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The views expressed belong to the author and are not necessarily shared by the ECB and the Eurosystem. Thanks to Roland Beck, Catherine Casanova and Fabrizio Venditti for useful comments.

The EME policy reaction in the Covid episode: what is new?

CEMLA-FRBNY-ECB Conference
Policy Panel
9 July 2021
The Covid shock on capital flows

Capital flows in response to crisis episodes

The EME policy reaction pre-Covid

- Ferrero, Habib, Stracca and Venditti (2021)
  - Following an adverse global financial shock, EME experience falling stock prices, rising spreads, and depreciation
  - Countries loosen macro-prudential policies, some also use reserves and capital controls/CFM
  - Policy reaction depends on the quality of institutions: more muted with higher quality (except monetary policy) but still better outcomes
  - Institutions rule!
The EME policy reaction in the Covid episode

- CGFS report: “The changing pattern of capital flows”
  - Amplifying role of market finance in March 2020 (non-bank intermediaries and rating agencies)
  - EME however proved more resilient than in the GFC, for several reasons
    - Massive stimulus in advanced economies, plus swap and repo lines and new IMF instruments
    - More policy space in EME, which led to more countercyclical monetary policy (Aguilar and Cantu 2020) but less use of CFM
    - Better fundamentals in EME (e.g., better anchoring of inflation expectations), less over-heating pre-crisis; local currency sovereign debt (mixed blessing)
    - New tool: EME asset purchases (even at r>0) have eased financial conditions in emerging economies (Mimir and Sunel 2021)
      - If asset purchases cause a de-anchoring in inflation expectations, their effectiveness diminishes
A new paradigm for the future?

- Maybe
  - Have EME “graduated”?
  - ADV/EME distinction blurry – e.g., EME-like ADV; high debt burden in both, which may imply negative externalities
  - Not all of them – institutions continue to be important, and markets have discriminated
  - The recovery in flows has been uneven across countries, asset classes (CGFS 2021)
  - Advanced economies and EME pulled in the same direction – not necessarily the case in the future
  - Higher inflation environment post pandemic: ADV more likely to “look through”, but some EME cannot afford it