Leonardo BADEA

POLICY PAPER

The need for sustainable accommodation of increased capital flows in countries with emerging economies

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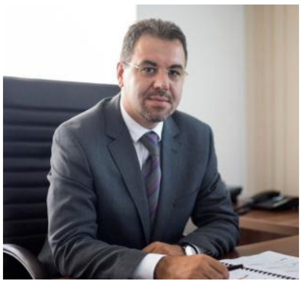
CONTACT:
Institute for Development and Social Initiatives „Viitorul”
Iacob Hîncu 10/1, Chișinău, MD-2005, Republic of Moldova
Telefon: (373-22) 22 18 44
Fax: (373-22) 24 57 14
www.viitorul.org

THE NEED FOR SUSTAINABLE ACCOMMODATION OF INCREASED CAPITAL FLOWS IN COUNTRIES WITH EMERGING ECONOMIES



Autor:
Leonardo Badea
Professor, Ph.D.
Member of the Board, Deputy Governor of the National Bank of Romania

It has been already said and proven that the current crisis has different characteristics and implications than other crises from the past. We are in the presence of a pandemic/medical crisis that is moving towards an economic crisis and perhaps even a financial one, further down the road. Financial packages and anti-crisis measures taken by national states, international and European bodies are necessary and helping, easing but not yet solving the situation.

The test for unity of Europe in the face of a once in a hundred years disaster, quickly followed by clear and decisive proves of solidarity took the form of a massive mobilization of nations and the initiation of unprecedented economic support programs.

We are in a situation of self-learning. It is very difficult to know from the beginning what the results of the economic measures will be (maybe this is exactly the challenge of economics), but we can discover along the way what type of instruments work under such circumstances (in a similar manner that we will discover the proper vaccine and treatment formulae for the disease). It is equally true that there are development gaps between European economies, some of them being differently (more heavily) affected and having to solve structural problems dating from before the crisis (also in a similar manner to how the disease has different – more sever – manifestations for individuals with already existing medical conditions).

For example, in Romania we are for quite some time aware of few economic problems, including a vulnerability related to the low level of financial intermediation which is around 26 percent for banking ((measured as bank credit to GDP) and around 17 percent for the non-banking financial market (measured as total assets to GDP). Under these circumstances, among the many important questions that we need to find answers/solutions for, we should also include the two listed below:

- How can this level of intermediation be increased, under the given conditions?
- What will be the mix of conditions that will catalyze the banking and non-banking financial players, local and abroad, and enable them to identify new/more opportunities to grow sustainably, and, while in the process, also to develop/enlarge the local market, given the (inherent) risks involved?

Everyone that looks at the economic growth of Romania, will find that it has been sustained and fast paced for the last 5 years, prior to the COVID-19 pandemics. Some will also find deficiencies, vulnerabilities and embedded risks. Some of them are natural, as there is no doubt that we will probably always be able to always identify some risks in everything that is rapidly growing. Nevertheless, this proves that our economy has potential and resources, and will continue to offer growth opportunities to investors, even under a more balanced and conservative policy framework.

Let's also not forget that the Romanian capital market has passed to the status of emerging secondary market, which will enter into force starting with September 2020.

These are only a couple of top-level arguments towards the hypothesis that banks should be able to spot financing opportunities and can expand the products that they are offered for the local public and companies. This is will be facilitated especially if we will manage to architect a reshape of the capital structure of the companies. In fact, we are facing an economic challenge, which can be solved if two conditions are met cumulatively: the first, for companies in general, to (re)capitalize in order to increase the number of bankable companies, and the second, for banks, to identify the business opportunities.

But banks are not the only actors of the financial system. As already mentioned, non-bank financial intermediators also can play an increasing role. From the point of view of capital market financing, European countries, and even more so the Eastern European countries, do not have such a significant and successful tradition in comparison with the US. In Romania also, the banking system is the main financier and that is why the financial flows generated by it are (the most) important. But financial flows generated by the capital market, have some history already and can become more relevant, with time. Among them, foreign portfolio flows are very important as a signal of confidence in the Romanian economy.

The economic changes that will follow the current medical crisis are inevitable. The COVID-19 pandemic determined an impetus for the adoption of fintech solutions in the economy and financial system. The non-banking financial companies are currently more used to such instruments and technologies, than the more prudent and heavily regulated banks. Thus, the crisis could furthermore accentuate a trend that was already emerging before the crisis: the increase in the role of non-bank financial intermediators. This could enhance the capital market related financial flows, with their advantages and with their already known (and maybe with some additional unknown) caveats.

Foreign portfolio flows, which are usually linked with capital market related flows, are recognized for their potential to increase the levels of volatility for key financial and macroeconomic variables, that's why it's essential that emerging countries in particular have robust economies able to withstand the shocks of sudden stops of capital flows or even large withdrawals. Still, the foreign portfolio flows should not be ignored as they can complement the larger and more significant foreign direct investment flows that are usually in the spot light, especially in emerging economies, and particularly in Romania, can also contribute to the much needed increase of the level of financial intermediation (via the local investment funds).

Foreign investments represent a key driver of economic performance and macroeconomic equilibria. Especially for small open emerging economies, as it is the case of the Romanian economy, where the local capital is usually insufficient to support the normal functioning and development of all the branches of the economic activities, foreign investments (or lack thereof) have a determinant impact of the overall output and are shaping the structure of the economy, influencing the capital formation and the level of external competitiveness. From another point of view, small emerging economies are also, in general, characterized by shallow capital markets, thus the inflows and outflows of capital usually have an impact on demand and supply of several classes of financial assets, influencing the trends (over medium term) of their prices, as it happens with listed equity prices, bond yields and interest rates or FX rates.

There is also an indirect effect of foreign investments on the above mentioned economic and financial variables, because their size and direction of flows are often compared by analysts and investors with the size and dynamic of the current account balance (which partly describes the external position of a country). Thus, the foreign direct investments are interrelated with the overall investor sentiment towards that country and reflect the level of trust that the investment community has in its future prosperity, predictability, good functioning and fairness in conducting business.

Potentially volatile foreign portfolio flows can complicate the macro-financial policy framework for emerging economies and could have negative implications for the financial stability, leading to the materialization of vulnerabilities and facilitating contagion. According to a study included by ECB in its June 2011 edition of Financial Stability Review, two years before the 2013 “tapper tantrum” that followed the announcement made by the FED that it would be reducing the pace of its purchases of Treasury bonds, “over the short term, foreign portfolio flows driven by volatile factors, such as, for example, herding behaviour among investors, the search for yield and global risk appetite, could lead to a mispricing of financial assets, with the associated risk of a sudden adjustment.” There were quite a few other very well-known situations where foreign portfolio flows were associated with episodes of financial instability in emerging markets, just to give the examples of the Mexican crisis in 1994 and the Asian crisis in 1997. The most prominent negative effects identified by the ECB study were related to increased exchange rate and asset price volatility, followed by a sudden deterioration in the domestic financing conditions.

Having all these in mind, many macroeconomic analysts and researchers are studying the pattern of evolution of the foreign investments, both in total and on components, and investigating the interlinkages with relevant macroeconomic and financial variables, at national or regional level. While most studies on foreign direct investments look to identify links between their evolution and macroeconomic developments, the foreign portfolio investments are mostly investigated in relation with financial market movements. More specifically, comparing and summarizing the most relevant research papers in this field, most studies could be categorized according with two main criteria:

- The type (nature) of the economic variables that are investigated in relation with the foreign portfolio investments, mainly having two categories: financial markets variables and macroeconomic variables
- The nature (direction) of the relationship, also having two possible types of studies: one where the authors look for the determinants of foreign portfolio flows and another category where the effects of these flows are investigated.

A more encompassing approach bridges the two perspectives when analyzing the foreign portfolio investments, looking at foreign portfolio investments both in total and in the main components and, sequentially, testing their links with a selected set of relevant variables that include some related to the evolution of the financial markets but also others related to the evolution of the real economy.

A recent study that I have done having in mind this comprehensive approach, on data both at the monthly and the quarterly frequency, using methods that include the OLS linear regression, VAR models and Granger causality tests, offered enough statistically evidence to argue that, for Romania, during 2005-2009, there were statistically significant linkages (at levels of confidence ranging from 90% to 99.5%) between most measures of foreign portfolio investments and the main local equity market index (BET Index), long term fixed income instruments yields (10yr Romanian sovereign bonds issued in local currency), EURRON exchange rate and net exports.

At the same time, our results do not offer enough evidence to support the hypothesis of an existing link between changes in foreign portfolio investments and the variation of money market rates, gross fixed capital formation or gross value added.

Understanding the particularities of the effects of foreign portfolio investments to the Romanian financial markets and economy is important because policy responses need to be adapted to individual countries' circumstances. Thus, maintaining a proper mix of macroeconomic and macroprudential policies, doubled by a flexible but efficient and robust framework for financial regulation and supervision will facilitate an increase in financial intermediation, in the presence of well calibrated structural reforms, while mitigating the potential risks organically associated with foreign portfolio flows.

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