

Managing Capital Flows: Experience, Challenges and Policy Implications

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Outline

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

1. Introduction

- Benefits of capital inflows
 - Finance needed investments, smooth consumption, diversify risks, and expand economic opportunities
- Risks of capital inflows
 - **Loss of macroeconomic stability**
 - **Damage to financial stability**
 - **Risk of sudden capital flow reversal**

Note: Cyclical of global capital flows to emerging and developing economies can aggravate these risks

- Past experience
 - 15% of the large capital inflow episodes over the last 20 years ended in a crisis
 - Emerging Asia experiencing proportionately more episodes of hard landing
- Mandate of Asian authorities
 - Manage these risks well so that they can fully enjoy the benefits of capital inflows

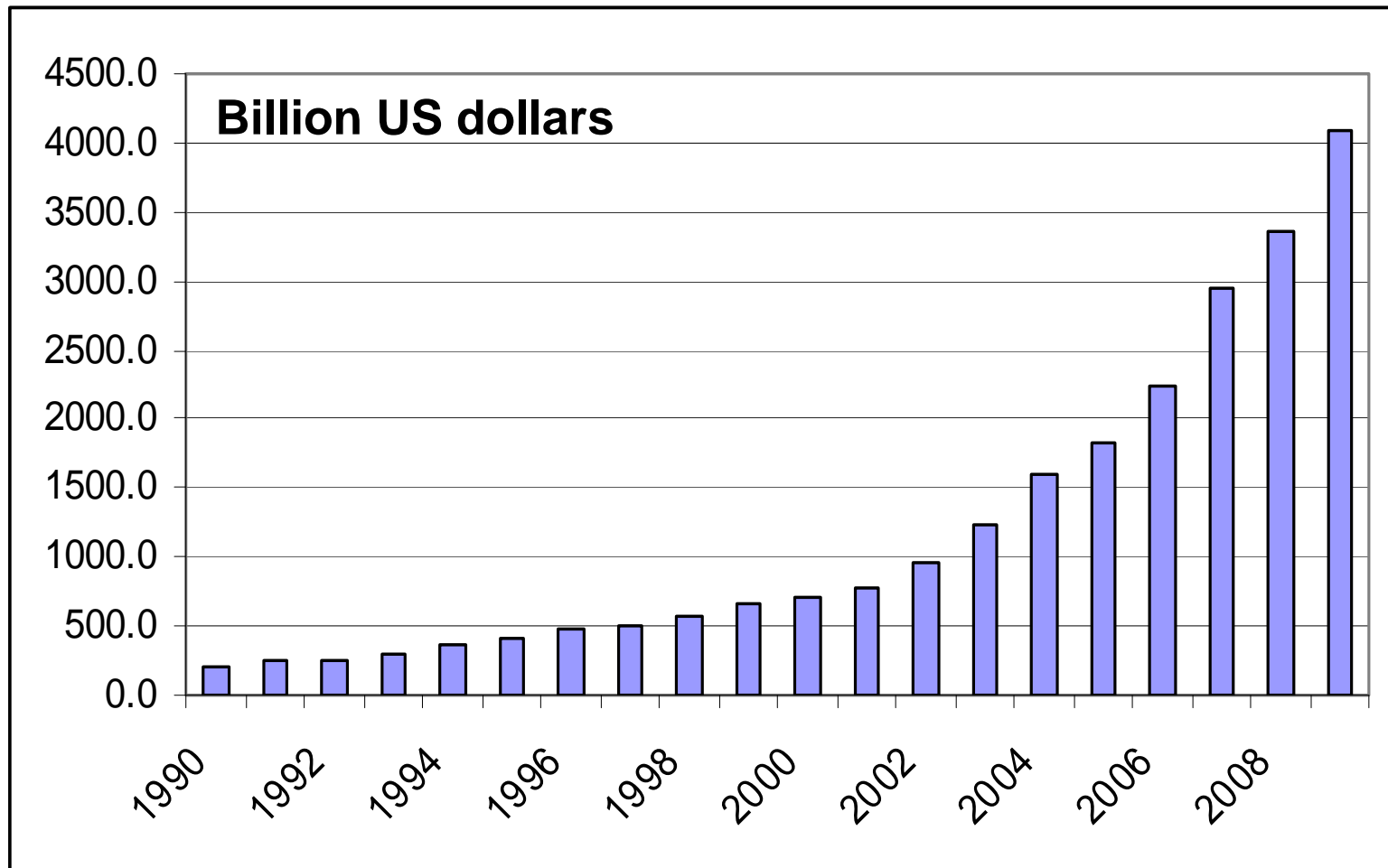
2. Capital Flows in Emerging Asia

- Emerging and developing economies have received net capital inflows, but these inflows have been volatile in the past 20 years.
- Discernible pattern:
 - 2 years before the Asian financial crisis and 5 years before the global financial crisis saw surges in capital inflows in emerging and developing economies
- Rise in net capital inflows in 2009:
 - Emerging Asia - \$145 billion
 - Central and eastern Europe - \$23 billion
 - Western Hemisphere - \$32 billion
- Only emerging Asia experienced net inflows of portfolio and other forms of capital in 2009

Foreign exchange reserves

Rapid accumulation of reserves resulting from
in the currency market intervention

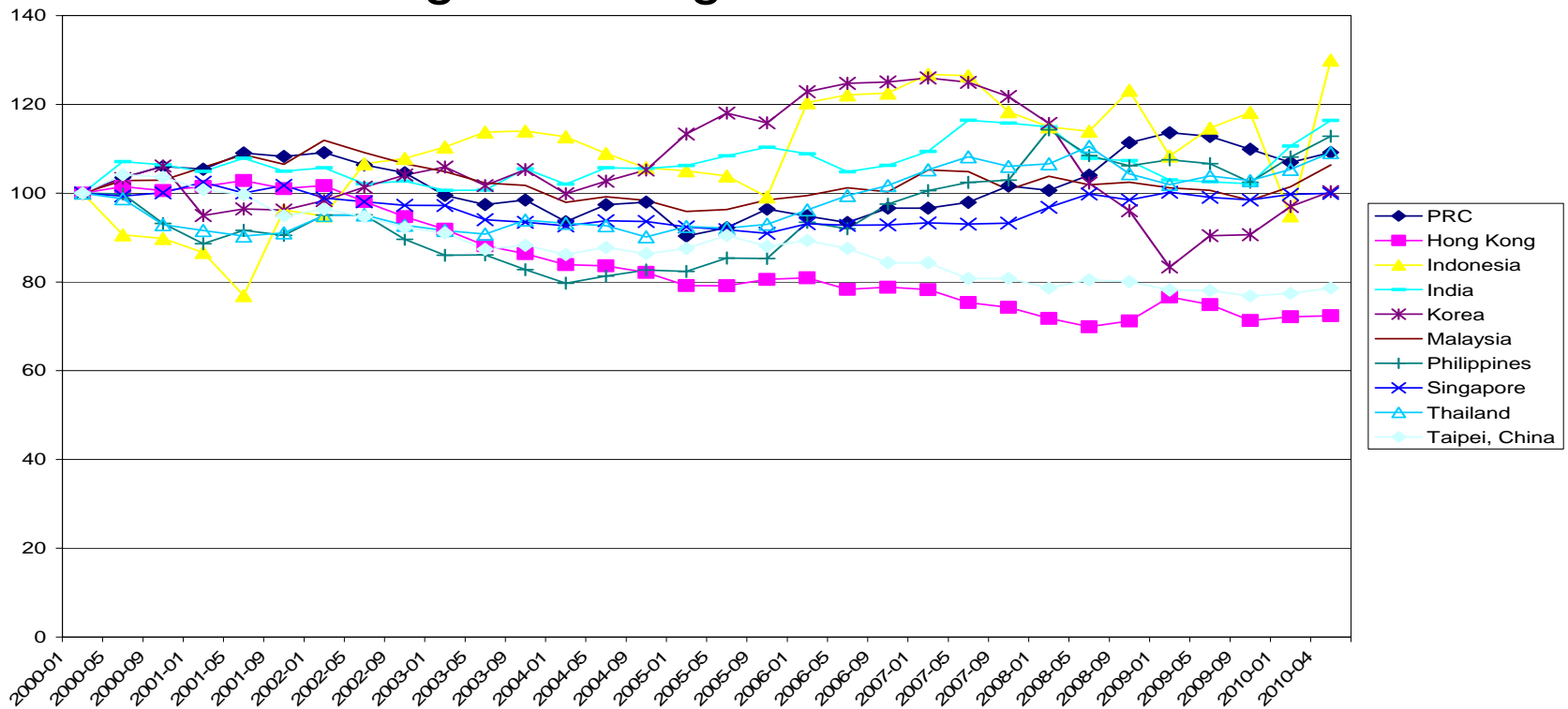
\$4.1 trillion or 45.5% of GDP in 2009



3. Impact of Capital Flows on Emerging Asia

Real effective exchange rate

stronger appreciation pressure before and after the height of the global financial crisis



Inflation, stock prices and bond yields

- Inflation rates generally declined throughout the period except during the tightness in commodity market in 2008
- Equity price increased in 2002-2007, fell sharply in 2008 and rebounded strongly in 2009 in most economies
- Bond yields generally declined from 2000, but rose at the height of liquidity crunch, and were generally stable in 2009

SVAR analysis for capital inflow shocks

Impulse response function shows:

- Most economies in the region showed currency depreciation in response to capital inflows (a bit puzzling result)
- The effects of capital inflows on the price level are mixed
- Capital inflows lead to an increase in domestic equity price for at least 10 quarters in all economies, except Taipei, China
- Capital flows have positive impacts on GDP in all, except Hong Kong and Thailand

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 (expansion of global liquidity and record low interest rates in advanced economies)
 - Internal conditions (rapid recovery and monetary policy exit under way in emerging Asia)
- Massive capital inflows could continue in the next few years, posing serious policy challenges to emerging Asia for macroeconomic management, exchange rate policy, & financial sector supervision

Possible policy measures to manage capital inflows

Macroeconomic policy measures

- Sterilized intervention
 - Unsustainable for a long time
- Greater exchange rate flexibility
 - Some countries lack depth of market, risk tolerance, and industrial diversification for wide exchange rate swings
 - Concern over international price competitiveness
- Fiscal tightening
 - Effective if capital inflows have strong pro-cyclicality with domestic economic activity
 - Lacks timeliness and flexibility, especially if there is little fiscal space
 - Requires strong automatic stabilizer function in place

Structural policy measures

- Financial sector reforms
 - A well capitalized, diversified financial system is more likely to be resilient to vulnerabilities associated with capital inflows (But this is a long-term solution)
- Controls on capital inflows
 - The best market-based controls can lengthen the maturity of inflows without much impact on overall inflows
 - Investor-based controls are more effective than type-based controls
 - Can be regarded as a type of *macroprudential policy* tool limiting foreign currency borrowing, etc
- Easing restrictions on capital outflows
 - Easier repatriation of funds can induce more capital inflows
- Import liberalization

Global solutions

- Global collective action to manage excessive capital flows desirable
- Recent initiatives have focused on national-level transparency (ROSCs, SDDS), but unlikely to be sufficient to minimize the cyclical nature of global capital flows
- Given the global financial crisis, greater transparency on the part of the supply-side of capital flows needed

Regional cooperation

- *Collective exchange rate appreciation vis-à-vis the US dollar and the euro is key in emerging Asia where regional interdependence is rising*
 - Can maintain relative stability of intraregional exchange rates, while reducing adjustment costs for each country
 - To be achieved through intensive policy dialogue and information sharing
- *Regional financial cooperation needs to be strengthened:*
 - Intensify regional economic and financial surveillance
 - Strengthen the Chiang Mai Initiative Multilateralization
 - Establish a high-level “Asian Financial Stability Dialogue” among the region’s financial authorities

5. Conclusion

- Given the robust growth prospects in the region relative to the US and Europe, East Asia continues to face capital inflows and, as a result, significant challenges in macroeconomic management and financial sector reform
- Some of these economies exhibit signs of overheating, and asset-price bubbles
- East Asia needs to consider its best response policy in the event of further surges in capital inflows
- Textbook national policy responses include: greater exchange rate flexibility, financial sector reform, and fiscal policy tightening

Conclusion (cont'd)

- More thought should be given to capital inflow controls—as a macroprudential policy tool—to limit volatile capital inflows
- But it is often difficult to cope with these problems by national policies alone as the emerging Asian economies' choice of exchange rate regime is constrained by those of other economies in the region
- It is time to coordinate exchange rate policy—in preparation for collective currency appreciation—to better manage each country's macroeconomic and financial sector conditions while maintaining intraregional exchange rate stability

Thank you

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