# Managing Capital Flows: An Asian Perspective

**Masahiro Kawai**
**Dean and CEO**
**Asian Development Bank Institute**

**PECC-USAPC-SINCPEC Conference**
**"Growing APEC Economies:**
**New Challenges and Approaches"**

Singapore 29-30 June 2011

1

## Motivation

- Recently, some emerging economies, including those in Asia, have imposed capital controls to limit speculative capital inflows
- This suggests that managing capital inflows remains an important policy issue for many emerging economies that needs to be clearly understood and debated openly
- Policymakers of emerging economies need to develop a framework for managing capital flows that is consistent with macroeconomic and financial sector stability

2

## Outline of the Presentation

1. Introduction
2. Capital Flows in Emerging Asia
3. Impact of Capital Flows on Emerging Asia
4. Policy Challenges and Implications
5. Conclusion

3

## 1. Introduction

- **Benefits of capital inflows**
  - Greater economic opportunities and cushion against shocks: to expand investment, smooth consumption, and diversify risks
- **Risks of capital inflows**
  - Loss of macroeconomic stability
  - Damage to financial system stability
  - Risk of sudden capital flow reversals

***Procyclicality of global capital flows to emerging and developing economies can aggravate these risks***

4

# Introduction (cont'd)

- **Past experience**

  - 15% of the large capital inflow episodes over the last 20 years ended in a crisis

  - Emerging Asia experienced proportionately more episodes of hard landings, with the example being the Asian financial crisis of 1997-98

- **Objectives** of emerging Asia's authorities:

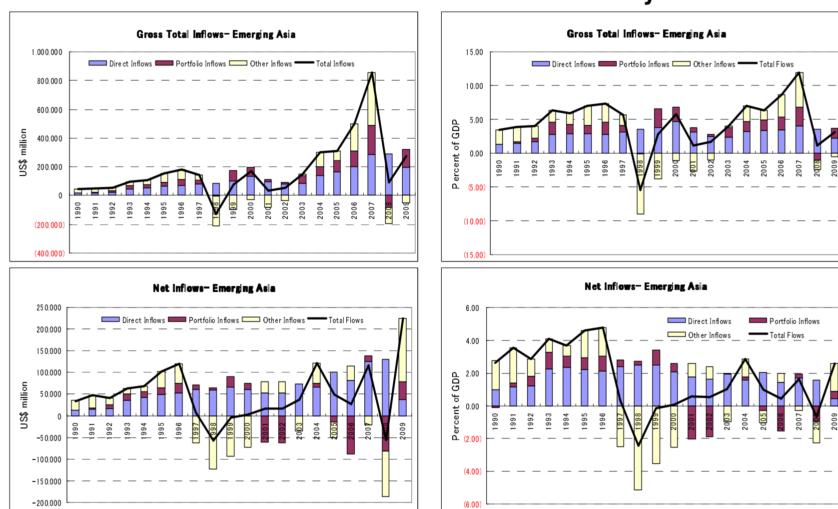
  - Manage these risks well so that they can fully enjoy the benefits of capital inflows

  - Achieve macroeconomic and financial stability

5

# 2. Capital Flows in Emerging Asia

**Emerging Asian economies have received net capital inflows, which have been volatile over the last 20 years**



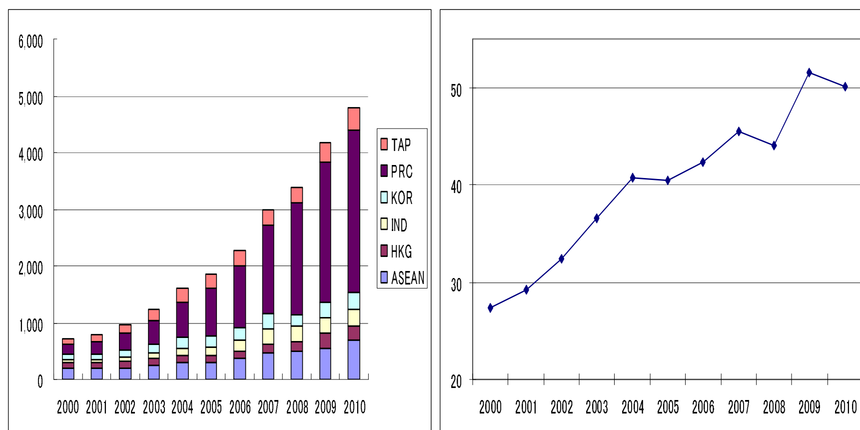

*Notes:* Emerging Asia: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand

*Source:* CEIC accessed on 15 April 15 2011

6

# Foreign Exchange Reserves, Emerging Asia

**Billion US$** **Percent of GDP**




*Notes:* Emerging Asia: Cambodia, China, Hong Kong, India, Indonesia, Korea, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Taipei,China, Thailand, and Viet Nam

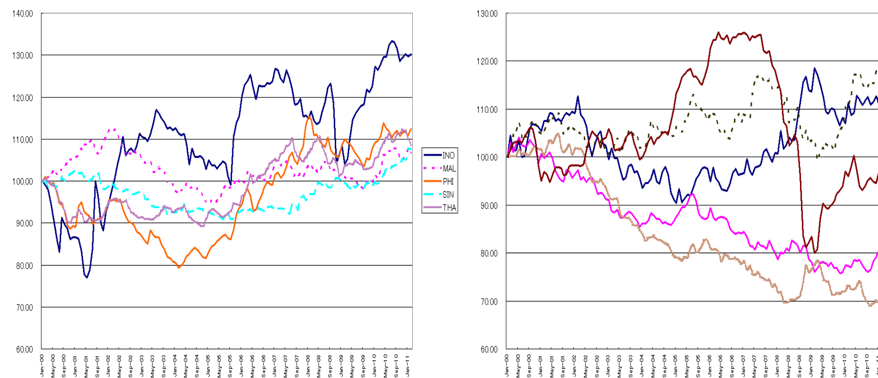
*Source: World Bank databank accessed on 14 April 2011; CEIC accessed on 14 April 2011; Bloomberg accessed* on 15 April 2011

7

# 3. Impact of Capital Flows on Emerging Asia

## Real Effective Exchange Rate

**ASEAN 5** **Non-ASEAN**

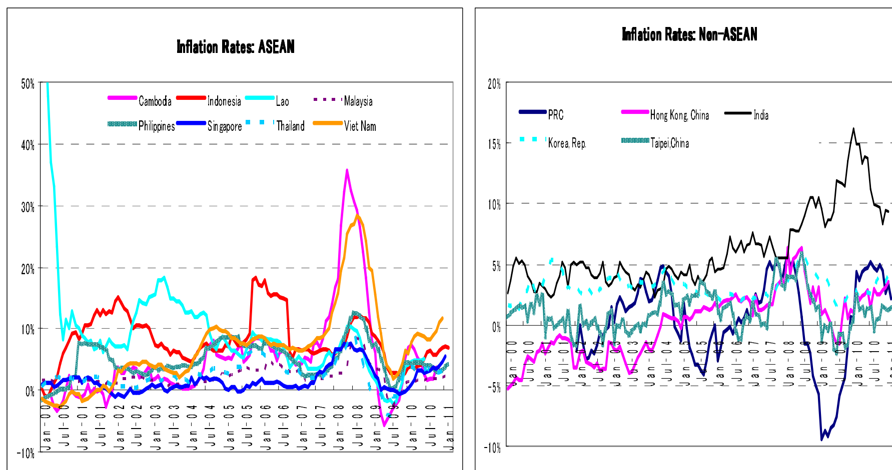



*Source: Bank for International Settlements (BIS) accessed on 14 April 2011*

8

# Inflation Rates

Generally low in the last decade except in 2008
But inflation has been rising in recent months



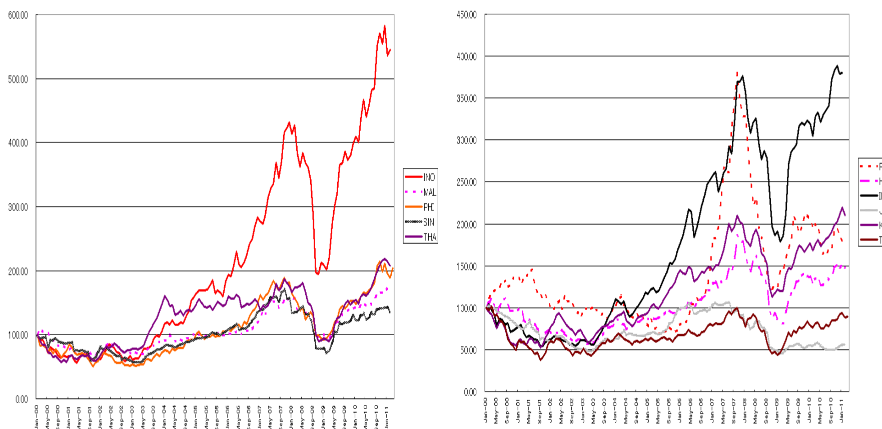

*Source: CEIC accessed on 11 April 2011*



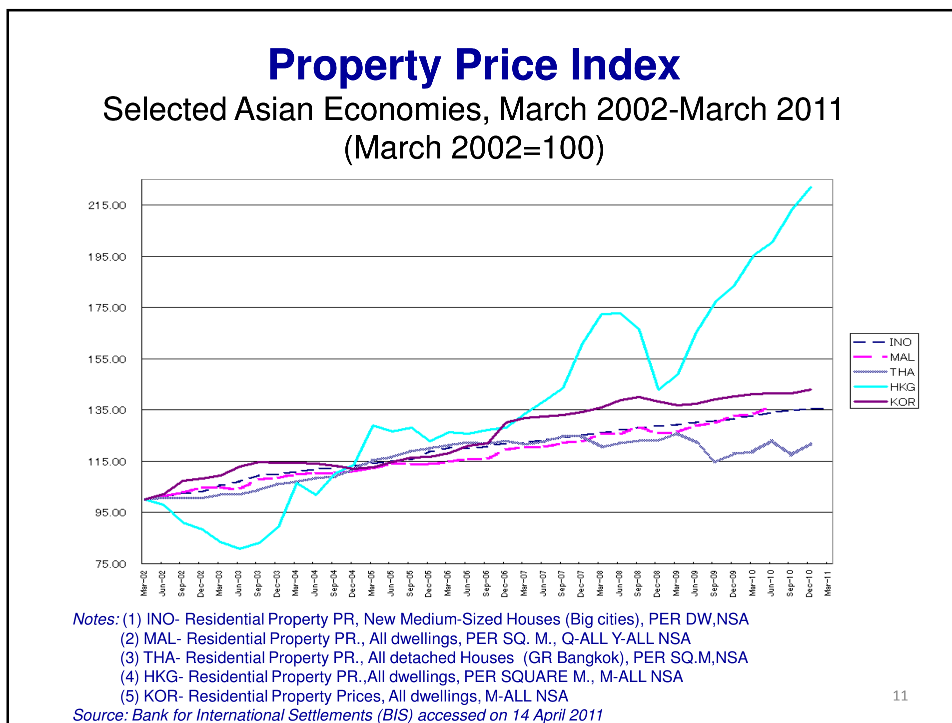
# Asset Prices

Rose markedly during large capital inflow episodes
and dropped sharply during capital flow reversal episodes

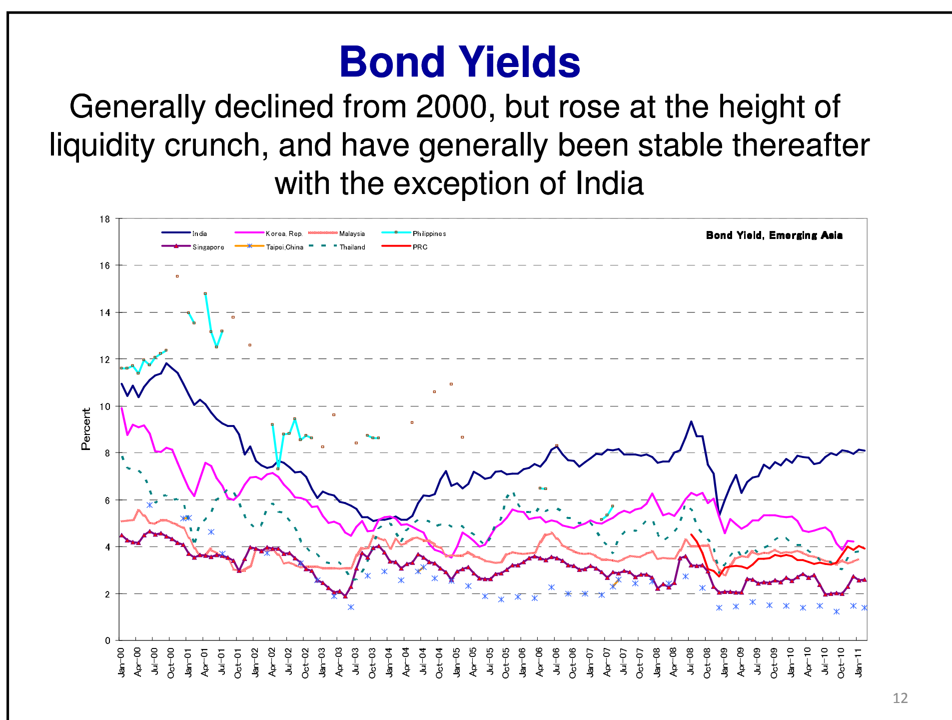
**Stock Price Indexes, 2000-2011 (Jan. 2000 = 100)**




*Source: CEIC accessed on 14 April 2011*



Property Price Index
Selected Asian Economies, March 2002-March 2011
(March 2002=100)
INO
MAL
THA
HKG
KOR
Notes: (1) INO- Residential Property PR, New Medium-Sized Houses (Big cities), PER DW,NSA
(2) MAL- Residential Property PR., All dwellings, PER SQ. M., Q-ALL Y-ALL NSA
(3) THA- Residential Property PR., All detached Houses (GR Bangkok), PER SQ.M,NSA
(4) HKG- Residential Property PR.,All dwellings, PER SQUARE M., M-ALL NSA
(5) KOR- Residential Property Prices, All dwellings, M-ALL NSA
Source: Bank for International Settlements (BIS) accessed on 14 April 2011
11

Bond Yields
Generally declined from 2000, but rose at the height of liquidity crunch, and have generally been stable thereafter with the exception of India
Bond Yield, Emerging Asia
Percent
12

# 4. Policy Challenges and Implications

## Challenges of capital inflows:

- The past surges in capital inflows, followed by capital flow reversals, still fresh in emerging Asia's mind
- Most recently, foreign capital has started to return to emerging Asia

  - External conditions (record low interest rates in advanced economies)

  - Internal conditions (rapid recovery and monetary policy tightening in emerging Asia)
- Massive capital inflows could continue, posing serious policy challenges to emerging Asia for macroeconomic & financial system stability

13

# Advanced economy view on policy responses to large capital inflows

- **"Best" policy mix:** Fully flexible exchange rate, capital account openness (no capital control), and low-inflationary monetary policy
- This is appropriate for **advanced economies** with deep, liquid and broad financial markets
- **Problems** for emerging economies

  - Lack of depth of foreign exchange markets, risk tolerance, and industrial diversification for wide exchange rate swings

  - Shallow financial markets and systems, not resilient enough to large inflows and outflows of capital

14

## Emerging economies' realistic policy responses to inflow surges

- **Structural measures**
  - Develop and deepen financial markets
  - Liberalize imports and capital outflows
- **Macroeconomic measures**
  - Sterilize FX market intervention
  - Ease monetary policy
  - Tighten fiscal policy
  - Allow exchange rate appreciation
- **Macroprudential measures**
  - Tighten macroprudential supervision and regulation over domestic markets
  - Control short-term capital inflows

15

## Pros & cons of currency appreciation

- If capital inflows are permanent and driven by fundamentals, the best response should include exchange rate appreciation
- Currency appreciation has the benefit of:
  - discouraging speculative capital inflows
  - allowing the central bank to pursue independent monetary policy to contain inflation, asset price increases and financial vulnerabilities
- But, the loss of international price competitiveness is a major concern, when only one country allows currency appreciation
- This suggests a need for coordination on exchange rates

16

## Effectiveness of capital inflow controls

- The best market-based controls (temporary, selective, price-based controls a la Chilean unremunerated reserve requirements) are less distortionary and can **lengthen the maturity** of inflows without much impact on overall inflows
- Investor-based controls (e.g., China and India), rather than type-based controls, could be more effective in limiting the **total volume of inflows** as it is easier to monitor who is investing than how inflows are coming
- Authorities' **administrative capacity** is essential
- Effectiveness of capital controls tends to weaken over time as agents in the markets find ways to **circumvent** them
- One country's capital controls can potentially affect others' capital inflows, suggesting a need for **coordinated action**

17

## Recent capital controls in emerging Asia

| | |
|---|---|
| China | 2002: QFII introduced<br>2006: QDII limits introduced<br>2011: Limits on Hong Kong banks' net open positions and ability to access yuan through mainland foreign exchange market |
| India | 2007: Capital controls introduced against "participatory notes" |
| Indonesia | 2010: One-month holding period on SBIs (central bank notes)<br>2010: Sort-term external bank borrowing limited to 30% of capital |
| Korea | 2010: Limits on FX derivative contracts on domestic banks (50% of capital) and foreign banks (250%)<br>2010: Reimposing a withholding tax on foreign investors' earnings from government bonds |
| Taipei,China | 2009: Prohibited use of time deposits by foreign funds<br>2010: One-week deadline for money to be invested or repatriated |
| Thailand | 2006: Unremunerated reserve requirements (30%) on loans, bonds, mutual funds, swaps and non-resident Baht accounts<br>2010: 15% withholding tax on capital gains and interest income on foreign bonds |

*Notes: QFII = qualified foreign institutional investors; QDII = qualified domestic institutional investors*
*Source: Central bank reports and other reports*

18

## ~~New IMF Orthodoxy?~~

- IMF now views capital controls, or so-called "capital flow management measures" as part of the policy toolkit to manage capital inflows
- IMF recommends the use of macroeconomic policies and prudential policies as primary policy tools to respond to capital inflows
- IMF places capital controls at the bottom, that is, the use of capital controls must come after other tools have been adjusted in response to the inflow surge.

* Ostry, et.al., "Managing Capital Inflows: What Tools to Use?" IMF Staff Discussion Note, SDN/11/06 (April 2011)

***But why should capital controls be a last resort policy measure?***

19

## Scope for regional coordination

**Regional financial monitoring**

- A need to step up regional financial market monitoring
- Creation of an Asian financial stability dialogue (AFSD) among the region's finance ministry officials, central bankers and financial regulators

**Coordinated capital inflow controls**

- A country's successful capital inflow controls could drive foreign capital to countries without such controls
- To be effective, coordinated capital controls are desirable

**Exchange rate policy coordination**

- Asian economies need to work together for collective currency float vis-à-vis the USD while keeping relative currency stability within the region, so as to:
  (1) maintain national financial & macroeconomic stability,
  (2) support intra-regional trade and investment
  (3) minimize loss of national price competitiveness
- This requires greater exchange rate flexibility in China

**Financial safety nets (CMIM and AMRO)**

20

## 5. Conclusion

- Given the robust growth prospects in the region relative to the US and Europe, emerging Asia continues to attract capital inflows and, as a result, face significant challenges in macroeconomic management and financial sector reform
- Some of these economies exhibit signs of overheating, inflation and asset-price bubbles, and they need to consider its best response policy in the event of surges in capital inflows
- Advanced economy view would be to adopt a freely flexible exchange rates and an open capital account
- IMF policy responses include: macroeconomic policy (greater exchange rate flexibility, fiscal policy tightening) and prudential policy as primary tools

21

## 5. Conclusion (cont'd)

- A combination of policies is needed, including capital inflow controls—as a macroprudential policy tool—to limit volatile capital inflows
- But it is often difficult to implement these policies at the national level alone because of regional interdependence
- Asia needs to strengthen regional financial and monetary cooperation:
  - Asian financial stability dialogue, CMIM/AMRO
  - Coordinated capital inflow controls
  - Exchange rate policy coordination for collective currency appreciation, to better achieve each country's macroeconomic and financial sector stability while maintaining intraregional exchange rate stability

22

# Thank you
# For more information:

**Masahiro Kawai, Ph.D.**
Dean & CEO
Asian Development Bank Institute
mkawai@adbi.org
+81 3 3593 5527
www.adbi.org

23