Growth, Capital Flows and Fiscal Deficits: Some Thoughts in the Aftermath of the Recent Crisis

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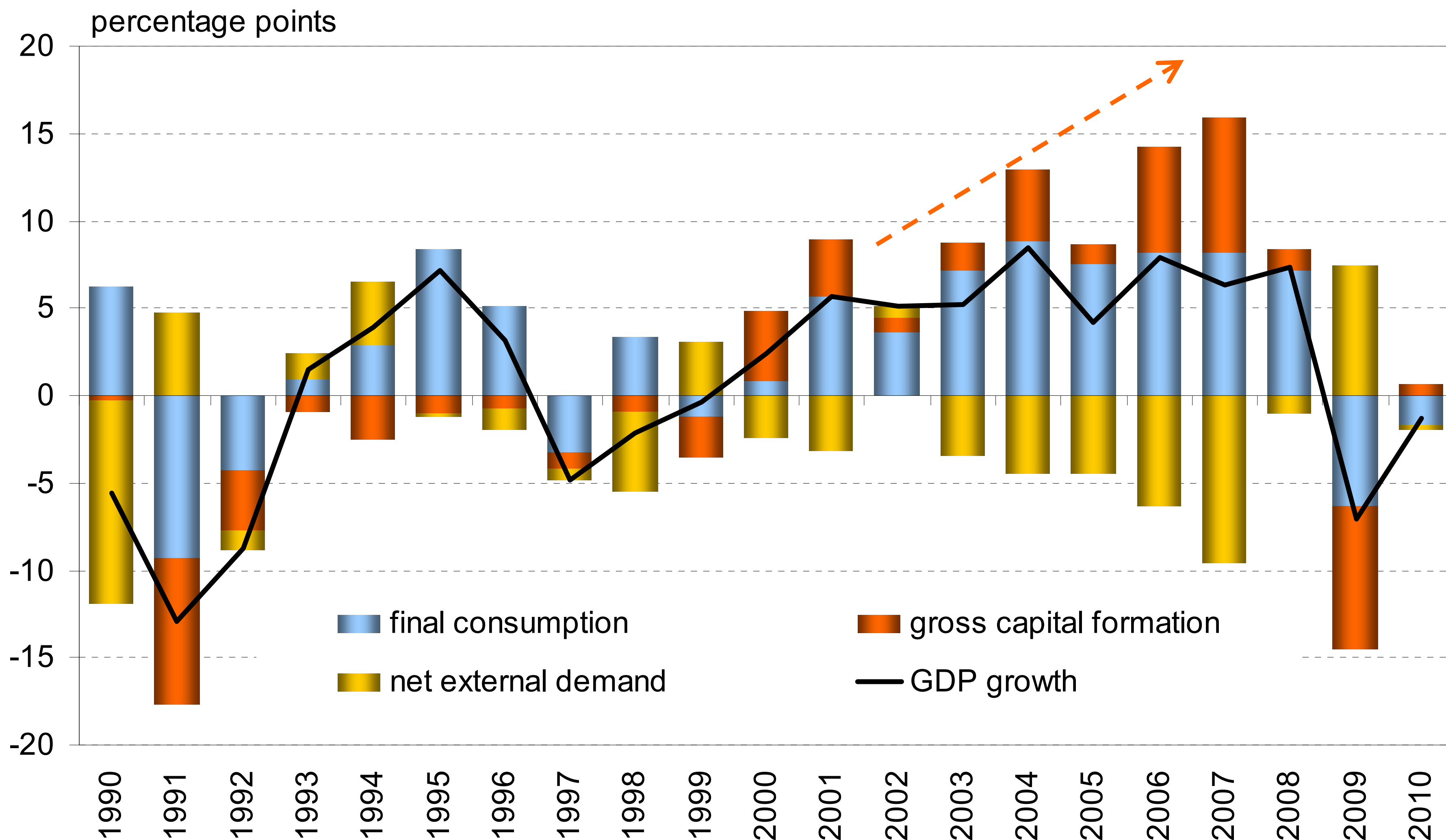
I. Is the discussion about changing the growth pattern properly tackled? (1)

- Since the beginning of the crisis we have been talking about changing the growth pattern. Many said that the growth pattern was inappropriate, and consumption was blamed for overheating

- Suggestions were made for investment to become the main growth driver. But the contribution of investment spending to growth increased in the period 2002-07

Engines of growth and their contribution to GDP dynamics



Source: NIS

Is the discussion about changing the growth model properly tackled? (2)

- Few recognized that the policy mix was wrong, as the fiscal policy was pro-cyclical
- Discussing about changes to the growth pattern in terms of what should be the main contributor to growth may be misleading. It is the (domestic and/or foreign) private sector that decides on the contribution of growth engines
- An example: Exports may become the main growth driver (as some analysts suggested) only if the private sector decides so. But even so, high dependence on exports is risky
- The focus has to be shifted to the appropriateness of the policy mix
- When capital inflows flooded Romania, the policy mix caused the economy to overheat. This time we should avoid making the same mistake
- We can learn what mistakes are likely to occur in managing growth

Growth in Romania depends heavily on capital inflows

Period	Average growth rate	Cumulated growth over the period	Foreign capital	Policy response
1990-1992	-9.1	-25.0*	low private capital inflows	
1993-1996	3.9	16.6	low private capital inflows	implicit interest and exchange rate subsidies
1997-1999	-2.5	-7.3	low private capital inflows	
2000-2004	5.4	29.8**	moderate private capital inflows	fiscal consolidation
2005-2008	6.4	28.2	high private capital inflows	pro-cyclical fiscal policy
2009-2010	-4.2	-8.3	high public capital inflows	expenditure-driven fiscal consolidation

* 3 years

** 5 years

- Lesson 1: We cannot control foreign capital …
- Lesson 2: … but appropriate policy measures can be implemented
  - ✓ Negative real interest rates and an overvalued currency are not sustainable, as proved in the period 1993-97
  - ✓ High private capital inflows during 2005-08 led to large imbalances and mismatches (we were fiscally undisciplined). Counter-cyclical fiscal policy to build buffers for the problems that may occur given a sudden stop
  - ✓ We were lucky (moderate capital inflows) during 2000-04, but also disciplined (implemented the IMF program)

II. Before and after capital inflows

- In a previous presentation*, I explained why the policy mix implemented in Romania starting with 2009 was the correct one
- My statement was based on findings of many papers on the expected movements in some key indicators during a period of capital flow bonanza and after a "sudden stop"
- The NBR favoured the idea of borrowing from the EU and the IMF to cope with dramatic turning points in capital flows and the current account deficit, the exchange rate, inflation and GDP growth

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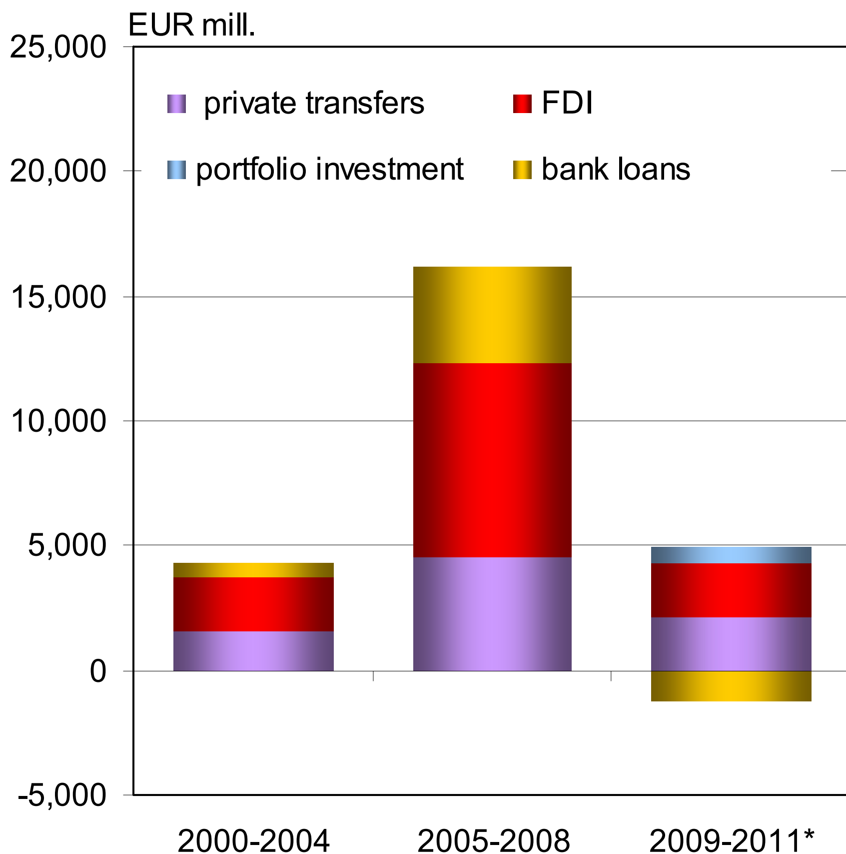
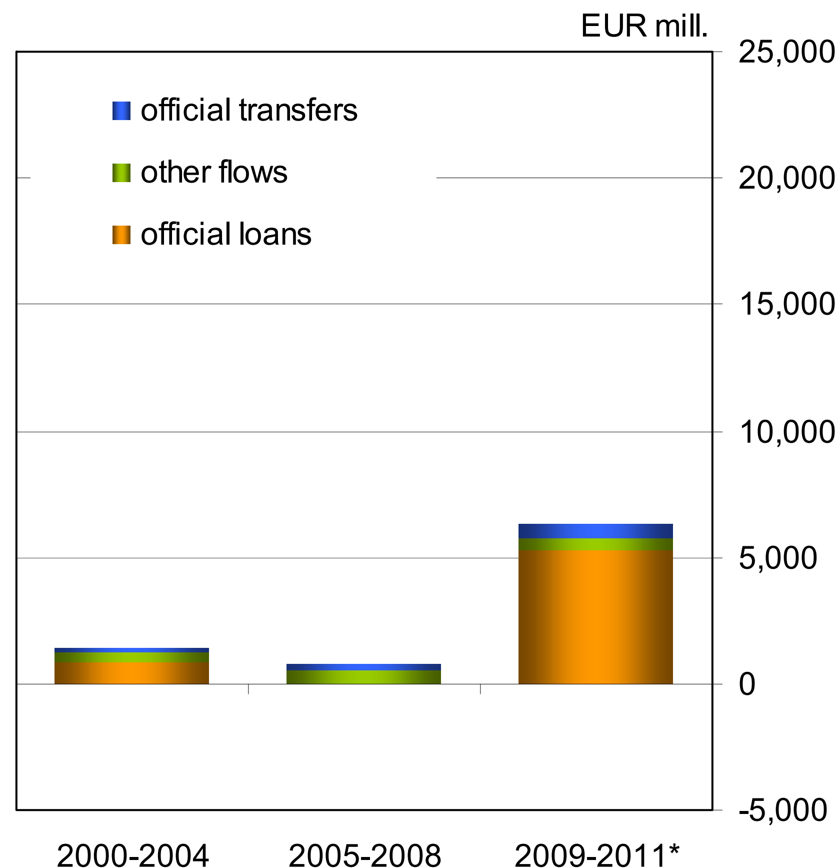
* *External deficit financing and macroeconomic adjustment during the financial crisis. The case of Romania,* July 2009

Romania: Capital flows before and after the crisis

Private capital inflows were three times higher than inflows from official bilateral creditors





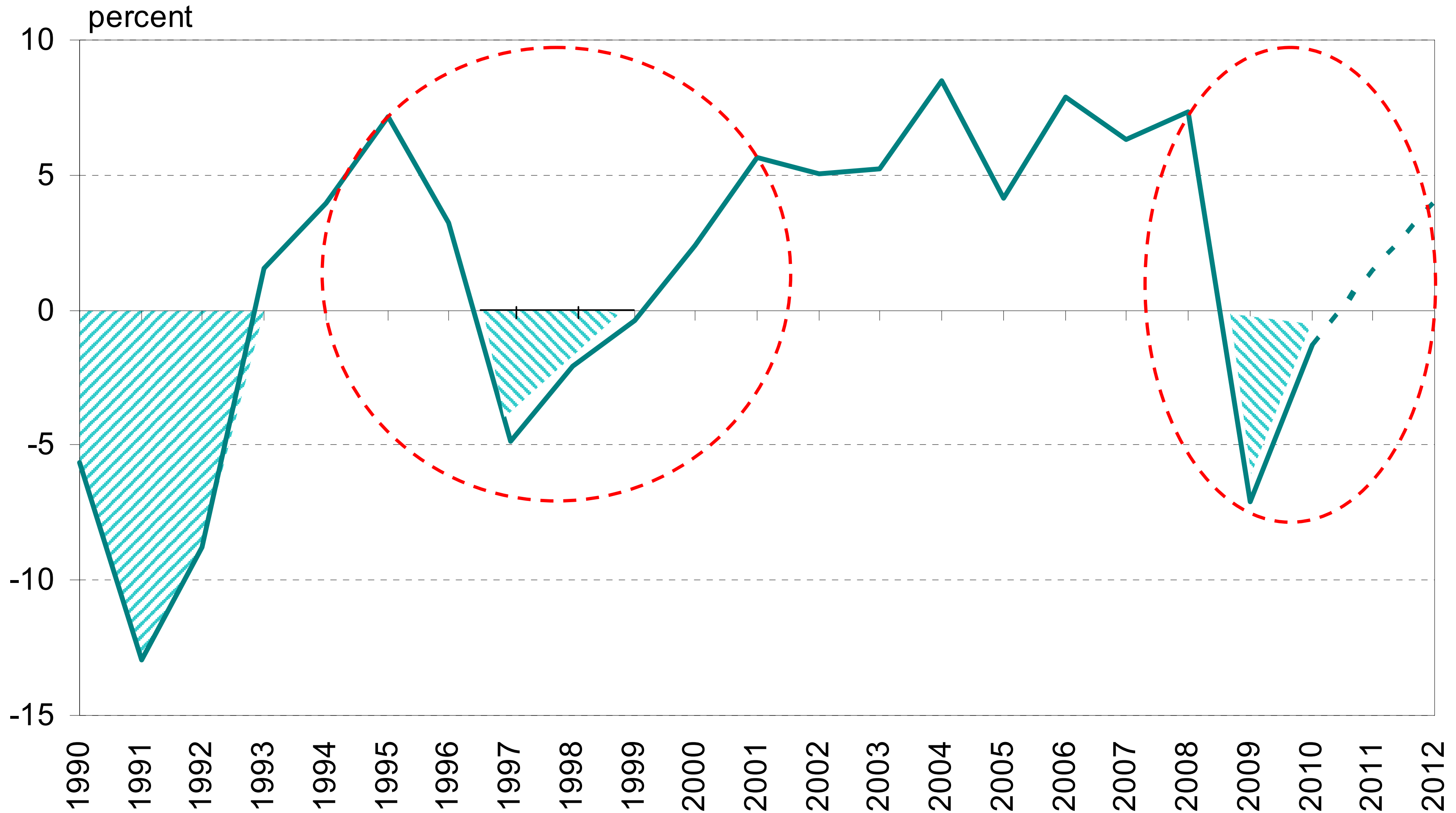
Note: average values based on annual data

Source: NBR

* January - February 2011

GDP growth rates in Romania*

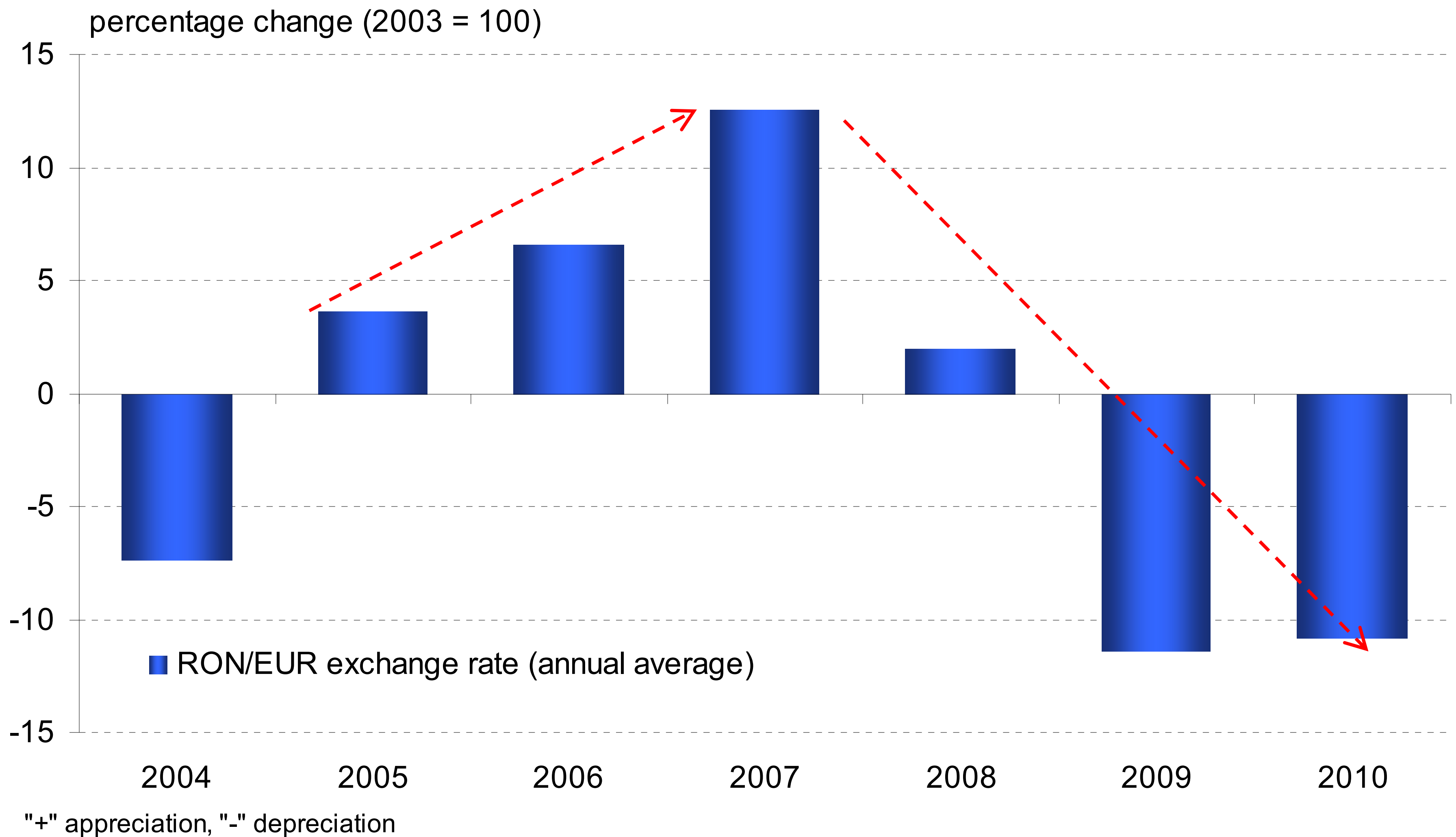
The “V” shape of GDP growth rates following sudden stop in capital inflows



Source: NIS, IMF

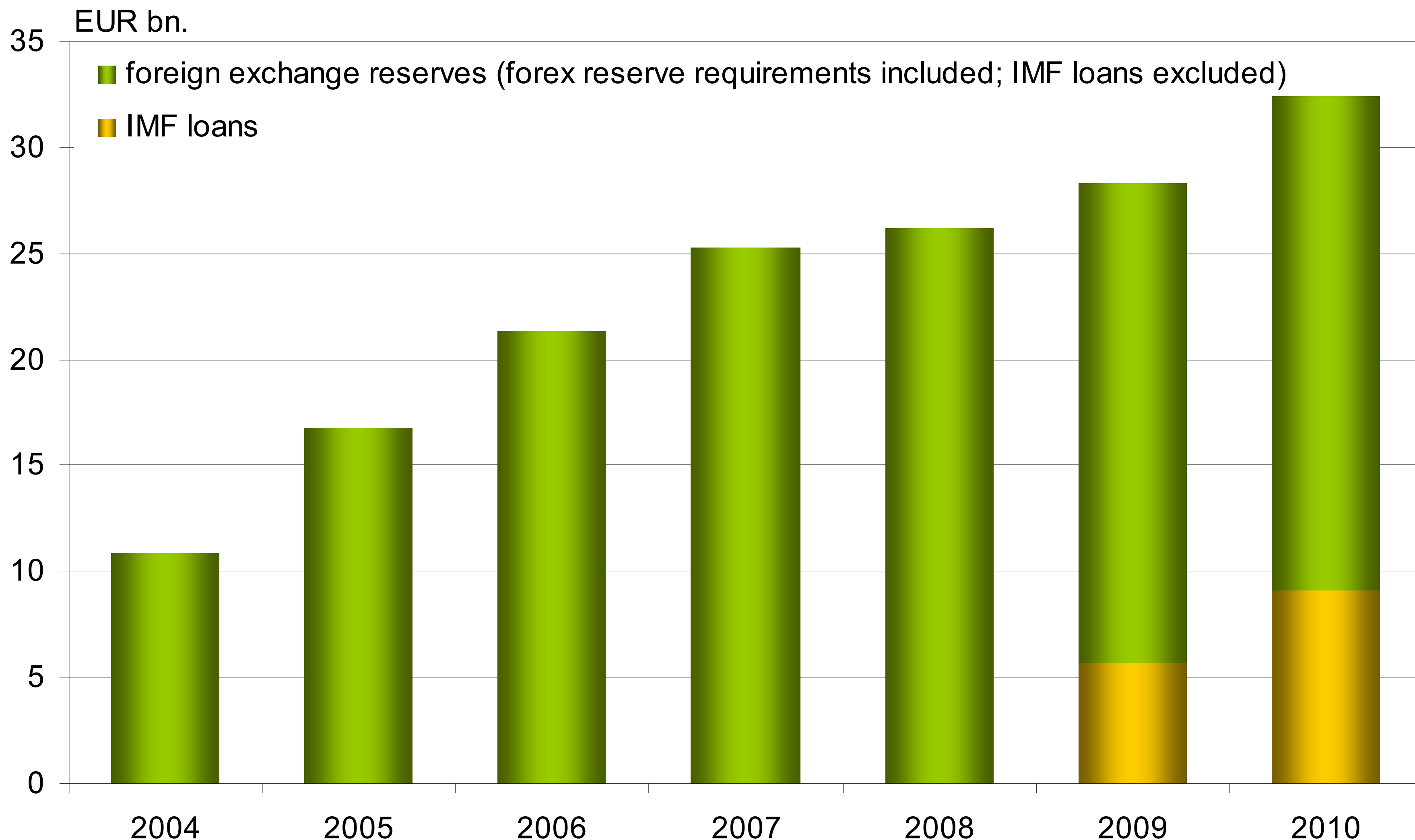
* forecasted growth rates for 2011 and 2012

Significant currency movements…



Source: NBR

…despite significant reserve accumulation, which would not have been possible without external financing support



Source: NBR

What are we facing now?

- Capital flows appear to re-emerge while inflation is rising
  - ✓ This phenomenon is manifest in emerging markets in Asia, Latin America and Central and Eastern Europe:
    - on the one hand, capital inflows put upward pressure on the currencies in nominal terms, thereby eroding competitiveness
    - on the other hand, imported inflation is the main determinant of higher CPI inflation in many of these countries

Real effective exchange rate (REER) and capital inflows structure

- It is essential to know the potential that various types of capital inflows have for REER appreciation. Combes, Kinda and Plane (2011) identified the following features:
  - ✓ Appreciation triggered by public capital inflows is higher than that caused by private capital inflows, suggesting that the latter are used for productive investment, while public flows are largely used for boosting government consumption
  - ✓ The 1pp increase in the ratio of portfolio investment to GDP is associated with a 7.8% REER appreciation
  - ✓ The 1pp increase in the ratio of FDI or bank loans to GDP translates into a 1% REER appreciation
  - ✓ The 1pp increase in the ratio of private transfers (mainly remittances) to GDP is associated with a 0.3% REER appreciation ⇨ remittances are counter-cyclical

The structure of capital inflows and the policy mix

- The structure of private capital inflows is mainly the result of decisions at company and household level. There is little that the public sector can do, except for ensuring a friendly business environment
- However, private investment depends on policy coherence. A flaw in the policy mix can be exploited by hot money

Tailoring economic policies to the new challenge: a closer focus on inflation

- Evidence seems to indicate a shift in focus on inflation in emerging markets
  - ✓ Fewer interventions and increased tolerance for appreciation to support inflation
    - compared to last year, many emerging markets have opted for fewer FX interventions (China, Peru, Israel, Korea, Taiwan, Indonesia, Brazil, Turkey, South Africa, Mexico, India)
  - ✓ Monetary policy tightening so as to prevent the worsening of macroeconomic and financial equilibria (Brazil, Israel, Turkey)
  - ✓ Increased resort to macroprudential measures in order to manage capital inflows, complementing monetary policy tightening

Perverse side effects of macroprudential measures

Long-term stability gains due to macroprudential measures entail further capital inflows

The tolerance for appreciation (fewer interventions) noticed recently may be reversed

Self-neutralizing potential of the structure displayed by FX market management measures (more frequent interventions)

Challenge for policies

Challenge for the economic policy mix

- The challenge consists in an integrated approach encompassing currency competitiveness (interventions), inflation (macroeconomic measures) and private sector (banks, companies, households) balance sheets (macroprudential measures)

- Tolerating an appreciation supportive of inflation might not be feasible in terms of the risks to private sector balance sheets

III. The fiscal illusion of cash deficits in a period with large capital inflows

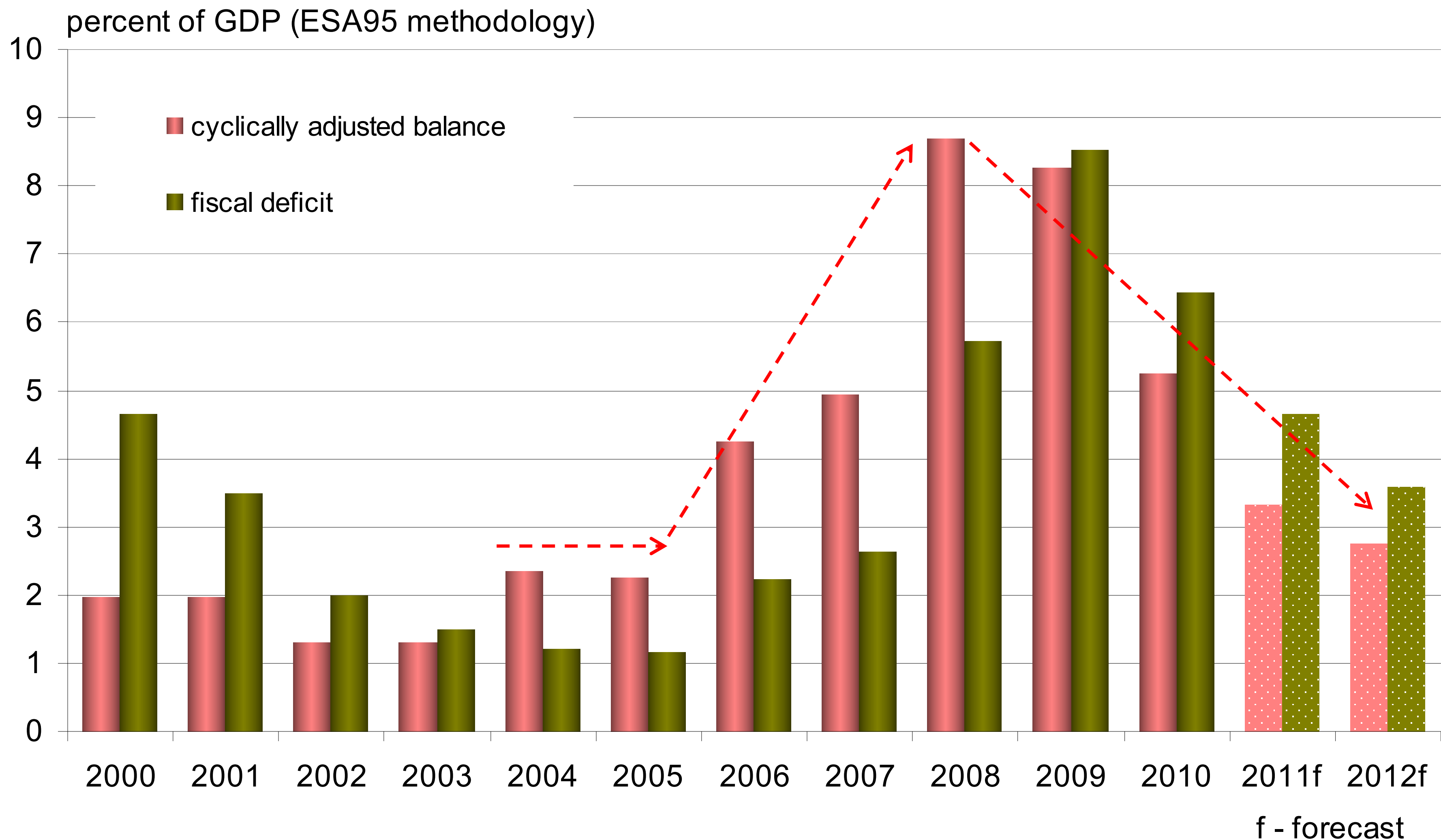
- Politicians were not concerned about budget deficits in the period 2006-08. They were convinced that Romania’s budget deficits were at low levels

- They were looking at deficits computed using the cash definition of the public sector deficit, not at deficits defined as structural deficits

  - ✓ Structural deficit = cash deficit – the cyclical component of the cash deficit

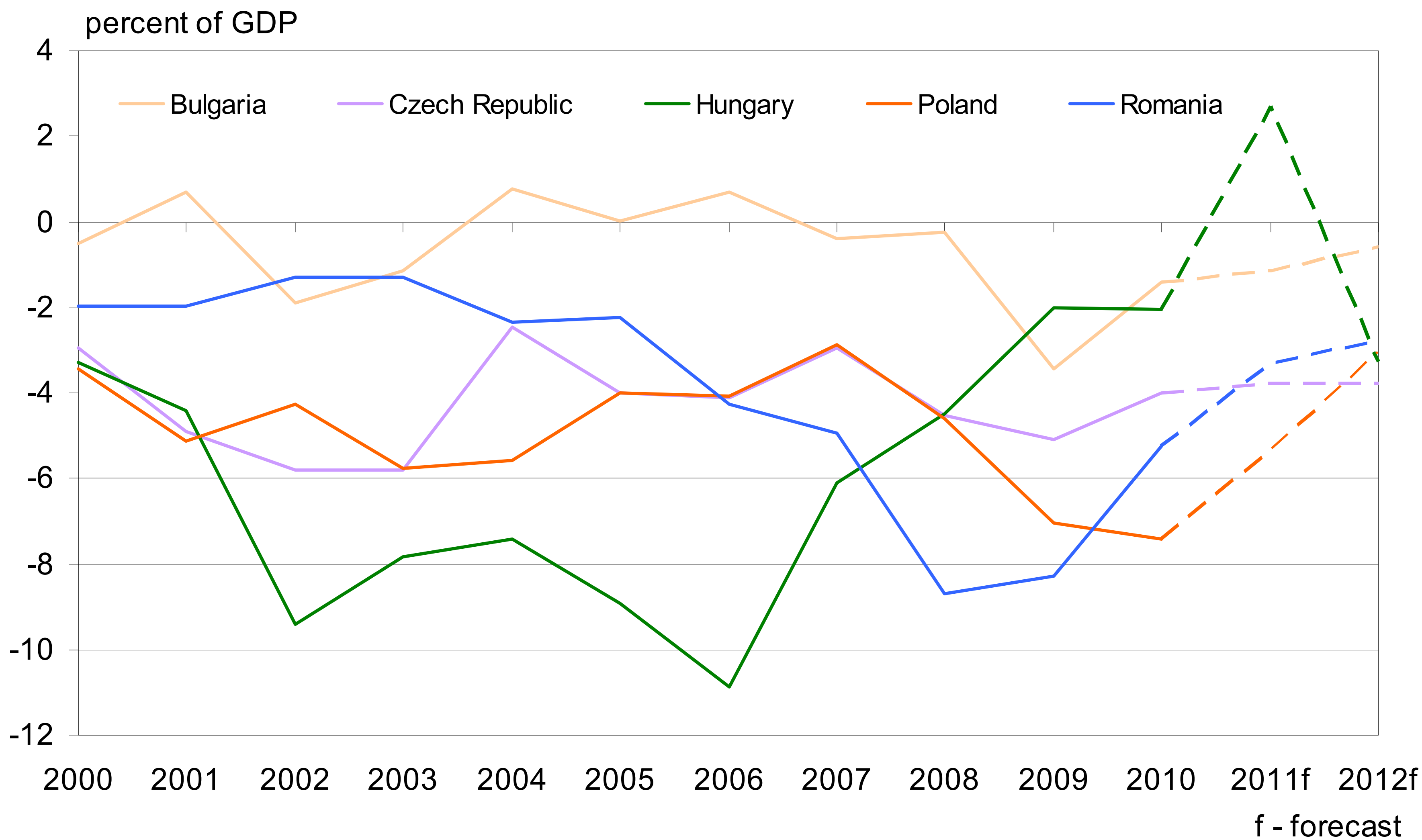
- Fiscal policy stance is estimated as a change in structural budget deficits

Cash and structural budget deficits: 2000-11



Source: European Commission

Structural budget deficits



Source: European Commission

Conclusions: we can have a different approach this time

- **When capital flows flood an economy**:
  - ✓ Addressing non-price competitiveness is more appropriate than protecting price competitiveness via forex interventions
    - competition is key to enhancing non-price competitiveness
    - reforms to enhance competition
- The public sector has to make room for the private sector development
  - ✓ On the ascending phase of the economic cycle, decreasing fiscal deficits or increasing surpluses are consistent with higher public expenditure in real terms
  - ✓ Is capital control a solution? NO. Capital flows always find a way out to intended destinations. There would be more distortions and less efficiency