# East Asian Experiences and Policy Lessons in Managing Capital Flows

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#### **Outline**

- 1. Introduction
- 2. Economic Characteristics of Selected Emerging Asian economies
- 3. Openness of the Capital Account
- 4. Patterns of Capital Flows
- 5. Impact of Capital Flows
- 6. Policy Responses of Asian Economies
- 7. Policy Issues and Recommendations

#### Introduction

- Types of risks arising from surges in capital inflows:
  - macroeconomic risks
  - financial instability
  - sudden and massive capital flow reversal
- Asian economies experienced surges in capital inflows until recently when the US subprime crisis deepened, affecting global liquidity
- Once global economic turmoil subsides, Asia will likely experience a resurgence in capital inflows
- Now is the time to put in place appropriate policy measures to manage risks arising from possible surges in capital inflows in the near future

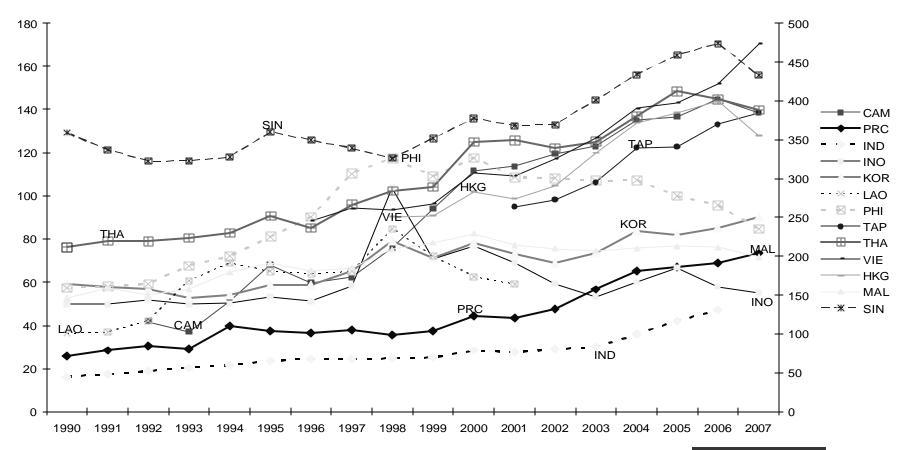
	GDP growth			Current account			Investment ratio			
	(in %)			(as % of GDP)			(as % of GDP)			
	1990- 1996	2000- 2005	2000- 2007	1990- 1996	2000- 2005	2000- 2007	1990- 1996	2000- 2005	2000- 2007	
CAM	5.8	9.2	10.5	-5.0	-3.8	-5.3	10.8	18.2	19.3	
PRC	10.7	9.4	10.7	1.1	3.1	10.2	31.2	37.7	37.3	
HKG	4.9	5.2	6.3		8.1	12.7	28.2	23.0	20.9	
IND	5.6	6.5	9.0	-1.3	0.2	-1.2	22.6	24.8	32.1	
INO	8.0	4.7	5.9	-2.5	2.8	2.6	27.9	20.6	24.4	
JPN	2.2	1.6	2.2	2.3	3.0	4.4	30.0	23.6	23.4	
KOR	7.9	5.2	5.0	-1.6	2.2	0.7	37.3	29.7	28.9	
LAO	6.5	6.2	7.9	-14.3	-2.6			28.5	32.5	
MAL	9.5	5.2	6.1	-5.5	10.8	15.9	38.7	22.9	21.4	
MYA	5.5	9.2	6.3	-0.6	0.0		13.0			
PHI	2.8	4.7	6.4	-4.0	-0.2	4.5	22.4	17.3	14.0	
SIN	8.8	5.1	8.6	12.4	18.0	25.9	34.4	26.1	24.0	
TAP	6.9	4.5	5.1		6.9	7.5		19.9	21.2	
THA	8.6	5.0	5.0	-7.0	2.7	3.6	40.4	24.5	27.7	
VIE	7.9	7.4	8.3	-8.9	-1.2	-1.7	20.2	31.3	35.2	

#### **Economic Characteristics**



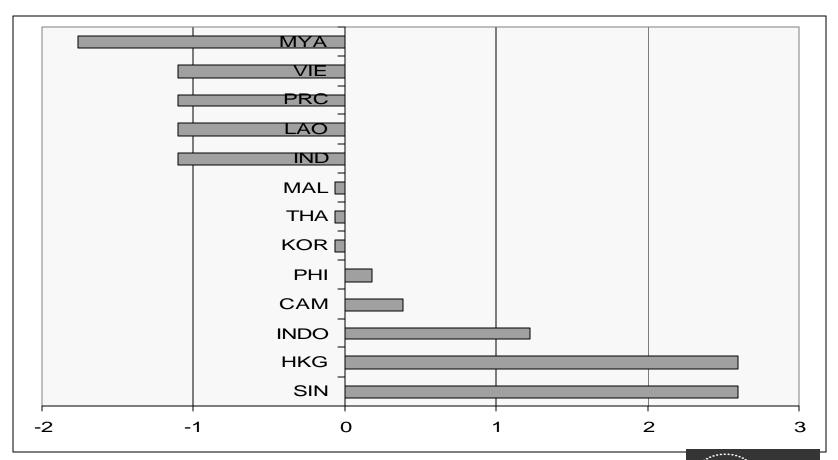
## Openness of the Asian Economies: Trade in Goods and Services as a Ratio of GDP

Openness (HKR, MAL, SIN - on right scale, all other countries - on left scale)



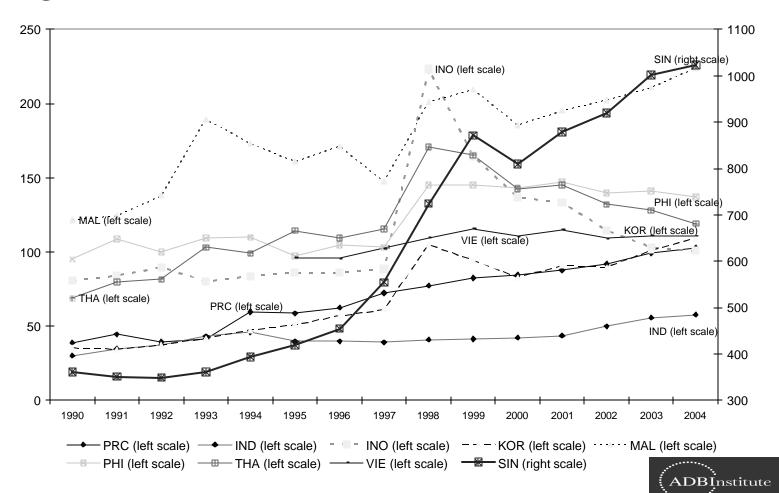
#### **Openness of the Capital Account**

Figure 2. Degree of Openness of the Capital Account: de jure (Chinn-Ito Index)



# Degree of Openness of the Capital Account: de facto

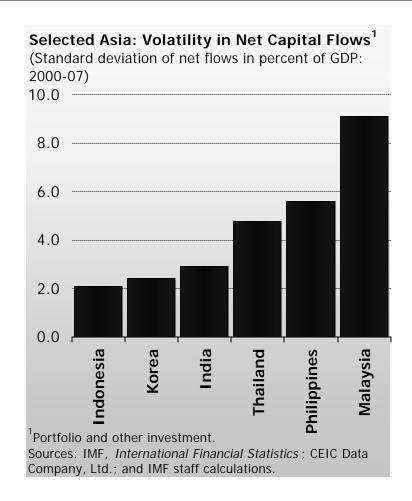
Figure 3. Ratio of Total Stock of Assets and Liabilities to GDP (%)

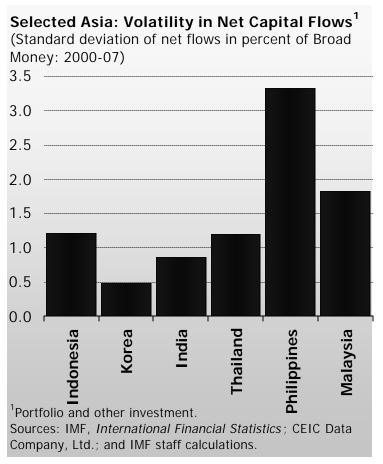


#### **Patterns of Capital Flows**

- Capital inflows increasing since 2001, but slowed in recent months
- Share of FDI has remained high, and share of portfolio inflows has been increasing fast
- Capital outflows have also been increasing, led by China, Singapore and Korea. Portfolio investment outflows have the largest share
- As a whole, capital flows in Asian have become increasingly symmetric

### Volatility of net flows is generally high and varies greatly across countries in the region...





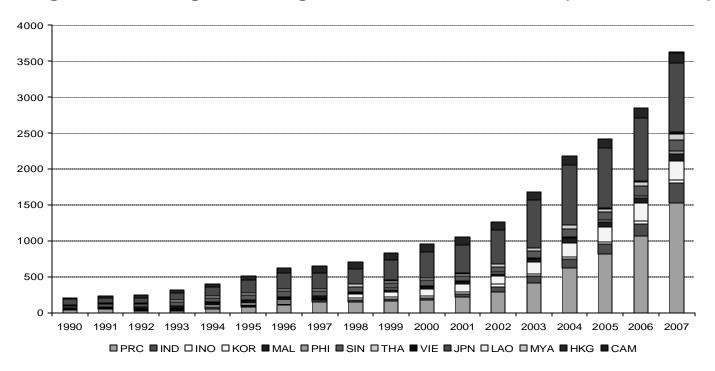
Source: David Burton, IMF, 2008.



#### **Impact of Capital Flows**

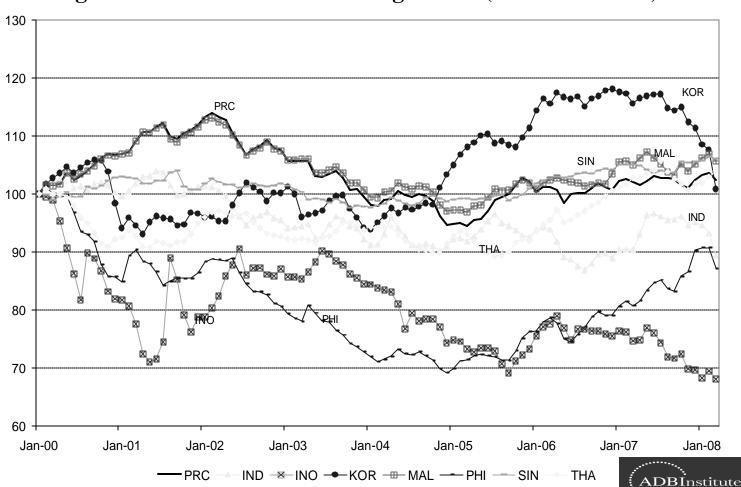
Rapid accumulation of foreign exchange reserves ....

Figure 14: Foreign Exchange Reserve Accumulation (in Billion US\$)



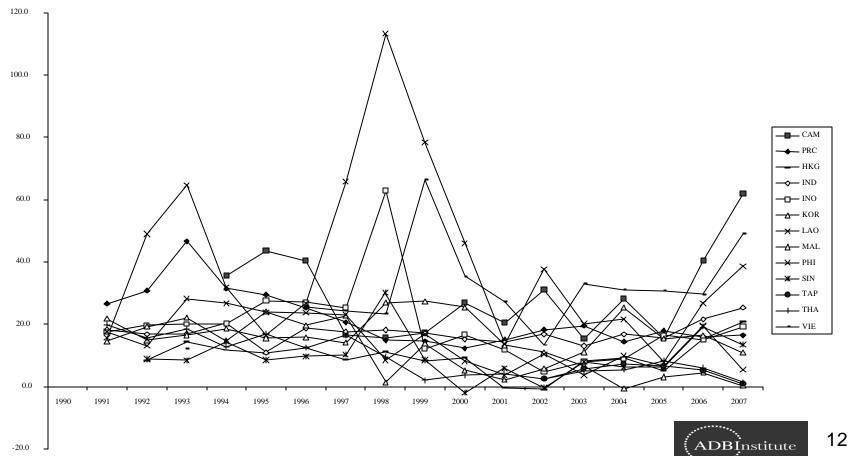
Most currencies in the region appreciated in real terms. In recent months, some currencies began depreciation due to the deceleration in inflows caused by global credit crunch, terms-of-trade deterioration, and rising inflation....

Figure 15: Real Effective Exchange Rates (Jan. 2000 = 100)



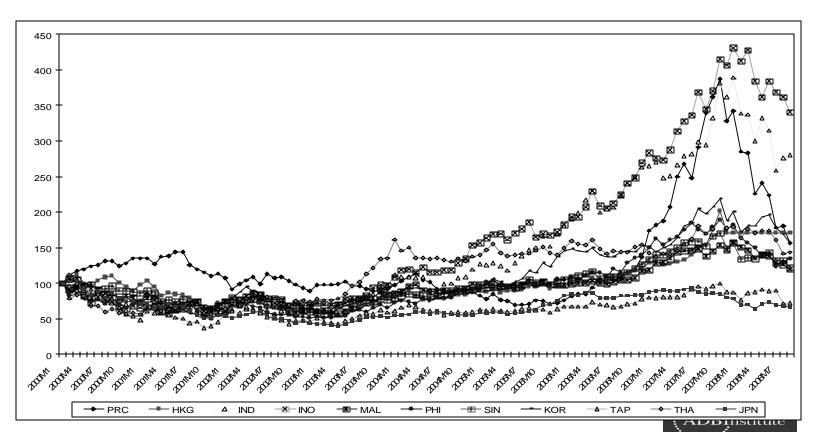
Money supply growth rates had been generally low and stable after the financial crisis, but tended to rise in most recent years...

Figure 16: Growth Rates of Money Supply (%)

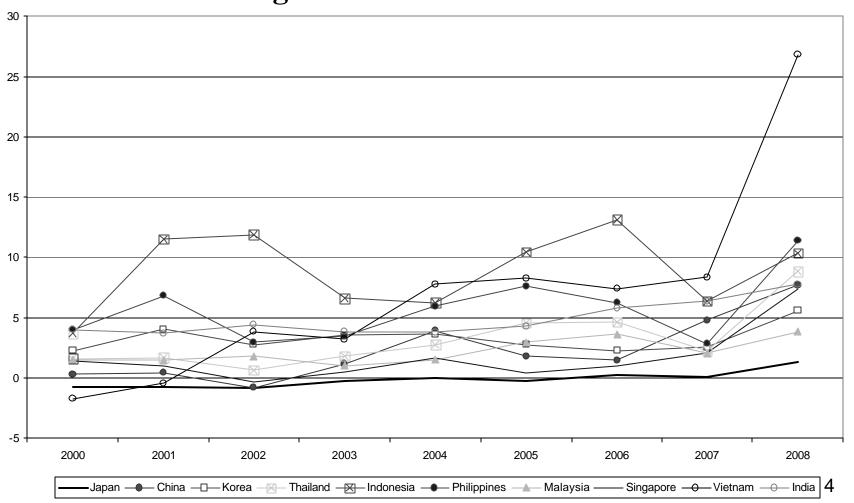


Equity prices increased markedly since 2003. Recently equity prices began declining as foreign portfolio investors made substantial withdrawal of their funds due to the deepening of the subprime loan crisis and rising risks in global equity markets ...

Figure 17: Equity Prices, Jan 2000-August 2008



# Inflation rates were generally low after the Asian financial crisis but have tended to rise for some countries in recent years... Figure 18. Inflation Rates



#### The Case of India (VAR)

- How much influence do capital inflows have on India's economy? Uses VAR analysis
- Variables: total capital inflows, exchange rate, CPI, equity prices, and GDP
- Results:
  - Capital inflows have little impact on economic growth
  - But capital inflows have significant impacts on major economic variables such as the exchange rate, inflation and equity prices.
- General conclusion: If not properly managed, surges in capital inflows could lead to asset price hikes, boom-bust-cycles

#### **Policy Responses of Asian Economies**

#### 6.1. Intervention in the Forex Markets.....

<u>Countries</u>	Sterilized Forex Market Intervention: Instruments			
PRC	PBC initially sold T-bonds and later replaced them with its own			
	Central Bank Bills (CBB).			
	Adjusts reserve requirement ratio			
India	RBI sells regular government bonds and special bonds under the			
	Market Stabilization Scheme.			
	Adjusts reserve requirement ratio.			
Indonesia	BI sells government bonds and central bank certificates.			
Korea	BOK uses Monetary Stabilization Bonds while the Ministry of			
	Finance issues treasury bills and deposits proceeds with the BOK.			
Malaysia	BNM Sells securities in the conduct of its open market operation.			
Philippines	BSP sells government securities and has opened a special deposit			
	accounts facility.			
	Adjusts reserve requirement ratios.			
Singapore	MAS carries out intervention in the foreign exchange market to			
	directly influence the value of the currency and defend the band.			
Thailand	BOT sells government bonds. Recently sold US dollars in the			
	forward market.			
Viet Nam	SBV sells T-bills and central bank bills.			
	Adjusts reserve requirement ratios.			

#### **6.2.** Interest Rate Policy

Interest rate policy in emerging Asia generally supports the narrowing in interest rate differentials, raising the potential cost of intervention...

Table 3: Interest Rate Differential between US T-bill Rate and Domestic Interest Rates

Country	2000	2001	2002	2003	2004	2005	2006	2007
PRC	-3.59	-1.20	0.37	0.97	0.88	-0.90	-2.20	-0.57
IND	3.23	4.06	4.38	4.50	3.32	2.23	1.64	2.75
INO	7.72	12.96	13.61	9.16	6.02	5.94	7.31	3.53
KOR	2.46	2.23	4.17	3.54	2.74	1.12	0.11	0.79
MAL	-2.98	-0.66	1.12	1.78	1.03	-0.67	-1.49	-0.95
PHI	8.75	7.86	7.64	8.09	7.63	6.16	5.03	3.56
SIN	-3.66	-1.76	-0.80	-0.37	-0.41	-1.11	-1.77	-2.09
THA	1.11	2.37	3.46	2.75	3.72	1.98	0.76	0.34
VIE	-0.42	2.04	4.31	4.82		2.98	0.01	

#### 6.3. Capital Controls

- General tendency liberalization of the capital account
- Imposition of new (fine-tuning) capital controls to slowdown short-term inflows
- Easing of controls on outflows
- Nonetheless, speculative capital inflows occurred through different legitimate channels such as trade accounts, FDI and investment account, and remittance, as well as illegitimate channels.

#### **Policy Issues and Recommendations**

- With the restoration of US financial market stability, Asia likely faces a surge in capital inflows [liquidity from further monetary easing in US and Europe]
- Policy Issues:
  - ➤Of the measures tried before, which can be applied again?
  - ➤ What other domestic policy options should be tried?
  - ➤ Is there scope for global solutions?
  - ➤ What is the role of regional cooperation 2

#### 7.1. Doing More of what has been tried before

- Sterilized intervention and reserve accumulation:
  - Authorities cannot continue sterilized intervention forever as the cost of intervention rises
  - ➤ Scope for reserve-sharing and SWF
- Strengthening national financial markets— need to accelerate reforms
- Controls on capital inflows:
  - Recent trends moving away from administrative controls to market-based controls (e.g., tax on inflows)
  - ➤ Mixed evidence on effectiveness of controls on inflows
  - For countries with open capital account, administrative controls are becoming difficult to implement
  - For countries with closed capital account, well-sequenced liberalization is called for



#### 7.2. Exploring other options

- Counter-cyclical fiscal policy utilize the automatic stabilizer function of the budget
- Rebalancing growth stimulating domestic private investment (in countries with low investment) and private consumption in countries with excessive savings
- Easing restrictions on capital outflows
  - run effectiveness in the short run
  - > could attract more capital inflows

#### 7.3. Scope for Collective Actions

- So far, global initiatives mainly focused on transparency as a way to minimize volatility of capital flows (e.g., ROSC, SDDS), but incidence of crises has not declined despite the increase in transparency
- Possibility of including countercyclical element in the regulation of financial intermediation and capital flows
- Regional financial cooperation
  - CMI, ERPD
  - Financial market development & integration (ABMI)
  - Regional financial market surveillance "Asian Financial Stability Dialogue"
  - Exchange rate cooperation
  - Capacity building to supply well-trained regulators and bankers

#### Thank you very much!

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