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**