EUROPEAN CENTRAL BANK
EUROSYSTEM

**Livio Stracca**
*European Central Bank*

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.

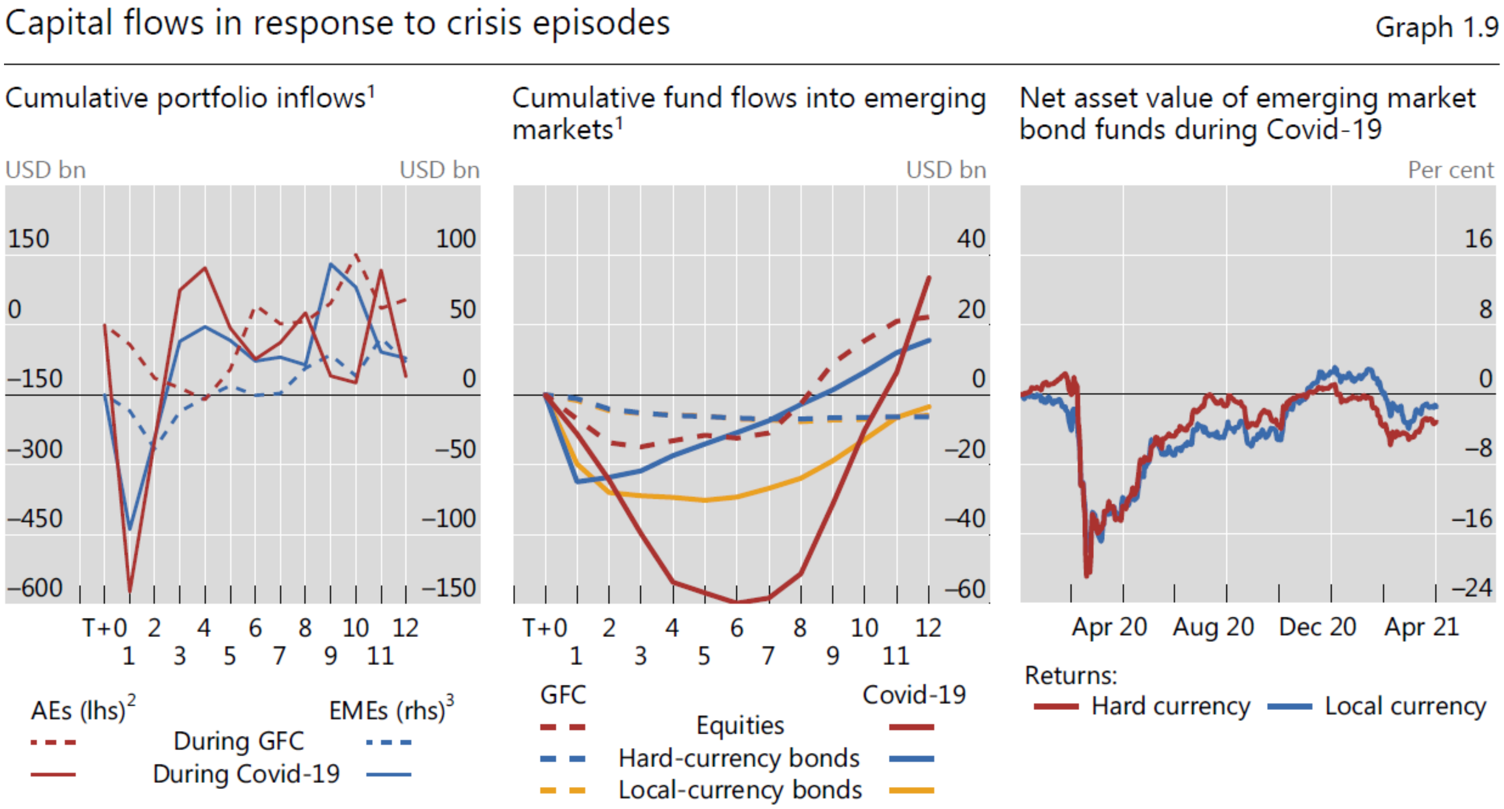
# The EME policy reaction in the Covid episode: what is new?

CEMLA-FRBNY-ECB Conference

Policy Panel

9 July 2021

# The Covid shock on capital flows

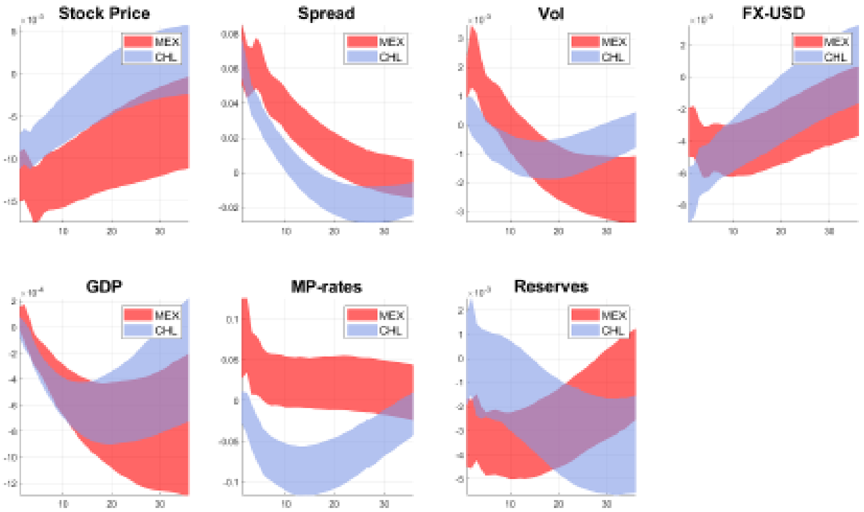



Source: CGFS (2021): Changing patterns in capital flows, https://www.bis.org/publ/cgfs66.pdf.

# 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!

Figure 1: The effects of a global financial shock on Mexico and Chile



# 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