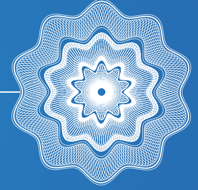
İMB BULLETIN

ISTANBUL SCHOOL OF CENTRAL BANKING

TÜRKİYE CUMHURİYET MERKEZ BANKASI



Issue:4 / January –June 2015

"Monetary Policy Workshop" merged theory with practice

The İMB organized the "Monetary Policy Workshop" in Izmir on May 28-31, 2015 and hosted 42 participants from 25 central banks. The program brought together central bankers and leading academics to discuss three major topics for monetary policy-making in the current global environment: (i) Credit Conditions and Banking, (ii) The Housing Market, Crises and Macroprudential Policies, (iii) The Aftermath of Quantitative Easing for Emerging Economies. In the morning sessions, each of the three topics was discussed by an experienced scholar in a seminar format that combined experience and practice as well as mentioning empirical and theoretical literature. In the afternoon sessions, experts from several central banks delivered presentations on the topics as seen through their experience and the policy approaches used in their countries.

Following the opening remarks made by Erdem Başçı, the Governor of the Central Bank of the Republic of Turkey (CRBT), the first day of the workshop started with a lecture by Gregorio Impavido from the International Monetary Fund (IMF). In the first half of his lecture, Impavido presented his research on financial stability and bank ownership in the Central, Eastern and Southeastern Europe (CESEE) region, where he examines whether foreign ownership amplified the credit boom and bust in the pre- and post-crisis periods. His findings suggest that foreign banks amplified the credit cycle only before the crisis. The second part of Impavido's lecture dealt with nonperforming loans (NPLs) in the CESEE region. Impavido stated that NPLs are a cause of concern because they can potentially lead to financial instability and the problem of debt overhang as well as drag out economic recovery. In the CESEE region, capital adequacy is high enough to absorb resolutions even in the most severe scenarios, debt levels are beyond their pre-crisis levels and debts mostly belong to non-financial corporations, so financial instability and debt overhang are not of concern. However, NPLs present a problem for speedy recovery as high NPLs increase funding costs and interest margins on the supply side and lead to reduced credit growth.

Impavido's lecture was followed by country experiences from Macedonia, Albania and Hungary which gave the participants a flavor of the country-specific effects of the crisis and the various macroprudential tools employed. Frosina Celeska from the National Bank of the Republic of Macedonia compared the high and low credit growth periods in Macedonia. Following the Macedonian experience, Erjona Rebi from the Bank of Albania analyzed the deleveraging period after the crisis and the concerns about the slowdown in lending and its impact on economic growth. Finally, Adam Banai from the National Bank of Hungary discussed the weakness of lending conditions in Hungary and presented the government mortgage schemes to tackle the issue of household borrowing.

The second day of the workshop was about the housing market, crisis and macroprudential policies. Abdullah Yavaş from University of Wisconsin-Madison, also a member of the CBRT Monetary Policy Committee, delivered a presentation on the topic at the morning session. Yavaş began by showing a global picture of the housing market to stress that it is a global concern. He pointed out the difficulties of detecting a bubble as it is even hard to define one. Using historical examples and research experiments, Yavaş argued that a bubble is unavoidable but is not necessarily harmful. If bubbles are accompanied by excessive lending, then the bursting of a bubble may create real problems. Central banks, as the lender of last resort, cannot avoid getting involved with bubbles; hence the question is when to get involved. Arguments can be made both in favor of and against intervening before or after the bursting of a bubble. The judgement call of when to interfere and how strongly is influenced by many factors. Yavaş discussed possible macroprudential policies against bubbles, such as loan-to-value ratios (LTVs) and concluded his talk by

ABOUT US

The Istanbul School of Central Banking (İMB), founded by the Central Bank of the Republic of Turkey (CBRT), provides a setting for thought provoking discussions and analyses on global economic and financial challenges with a specific interest in central banking topics. The School organizes research activities and training programs and engages in technical cooperation with central banks to promote collaboration on central banking.

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drawing attention to how one should still be watchful while using these policies since they are not infallible.

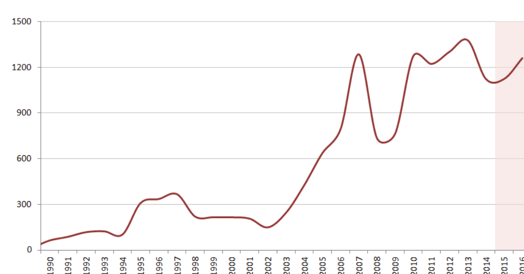
In the second half, the representatives from the central banks of Spain, Philippines and the Czech Republic shared their experiences in the housing market. Drawing on the housing bubble experience in Spain, Jesus Saurina from the Bank of Spain emphasized that while implementing macroprudential tools, one should be aware of the limitations of these tools. The Spanish experience also stressed the importance of lending standards to a safe and sound banking system. As a different experience in housing market, Evelyn Santos from the Central Bank of Philippines argued that the growing housing sector helps economic growth in Philippines. Despite the lack of evidence for the presence of a bubble, they are aware of the potential harm and are implementing a number of macroprudential policies. One such policy is to impose a 20 percent ceiling on the share of real estate in total loans. Jan Bruha from the Czech Republic shared several of their studies conducted on the housing market with the participants. In one particular study, they have constructed a dynamic stochastic general equilibrium (DSGE) model with housing and found that the model can replicate the business cycle facts about the housing market.

On the last day of the workshop, the executive director of the CBRT's Research and Monetary Policy Department, Mustafa Kılınç, explored how quantitative easing policies affected emerging economies in general. He started his talk by reminding his audience that the global financial crisis was a wakeup call that totally changed views about the efficiency of financial markets. Kılınç listed the major concerns in the post-crisis period as asset prices, housing sector, currency values, deleveraging in advanced countries vs excessive credit growth, volatile short-term capital flows, and current account issues in emerging countries. He suggested that although there is a consensus on the problems, there is not much agreement on the policy responses.

From the viewpoint of emerging economies, the most significant impact of the QE period was the excessive global liquidity that was channeled into the financial markets of these economies. Policies used by emerging economies to mitigate the negative impacts of the surge in capital flows were discussed during his speech. Kılınç explained that Turkey has been one of the interesting cases of emerging economies that proactively use new tools to alleviate the impact of capital flow volatility on domestic economy. How these tools smoothed capital flow volatility was explained during his talk.

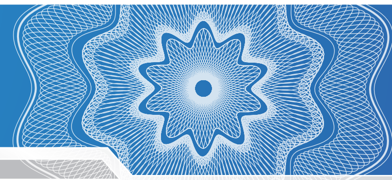
Following the talk given by Mustafa Kılınç, country experiences of the effects of QE were discussed. Witold Grostal from the National Bank of Poland explained that Poland has been somewhat affected by the QE carried out by the Fed. The ECB's full-scale QE that came soon after the tapering of the Fed, however, alleviated the negative impacts of the reversal of the QE period. He also commented that with the possibility of further capital inflows, the central bank faces a dilemma between lowering interest rates and keeping them unchanged given the solid economic performance of the country. The second country to share its experience was Malaysia. Fraziali Ismail from Bank Negara Malaysia discussed why these capital inflows resulted in less volatility in bond yields and stock markets in some countries. In the case of Malaysia the answer to this question was offsetting capital outflows that mitigated the impact of capital inflows. Differences in policy reaction to capital inflows observed in the aftermath of the QE period were also discussed. Among many other measures, Malaysia used sterilized intervention, an increase in reserve requirements and liberalization of capital outflows. Lastly, Biswajit Banerjee from the Bank of Slovenia observed that following the global financial crisis, Slovenia is facing a decoupling of real and financial cycles. He also stated that non-standard policy measures in Slovenia will be more effective with lower credit risk, efficient enterprise restructuring and more developed markets for alternative assets.

Capital Flows to Emerging Markets (billion US dollars)



Source: IIF.
* 2015 and 2016 values are forecasts.

Episodes of Capital Flows to Emerging Markets: *During his presentation, Mustafa Kılınç from the CBRT emphasized that the first episode of capital flows to emerging markets started in the 1990s and ended with the Asian crisis in 1997, leaving many emerging economies (EMEs) with financial strains. He noted that in response, many EMEs significantly improved their macroeconomic fundamentals by going through structural reforms and enhancing the composition of capital inflows through an improved debt structure. Mr. Kılınç highlighted that the second episode started around 2002 and continued until 2008. In this second wave, he said that EMEs improved on capital account openness and became more closely tied with the rest of the world through increased trade and financial channels. He called this period a phase of greater integration for EMEs.*



From Courses and Seminars in the First Half of 2015

The İMB organized three seminars and two workshops in the first half of 2015. Overall, 150 participants from central banks and related policy institutions attended the İMB seminars and workshops. The İMB events provided a platform for those participants from 49 countries to meet and share their experiences.

The *"Human Resources at Central Banks"* workshop, held on April 8-10 in Istanbul, is a new program designed by the İMB. It drew considerable interest among central banks and hosted 28 high-level representatives from 25 countries. This 3-day workshop reviewed career management, recruitment, and training issues from a different perspective. This event was planned to be discussion-based and all participants made contributions to the program through discussion or presentations using their country experiences and practices in human resources policies.

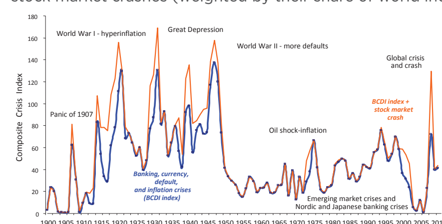
The second event, the *"Balance of Payments and External Statistics"* seminar, held on April 27-29 in Istanbul, discussed the methodology for collecting and compiling external sector statistics in line with internationally accepted standards, along with the practice in Turkey. The seminar for 25 representatives from 21 countries offered a platform to share experiences on many practical issues. It covered the underlying concepts of balance of payments and external statistics as well as enabling representative-presentations from the Central Bank of Slovakia and Morocco to elaborate on their respective country practices.

The *"Financial Stability, Financial Crises and Monetary Policy"* seminar was held on May 4-8 in Istanbul and hosted 28 representatives from 21 countries. Serkan Arslanalp from the IMF, Stephen Cecchetti from Brandeis University and Mahir Binici and Salih Fendoğlu from the CBRT delivered the seminar and shared their experiences with the participants. The seminar discussed standard models of currency and banking crises, presented international good practices with respect to macroprudential policies to safeguard macrofinancial stability and reviewed country experiences with capital inflows and policy responses to manage capital flow volatility, and their implications for foreign exchange stability in small open economies. The seminar also provided an emerging economy perspective using Turkey's experience by presenting the implications of macroprudential and monetary policies for macrofinancial stability.

Crises recur: now and then, here and everywhere, but of various types

Varieties of crises: World aggregate, 1900-2010

A composite index of banking, currency, sovereign default and, inflation crises, and stock market crashes (weighted by their share of world income)



Source: Reinhart and Rogoff in Claessens et al. (2014) Financial Crises.

Remark from the "Financial Stability, Financial Crises and Monetary Policy" seminar:

Serkan Arslanalp from the IMF explained that crises are extreme forms of booms and busts and recur in time, in different countries but in various types. He indicated that crises are often preceded by booms in asset prices and credit, which have multiple causes such as productivity increases, financial liberalization/innovation, and external shocks. However, overspending and/or overleveraging in some way without a proper "rainy day fund" are common features prior to almost all crises.

The *"Monetary Policy in Emerging Economies"* workshop, explained in detail in the previous pages, was the fourth event in the first half of 2015. This program welcomed 42 participants from 25 countries and offered a forum for both central bankers from different countries and leading academics to discuss the major concerns of emerging economies.

The *"Global Financial Integration and Capital Flows"* seminar organized on June 10-12 in Istanbul was delivered by John Beirne, Luca Dedola from the ECB along with Birol Kanık and Osman Furkan Abbasoğlu from the CBRT. The seminar hosted 26 representatives from 16 countries. The seminar presented the main theoretical considerations underpinning the benefits of having in-place international capital mobility and reviewed issues regarding management of capital flow volatility, factors driving the scale and composition of flows, and potential risks from having a fully integrated capital market. Furthermore, the seminar discussed policy tools adopted by different countries that reduce capital flow volatility and the effectiveness of these tools from an emerging market perspective. A representative from the Central Bank of Mexico shared the Mexican experience on management of capital flows with the participants at the seminar.

Major sell-off periods in global asset markets - 32 day period

Event	32 day duration commencing	EM equity index ?	AE equity index ?	EM bond index ?	AE bond index ?
Black Wednesday	16 September 1992	6.67	-2.38	n/a	-0.17
Tequila Crisis	20 December 1994	-14.09	-0.19	-11.81	2.23
Asian Crisis	2 July 1997	-6.37	-1.15	3.47	-0.84
Russian financial crisis	17 August 1998	-11.81	-7.17	-12.22	7.53
Dot-com bubble	10 March 2000	-14.55	0.76	-1.51	-0.22
September 11 attacks	11 September 2001	-2.90	1.70	-1.26	0.23
Lehman collapse	16 September 2008	-33.49	-25.45	-18.81	-2.01
Euro area sovereign debt crisis	27 April 2010	-11.77	-11.18	-0.98	-1.45
August 2011 stock market fall	01 August 2011	-18.63	-12.48	-0.86	0.64
May 2013 sell-off	22 May 2013	-13.30	-4.31	-8.77	-1.72

Source: ECB

Remark from the "Global Financial Integration and Capital Flows" seminar:

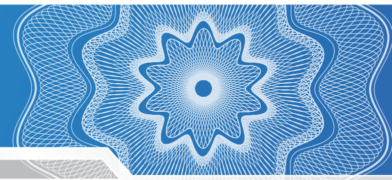
John Beirne from the ECB pointed out the power of the Fed's statements on the global asset markets. He presented a table which shows the effect of significant events on the equity and bond indexes of Emerging Markets and Advanced Markets. The table demonstrated that the effect of the Fed's statement on May 22, 2013 on global markets, where it signaled its intention to taper its bond-buying program some time in 2014, had a comparable impact to the Tequila crisis in 1994, the Dot-com bubble in 2000 and the Euro area sovereign debt crisis in 2010.

The İMB Offers Fruitful Environment for Research Discussions

During the first half of 2015, Loris Rubini from the Universidad Catolica de Chile, Selva Bahar Baziki from Uppsala University, François Velde from the Federal Reserve Bank of Chicago, Sina Ateş from the University of Pennsylvania, Fatih Yılmaz from ADA University, Ahmet Akyol from York University, Peter McAdam from the European Central Bank, Hakkı Yazıcı from Sabancı University, Yun Zhu from St. John's University, Emrah Şener from Özyeğin University, Serdar Özkan from the University of Toronto and Miguel Leon-Ledesma from the University of Kent all delivered seminars on various topics.

Loris Rubini presented his recent work on "Trade Costs and Markups" co-authored by Alexander McQuoid on the relationship between trade costs and markups of heterogeneous firms. He highlighted three stylized facts: 1) Markups are higher for exporters than non-exporters, 2) Markups increase when firms enter the export market and 3) Domestic and foreign sales of firms are negatively correlated. He presented a model with decreasing returns to scale in production, and three shocks that hit firm productivity, domestic demand and foreign demand. In his model, decreasing returns to scale in production play a pivotal role in explaining the empirical regularities. When we consider a positive domestic demand shock, additional firm output leads to increasing marginal costs which causes firms to increase prices in the foreign market where demand is unchanged. This results in a decline in foreign sales and consequently a negative correlation between domestic and foreign sales.

Rubini and McQuoid calibrate their model to Chilean firm data to analyze the explanatory power of their model. The measured correlation between domestic and foreign sales in the data is -0.19. However, in their model this correlation is -0.15. The decreasing returns to scale technology brings a negative correlation between the sales in the two markets while productivity shocks create a positive one. The net negative correlation points out the significance



of decreasing returns to scale in production. Rubini also stated that the distribution of markup responses of firms to a reduction in trade costs is heterogeneous, and this heterogeneity depends on firm-specific characteristics, elasticity of demand, and production scale. If a trade cost reduction is causing firms to start exporting, then these firms reduce their markups. However, if the same reduction causes some other firms to increase exports, then these firms tend to increase their markups. The mechanism is as follows: For new exporters, expansion in output due to exports implies an increase in marginal costs and consequently a reduction in markups. For currently exporting firms, reducing trade costs means reducing marginal costs. At the same time output expands, and due to the decreasing returns to scale technology, marginal costs go up. The ultimate net impact on markup for these firms depends upon the relative strength of each of these two forces. Their study shows that the net impact is driven mainly by the relative elasticity of domestic and foreign demands. Rubini concluded by stating that policymakers should be prepared for very different adjustments to trade liberalization along different margins.

In another seminar, *Hakkı Yazıcı* from Sabancı University gave a talk entitled "Idiosyncratic Risk and Skill Premium" (joint work with Ctirad Slavik from Goethe University Frankfurt). Wage inequality is significantly higher today than it was a few decades ago. The same holds true for both residual wage inequality and the skill premium as well. Residual wage inequality is the variation in workers' wages that cannot be explained with observable differences such as education, age, experience, etc. Skill premium is generally defined as the wage gap between workers with and without a college degree. Their work took the increase in residual wage inequality as a given and shows that it can increase skill premium using a model with skilled and unskilled labor, labor income shocks (residual inequality), capital-skill complementarity and skill-biased technological change.

The Descent of Central Banks

François R. Velde from the Federal Reserve Bank of Chicago gave a seminar entitled "The Descent of Central Banks" in which he reviewed the history of early European banks (1400-1815), using the evolutionary framework. He explained that the first appearance of these institutions was in the 1400s and the ending of the Napoleonic Era in 1815 led to the extinction of many early banks. Within the Darwinian metaphor, the presentation utilized the life histories of individual institutions, proposed a classification and suggested some hypotheses addressing the origin of today's species of central bank. There are two types of evolutionary processes: internal and external. The former refers to a process that takes place in response to local failures, while the latter addresses more clear observations such as the foundation of new institutions and the attempts to imitate the best models applied in other areas. According to Velde, the fundamental reason for the creation of public banks was to institute a reliable type of asset and the new system not only compensated for the damage stemming from the failures of private banks but also made government liabilities more liquid. However, as time passed the public banks followed a development path determined in an evolutionary way.

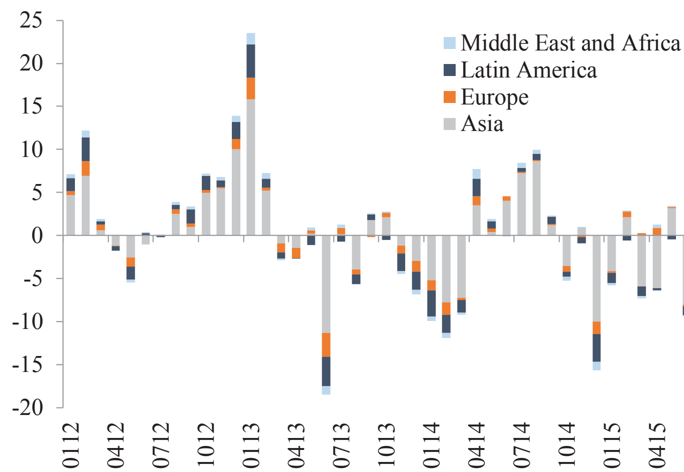
Velde emphasized there are three significant phases during the evolutionary process. The first phase began around 1400 when the first examples of public banks, whose main features were public ownership, a metallic reserve and a gearing towards a payment function, emerged in Barcelona and Genoa. This phase ended with the establishment of the Bank of Amsterdam in 1609. The second phase started in the late 17th century with beginnings of note issue by banks in Naples and Sweden, then famously in England. These privately owned banks were operated in monarchical states and were geared towards the securitization of public debt. Even though the Bank of England dominated the era, both the first and second generation banks existed in the same period. The third phase began with the successful integration of the Bank of England to the payment and management functions of earlier public banks in 1694 and finished in about 1815 with the

Napoleonic Wars. Velde noted that the Bank of England's structure at that time was a result of an evolution which included the accumulation of more than 400 years of institutional experience.

Velde concluded his presentation by emphasizing the remarkable impacts of past historical experiences of public banks on today's central banks. Using the biological metaphor, he claimed there are no true steady states in central banking and hence the development path of central banks does not exhibit a convergence. On the contrary, there is always a new environment in the economy and the central banks always try to adapt to this unfamiliar environment. In that respect, old ideas regarded as unorthodox may become orthodox for the new generation. We have frequently heard the notion of "unconventional policy" in monetary policy discussions and this "unconventional" has become more "conventional" in recent years. This is clear evidence of the reality of no convergence in central banking and the evolutionary process will continue to shape the new central banking structures.

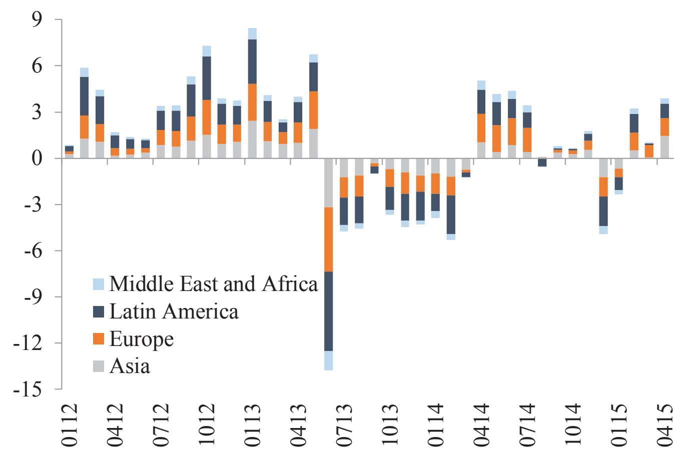
Emerging Markets Snapshot

Equity Fund Flows to Emerging Markets by Regions (monthly, US$ Billion)

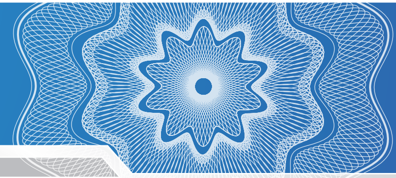


Source: EPFR

Bond Fund Flows to Emerging Markets by Regions (monthly, US$ Billion)



Source: EPFR



Events from the İMB Catalog in the second half of 2015

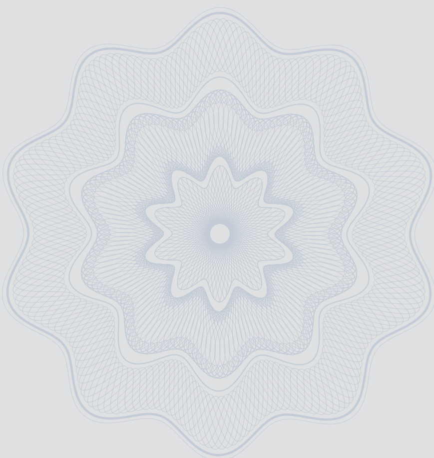
The İMB organizes its activities under five main categories: courses, seminars, workshops, customized bilateral programs and visiting programs. The İMB will organize one **course** and four **seminars** in the second half of 2015.

The 2015 İMB catalog has been published. For details please visit the İMB website: **imb.tcmb.gov.tr**

Courses	Dates
Introduction to Monetary Policy Modelling	December 7-11

Seminars	Dates
Payment Systems and Instruments	September 2-4
Prudential Supervision and Macroprudential Regulations	September 14-18
Foreign Exchange Reserve and Risk Management	September 30-October 2
Short-term Forecasting at Central Banks	November 9-13

Did you know?



- "The 1980s real estate bubble in Japan was so massive that by the end of the decade the chatter in Tokyo was that the market value of the land under the Imperial Palace was greater than the market value of all of the real estate in California.The land area in California is several billion times larger than the grounds of the Imperial Palace, which meant that the price per hectare was a million times higher than the price in California."
- "The Mitsui Real Estate Company paid $625 million for the Exxon Building on Sixth Avenue in New York City even though the asking price was $510 million because the company wanted to get into the Guinness Book of World Records."
- "The bubble in Japan reached its crescendo at the end of 1989. Real estate prices seemed so high that the quip by the much quoted baseball star Yogi Berra 'It's so expensive that no one can afford to live there' seemed applicable. Banks developed one-hundred-year, three-generation mortgages."

Source: C.P. Kindleberger and R. Z. Aliber: Manias, Panics and Crashes, A History of Financial Crises, 2011, p.173, 174, 176.

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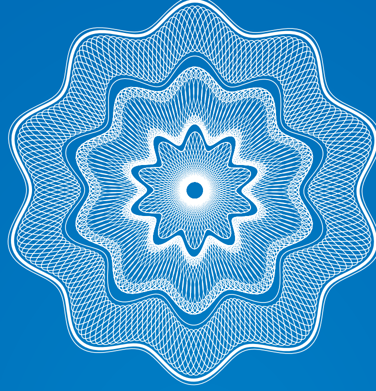

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Istanbul School Of Central Banking

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