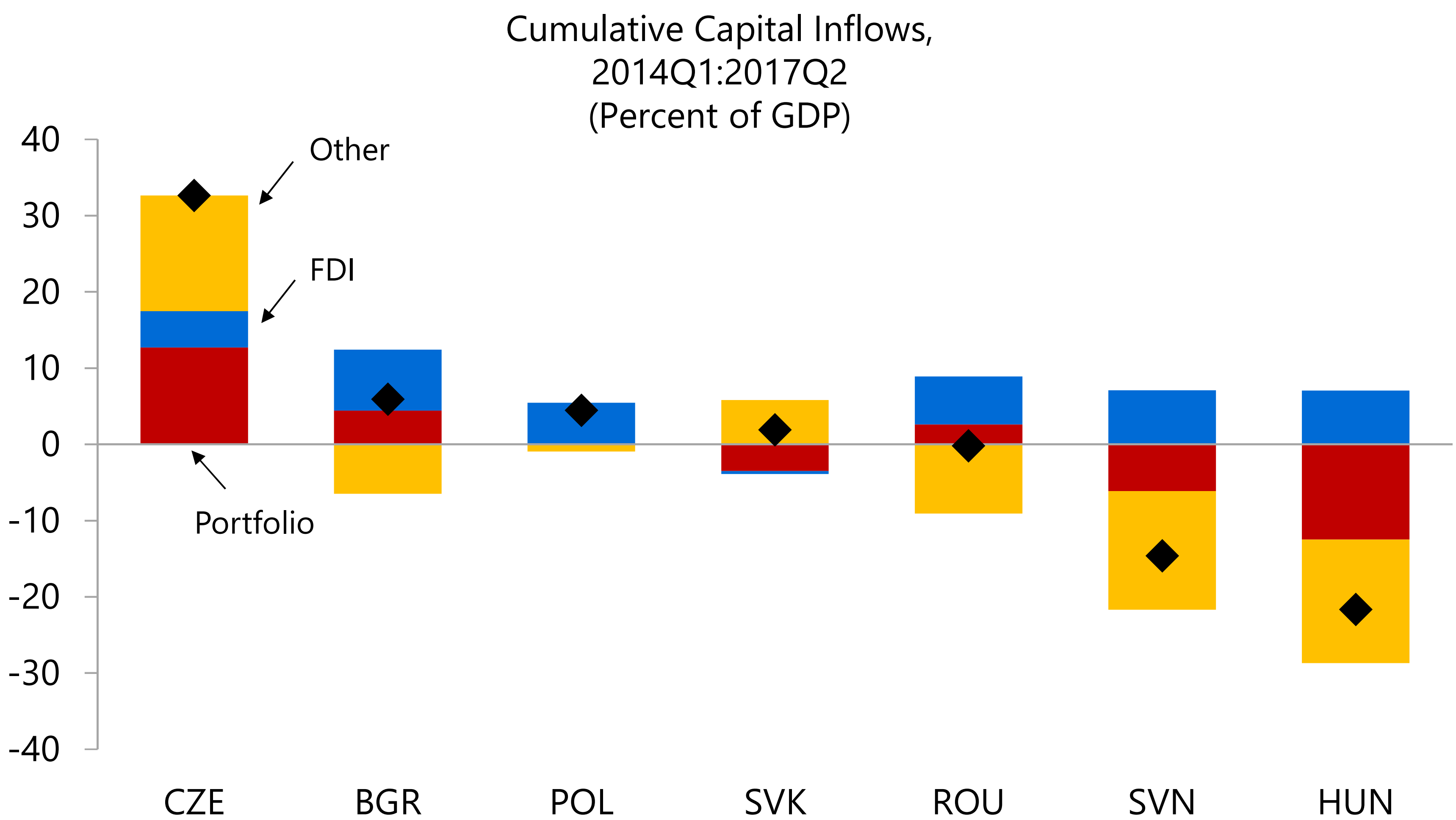
Between 2010 and 2013, this was partly offset by portfolio inflows

Capital flows to CESEE*
(percent of trend GDP)

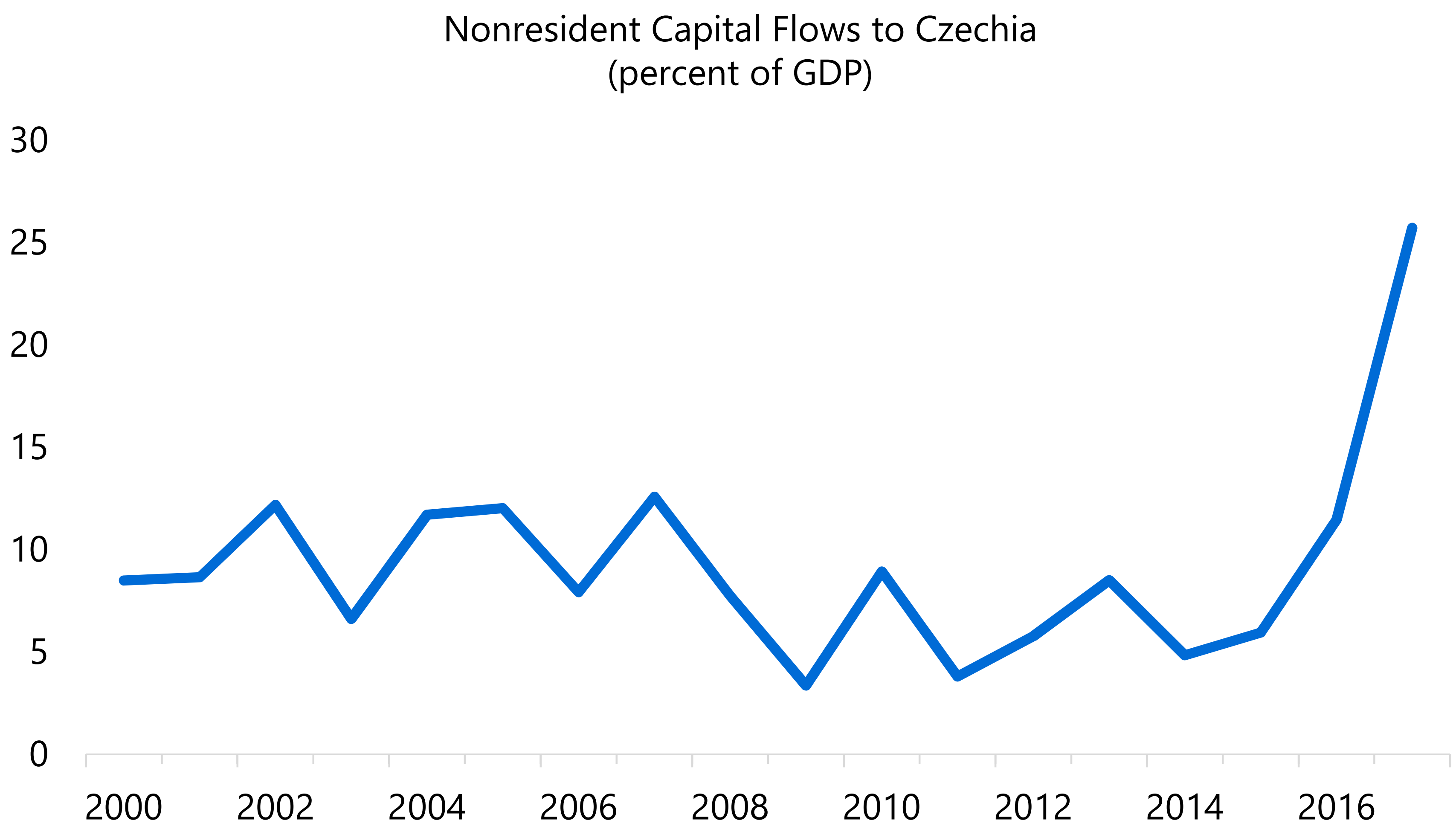


*Excluding Russia and Turkey.

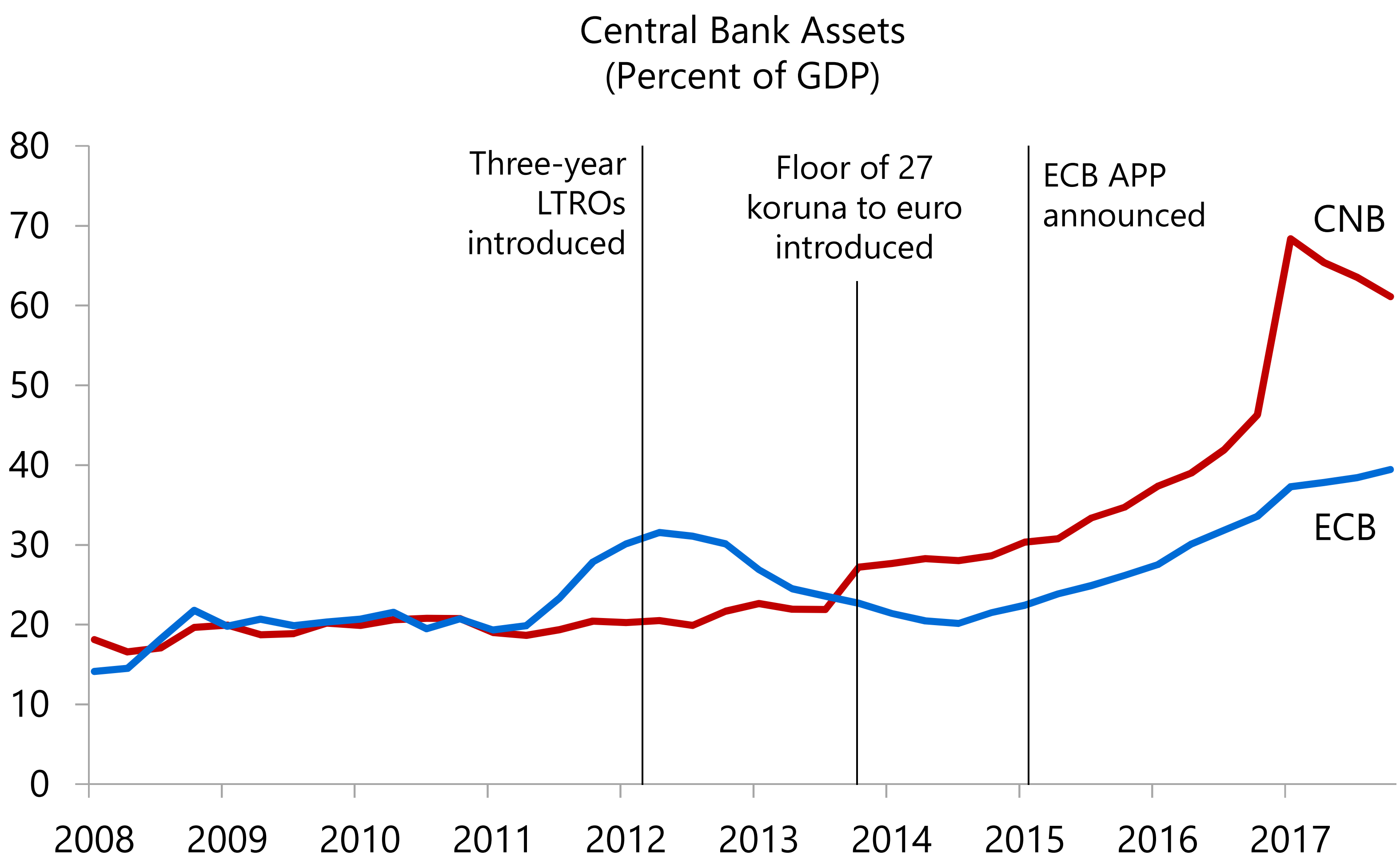
In recent years, there have been no portfolio inflows to speak of, with exception of Czechia



Czechia has been only country in CESEE with large capital inflows

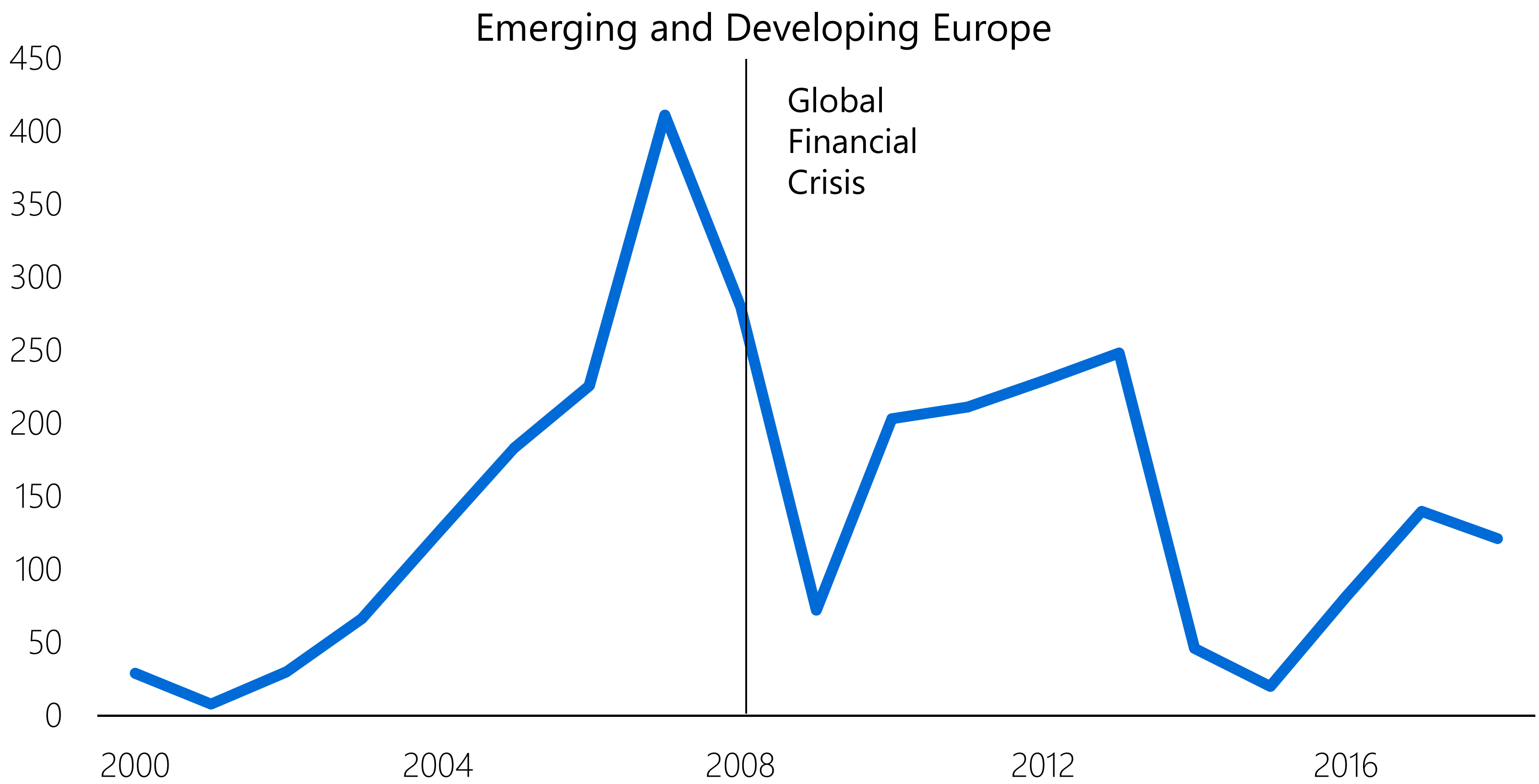


CNB massively intervened to prevent koruna appreciation



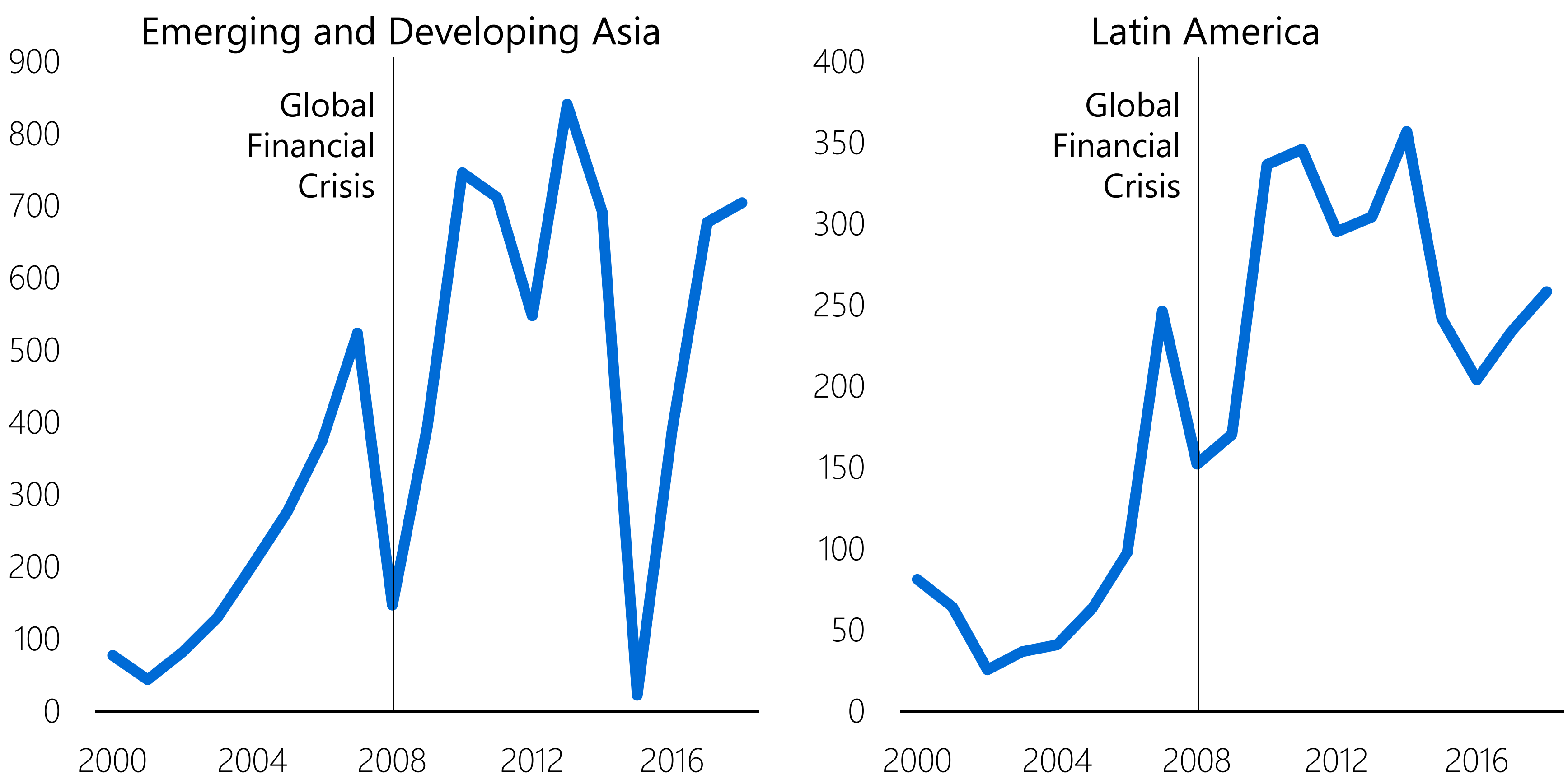
Loose monetary policy/QE post-global crisis did not create capital inflow surge into CESEE

Net Financial Inflows (excl. official reserves)
(USD billion)



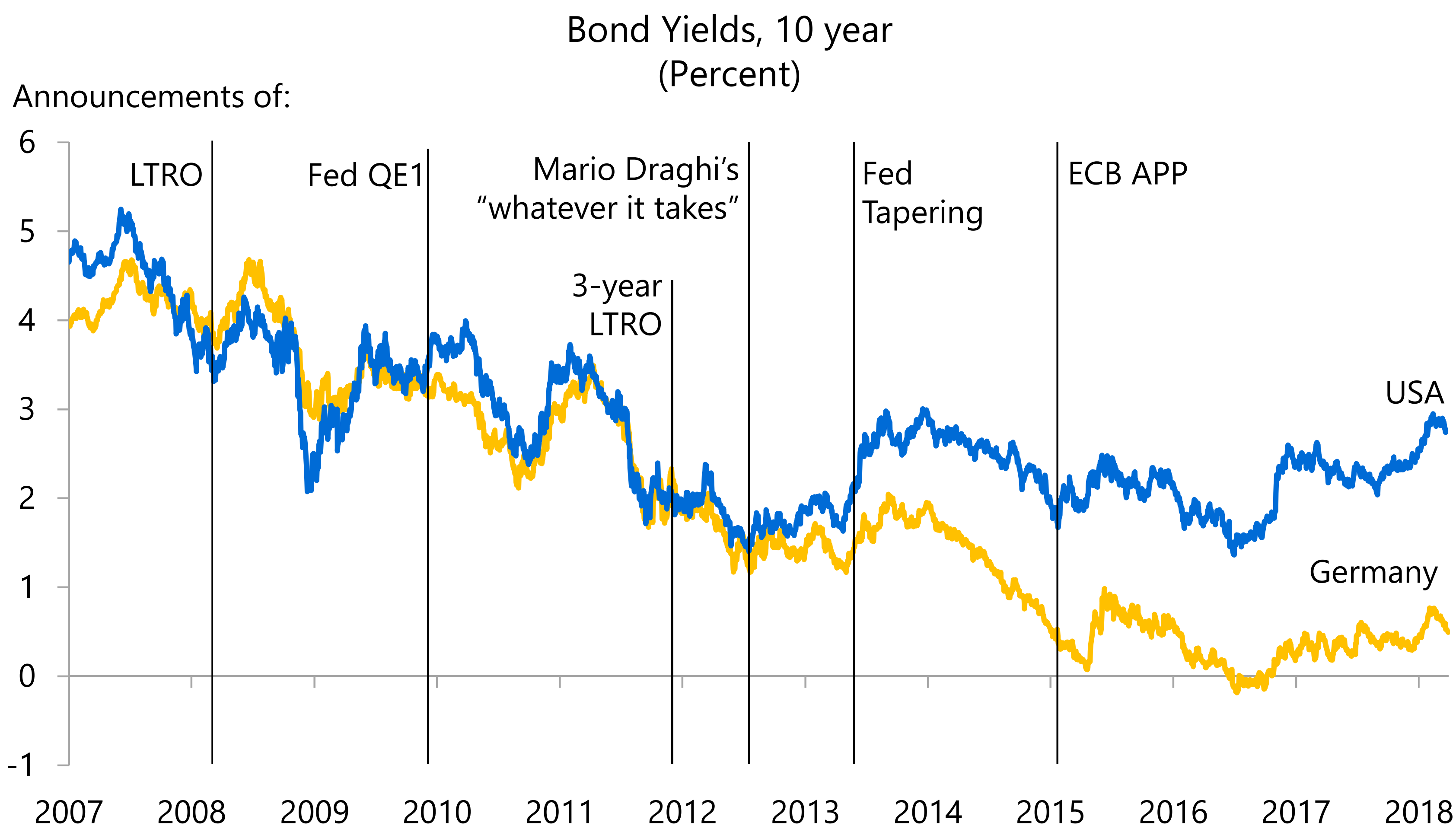
This was different from Latin America and Asia

Net Financial Inflows (excl. official reserves)
(USD billion)

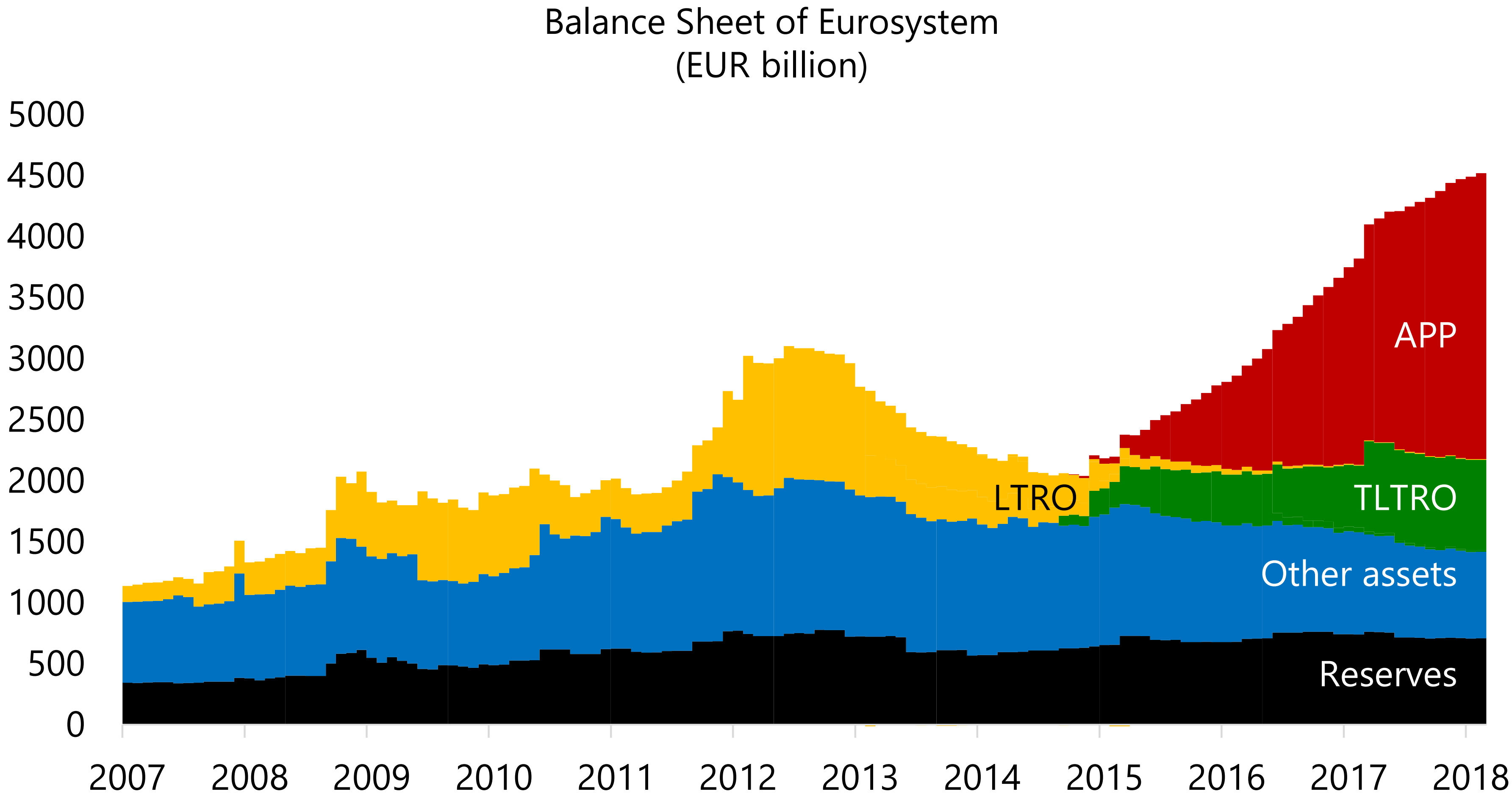


THE END OF QE

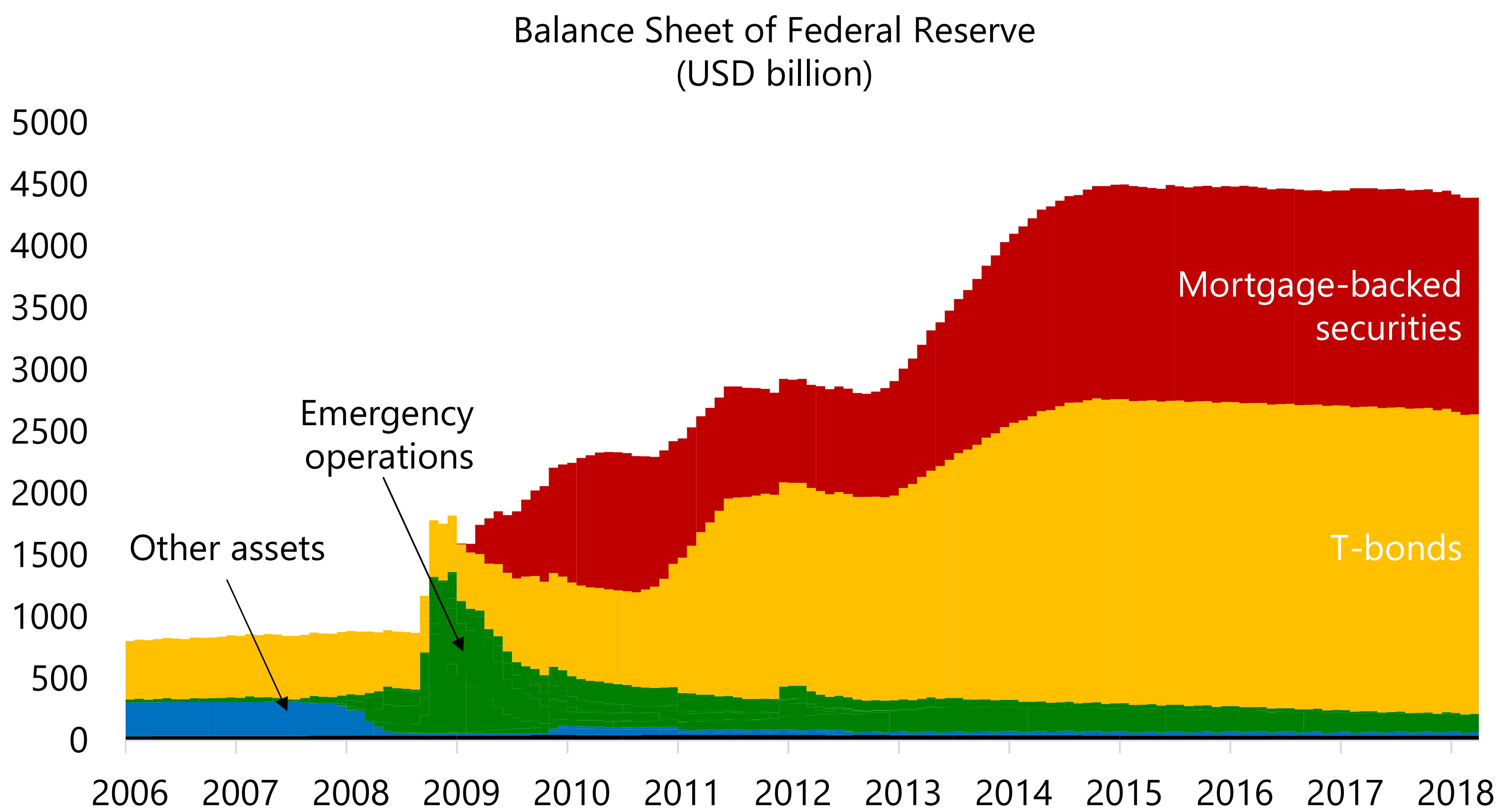
QE/Loose monetary policy have likely contributed to decline of long-term interest rates in advanced countries



In the euro area QE is still ongoing



QE in the US has already stopped; and the Fed has been raising interest rates



What happens if QE ends in Europe, Fed raises interest rates further?

- QE is likely to have led to
  - Lower interest rates
  - Reductions in risk premia

- End of QE and monetary tightening would likely lead to
  - Higher interest rates
  - Higher risk premia

What will be the impact of higher interest rates and risk premia?

- Is this something to be feared?
- Or is it welcome?

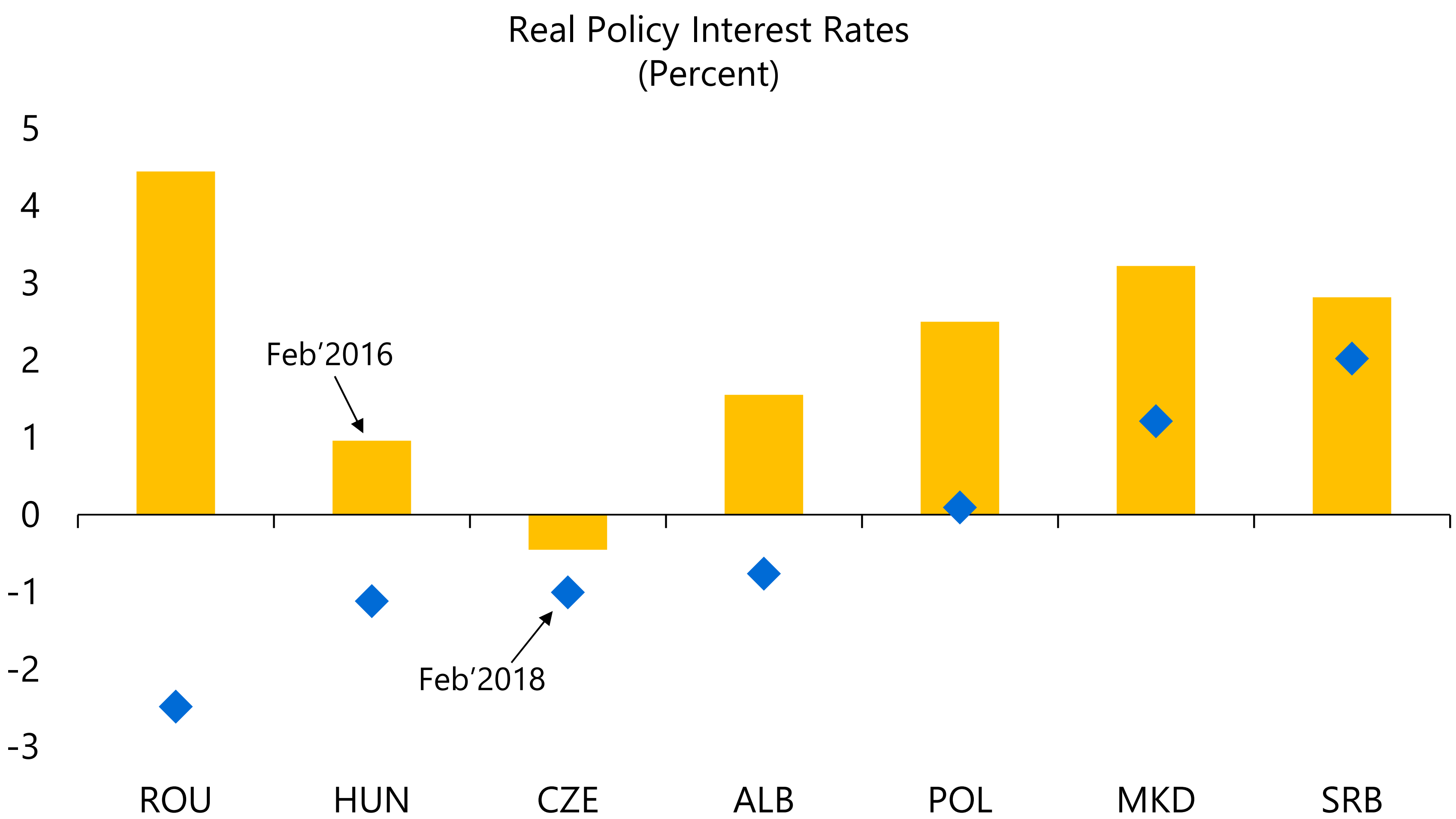
- Let's distinguish between impact higher interest rates and impact higher risk premia

We assume that interest rates in Western Europe will only be raised if growth remains strong

- ECB will raise interest rates only if growth stays high and brings unemployment down and wages and inflation up

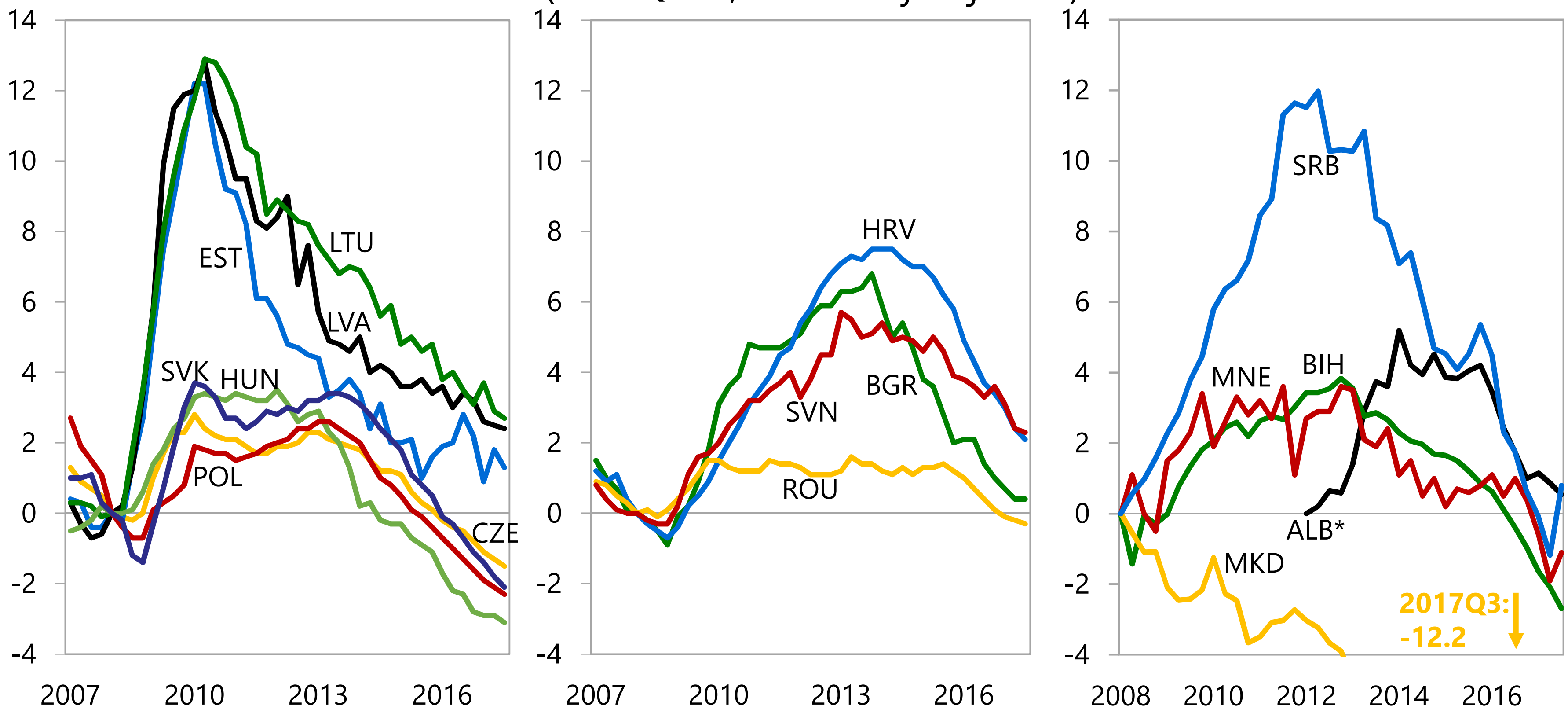
HIGHER INTEREST RATES

Real policy interest rates are *negative* in many countries



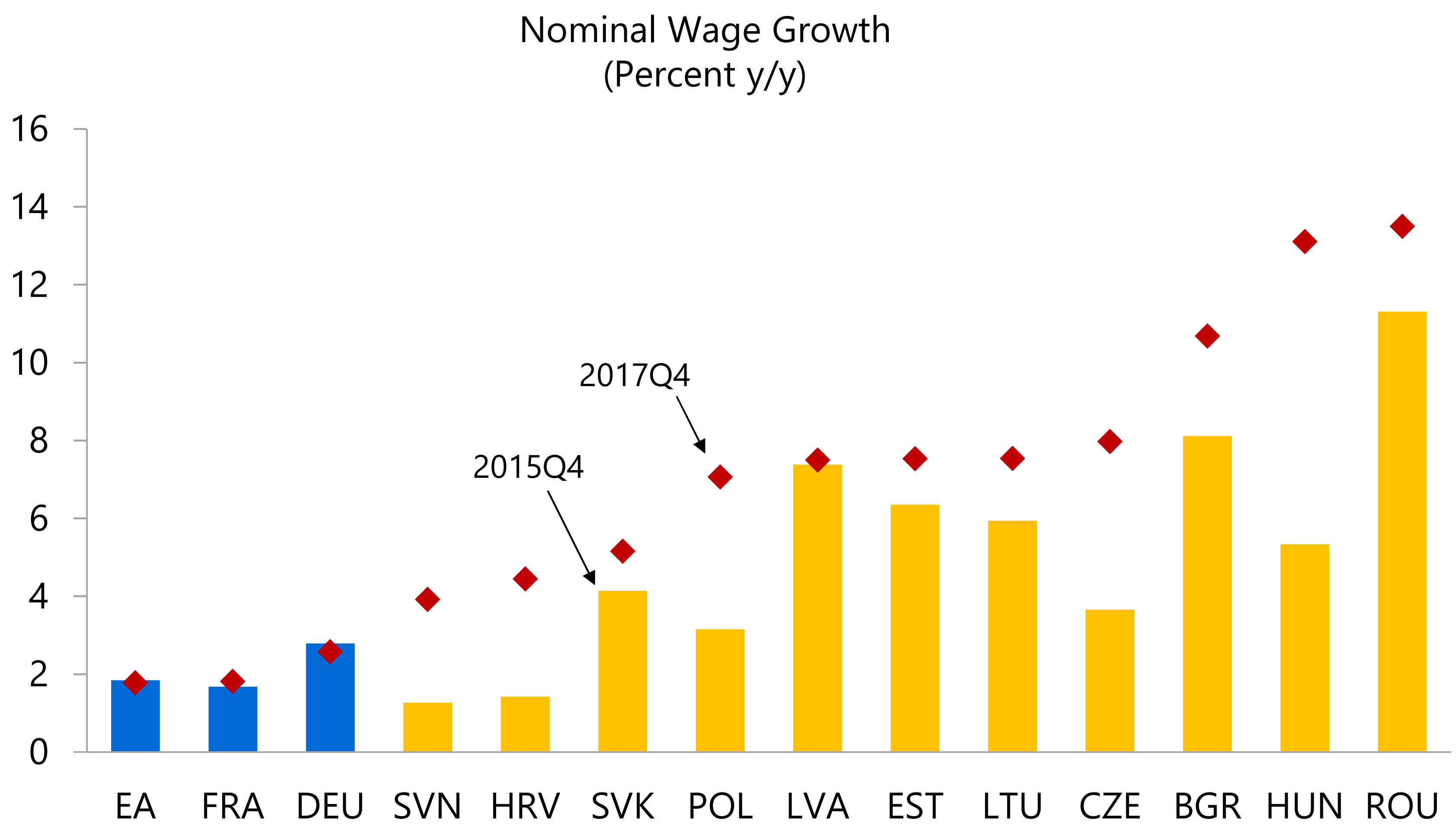
Even though unemployment is falling very rapidly…

Cumulative Changes in Unemployment Rate
(2008Q1=0, seasonally adjusted)

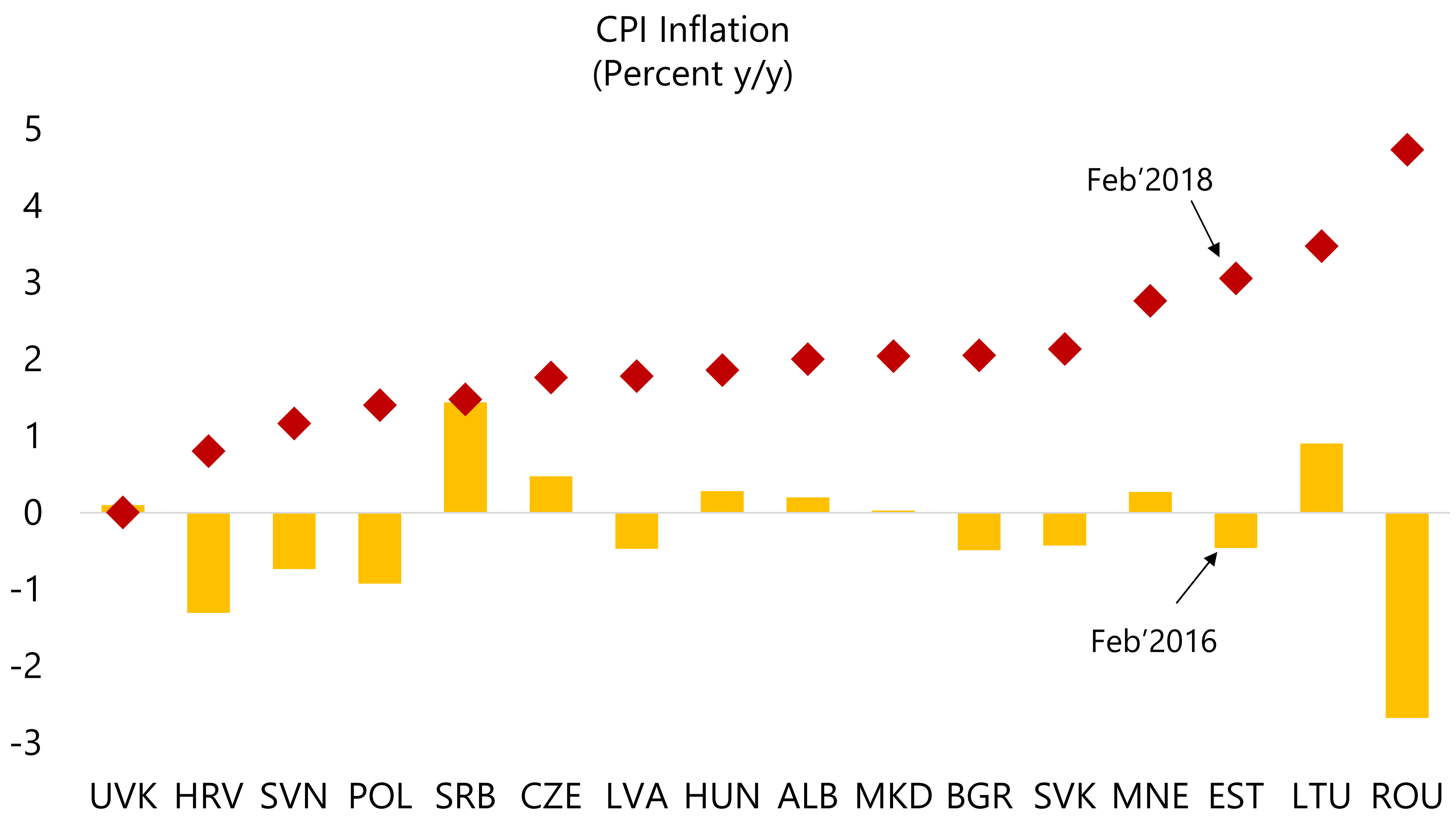


*For ALB 2012Q1=0

And wage growth has accelerated

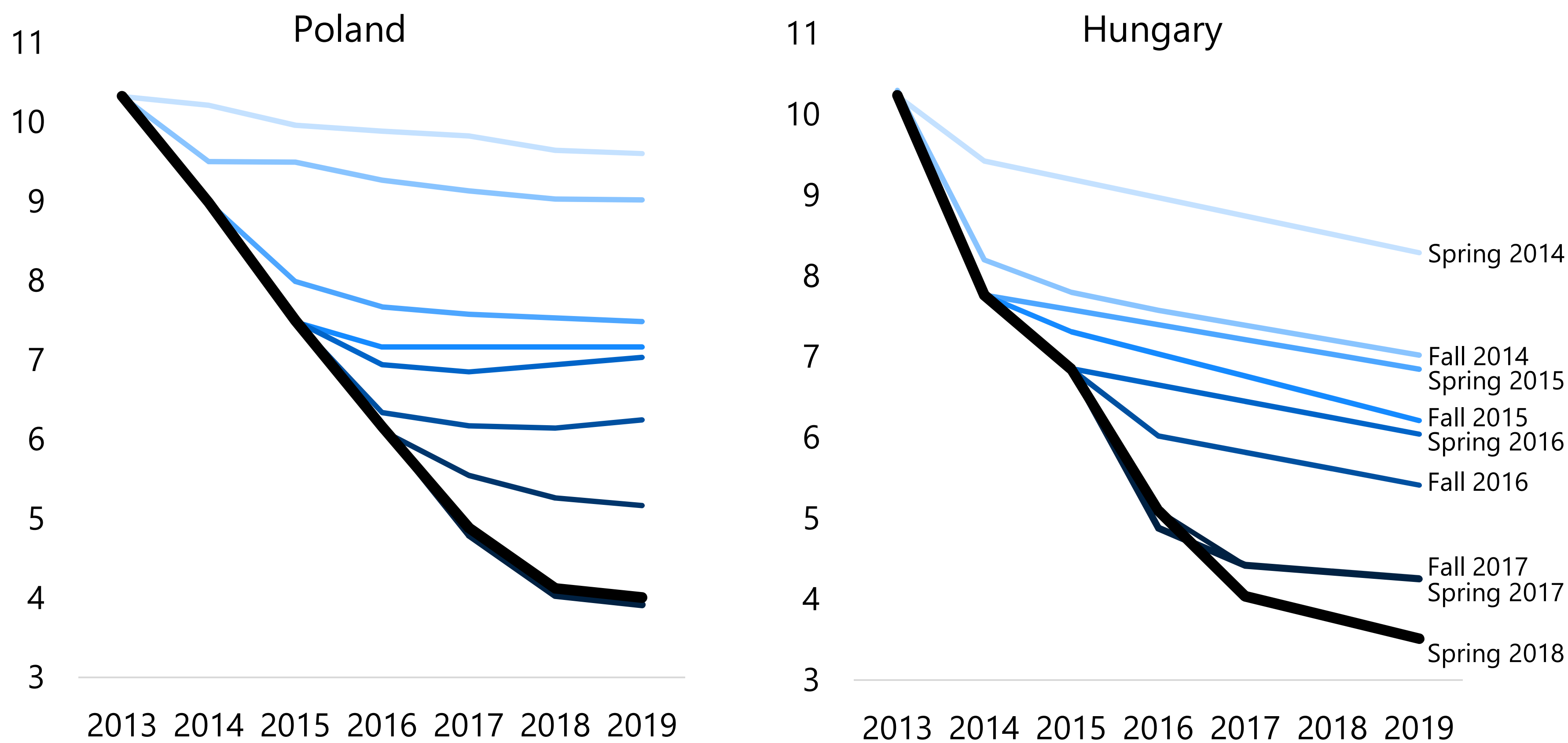


Inflation has increased, but is still moderate in most countries



Unemployment cannot continue to fall at current pace—either productivity needs to pick up or growth need to slow down

Unemployment rate forecasts by WEO vintage
(percent)



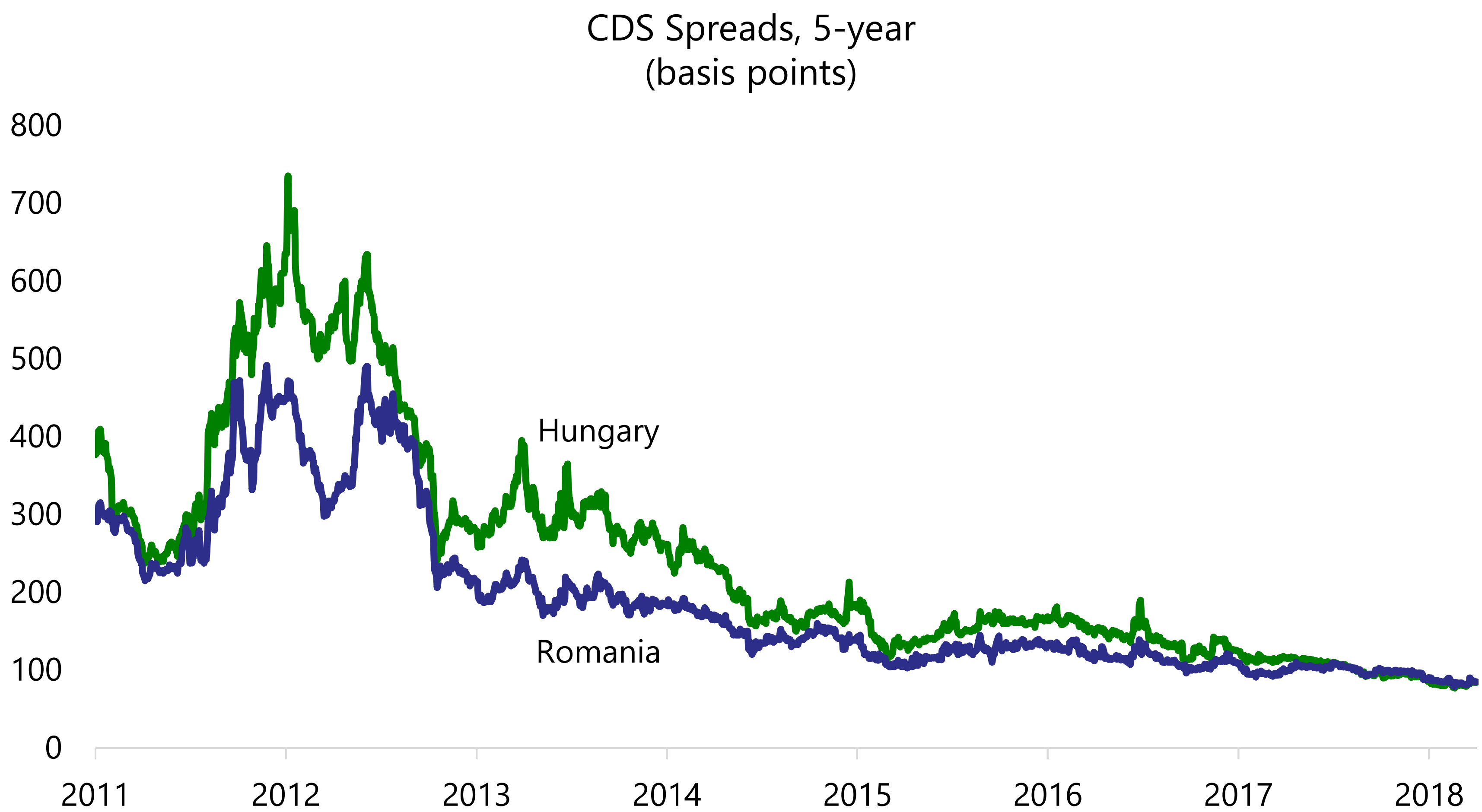
Higher interest rates in Western Europe would make it easier to raise rates in Eastern Europe

- Applies in particular to countries in CESEE that do not have own monetary policy

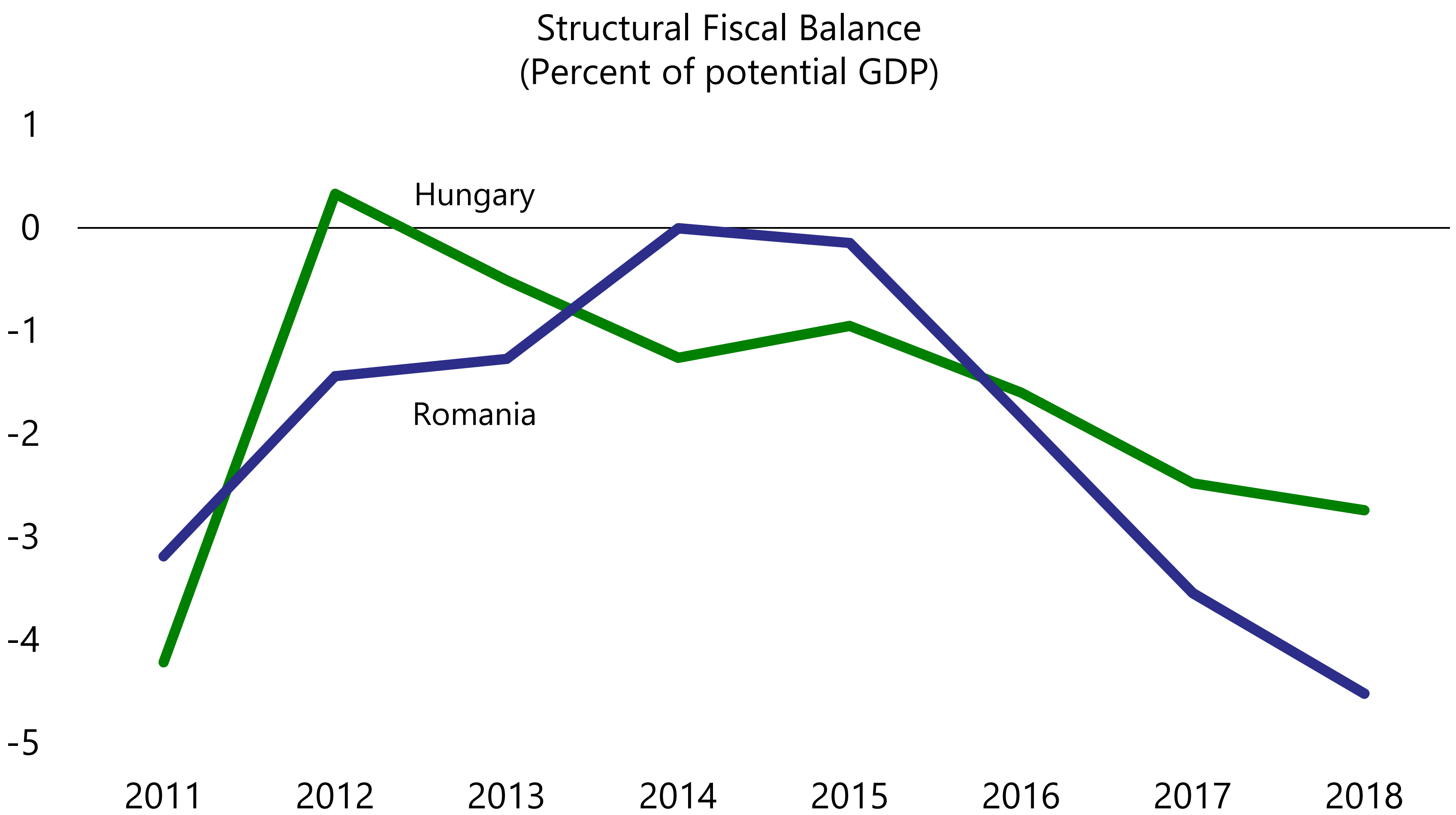
- But also for countries with floating exchange rates, which may be fearful of impact higher interest rates on exchange rate

HIGHER RISK PREMIA

In a number of countries, risk premia have declined to low levels…



Despite a deterioration of polices

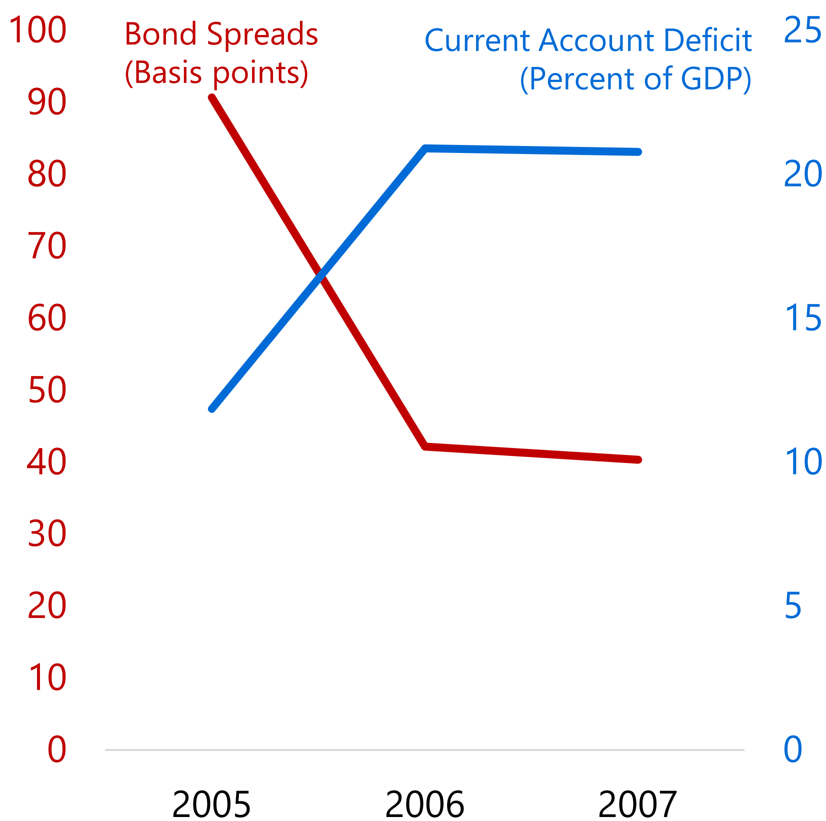


Given strong growth, risk premia may not rise in near future

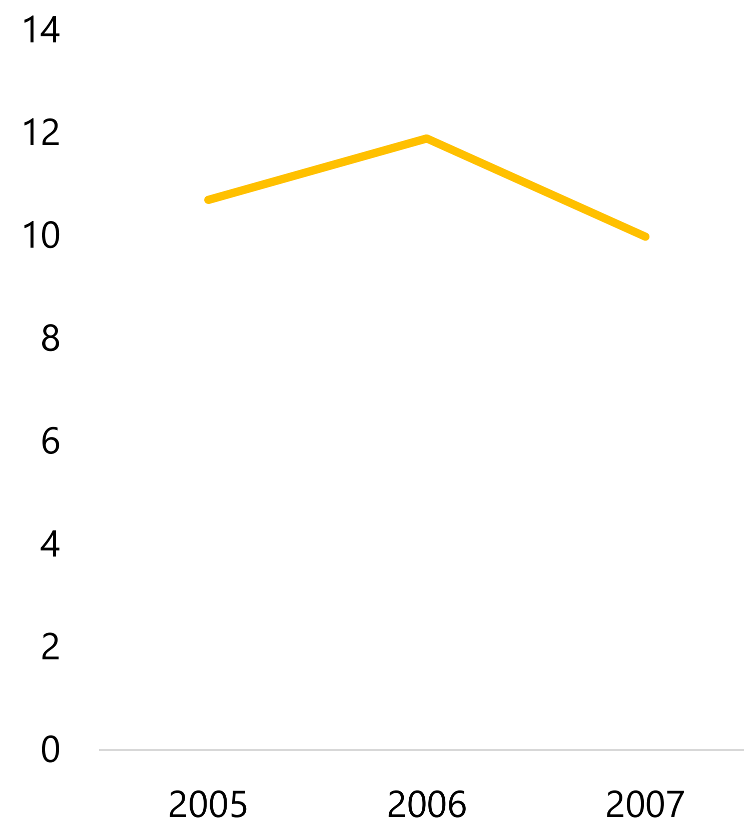
*Excluding Russia and Turkey.

Risk premia tend to be low when growth is strong—even when vulnerabilities rise

Latvia: L-T Eurobond Spread vs. Germany and Current Account Balance



GDP growth in Latvia (Percent y/y)



Combination of low risk premia and deteriorating policies makes region more vulnerable to shocks

- Low interest rates and strong growth may lead to deterioration of policies
  - Less incentives to reduce debt levels
  - Public finances look better than they are
  - Less perceived need for reforms

- Combination of low (and even falling) risk premia with deteriorating policies
- Danger of sudden repricing of risk when shock hits

Mispricing of risk will be problem if world gets hit by new shock

- If a large shock occurs
  - large correction in stock markets. Or, a
  - trade war
  - a big geopolitical shock.
- The resulting flight to safety will separate the weak from the strong
- Countries with weak fundamentals will see the sharpest increase in risk premia

CONCLUSION

The ECB will not harm CESEE, but other shocks may

- ECB will not harm CESEE
  - Tighter monetary policy in advanced countries might be welcome rather than feared
  - Higher interest rates might help prevent overheating in CESEE
- But other shocks may
  - Shocks may lead to large and sudden adjustment in risk assessment
  - The resulting flight to safety will separate the weak from the strong

Thank you