Comments: East Asian Experiences and Policy Lessons in Managing Capital Flows

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The paper has three parts:

• Part I: Trends in post-crisis Asian capital flows

• Part II: The Indian experience

• Part III: Policy response in Asia and Policy options going forward
I. Trends in Asian Capital Flows

• Capital inflows resurged in post-crisis Asia but mostly to different destinations: mainly China and recently India

• Composition changed somewhat:
  – FDI and equity remained large
  – But debt and bank borrowing has picked up
I. Drivers of Capital Flows

• Global Liquidity

• Higher Asian growth
I. Response and Impact of Capital Flows

• Massive sterilized intervention by central banks
• Why? Largely to prevent nominal FX appreciation
• Although other prudential and stability concerns have been forwarded as justification
• But inflation did take place, except
  – it was in asset prices
  – And now in goods prices
• So impact on CPI-measured real exchange rate muted
II. Indian Experience

• Not very different from other Asian economies

• VAR-based measured impact largest on exchange rate, asset prices, and inflation

• Negligible on growth
III. Policy Response

- Intervene to curb FX appreciation
- Struggle to keep foreign-domestic interest rate differential low, while curbing domestic inflation
- So can’t sterilize fully
- Liquidity flows into asset prices
- Asset prices inflate and then collapse
III. What’s Different This Time?

• Much larger FX reserves
• Much greater pre-emptive use of capital controls
• So far asset prices decline much less precipitous
• Economy much-more broad based
• Firms much less leveraged
• Fiscal, by and large, much better placed (including in India)
III. Policy Options Going Forward: Déjà vu all over again?

- The impossible trinity is a binding constraint: with or without partial capital controls (Old)
- Need greater FX flexibility (read allow FX to appreciate) (Old)
- Deepen domestic financial markets (old, but more emphasis now)
- Gradually open capital account (new lesson)
- Use countercyclical fiscal policy (old)
- Rebalance growth away from exports (new term for old policy)
- Global Solutions (semi-old)
- Regional collective FX policy and financial integration (new)
Reaction: Parts I and II

• Broadly Agree with the paper
• Expected a context: e.g., how different are we today from 1997
• And more analytical description
• The VAR on India should be dropped as it stands; not motivated, distracting, and appears like an afterthought
Reaction: Part III

- Policy options need a framework: e.g., the impossible trinity
- Greater FX appreciation: needs to be placed within the larger context of the undervalued FX model of growth
- Gradual capital account opening: If not now then when? Do we know what a “well-sequenced” path for liberalization looks like?
- Countercyclical fiscal: Few emerging economies have automatic stabilizers. Better to keep fiscal policy on a medium-term focus.
- Rebalance growth: Needs significant financial sector liberalization. Export financing is easy.
- Global Solutions: Difficult to come up with commitment strategies. Some countries have to change policy now, others can wait (and then not do it)
- Regional currency union: Why? Shouldn’t FX flexibility do it?
- Regional financial integration: Great idea, but how does it help in managing capital flows?
So what are we left with?

• More FX flexibility

• More avenues for capital outflows

• More domestic financial market liberalization