

Comments on “Capital Flows & Capital Account Management in Selected Asian Economies” by Sengupta & Gupta

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Presentation Outline

- Interesting paper that gives a detailed investigation of the evolutions of capital flows in 5 Asian economies, as well as provide a comprehensive assessment of the policy responses in terms of exchange rate flexibility, sterilized intervention & capital controls to manage capital flows.
- Learned much from this study; my comments focus on:
 - Evolution of Capital Flows
 - Analysis of trilemma configurations
 - Effectiveness of CFMs

Evolution of Capital Flows

Sample Period of Study

- In consideration of data availability, the sample period of this study from 1995q1 to 2011q4 is rather long, facilitating interesting comparisons between AFC & GFC.
- However, some major events related to capital flows happened more recently such as
 - Fed's QE2 (Nov 2010) & QE3 (Sep 2012);
 - BOJ QQE (Apr 2013); &
 - Fed's QE tapering announcement & commencement (May/Dec 2013).
- Interesting to extend the sample period to cover these events as well.

Waves & Compositions of Capital Outflows

- Identifying surge & stop episodes is useful to focus attention on relevant time periods & facilitate comparisons across countries. To have a fuller picture, include flights & retrenchment episodes associated with sharp increases & decreases in outflows.
- A country experiencing massive capital inflows will have a stock of gross external liabilities potentially at risk of reversal. When there is a sudden capital outflow, it is uncertain whether the country is able to remit its gross external assets back quickly.
- To assess this risk, may be useful to consider compositions of capital outflows in individual countries as well.

Trilemma Configurations

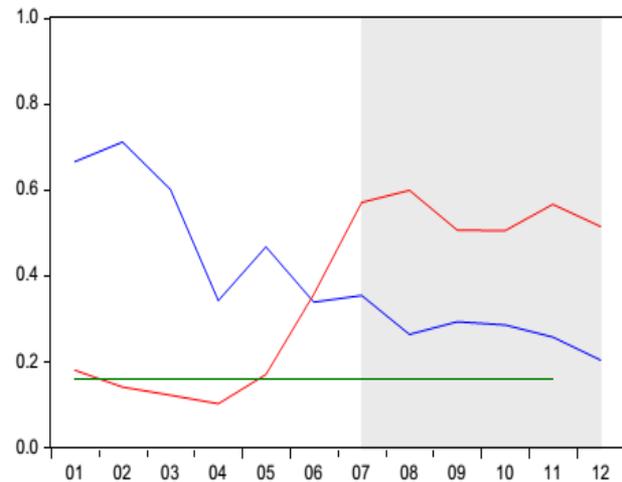
Rounding the Corners of the Trilemma

- Policy trilemma is an important issue for Asia because their financial systems are small, and exchange rate stability is crucial to their economic growth.
- Opt for intermediate measures: limited monetary policy autonomy, a managed float exchange rate regime & partial capital controls, giving different trilemma configurations across countries.
- Aizenman et al. (2008) developed a set of trilemma indexes. Indexes take the value between 0 and 1; a higher value means achieving the relevant policy goal to a greater extent.

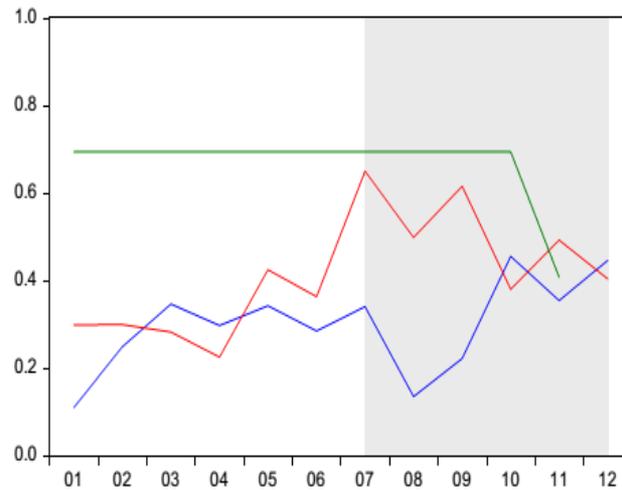
Aizenman-Chinn-Ito Trilemma Indexes

- Financial openness (KO) index is Chinn-Ito capital account openness index. A *de jure* index based on a country's reported restrictions in the IMF's AREAER. Paper uses a *de facto* index based on net capital flows.
- Exchange rate stability (ES) index uses standard deviations of exchange rate between a country and its base country "the country that a home country's monetary policy is most closely linked with". Paper uses goodness of fit to Frankel-Wei regressions.
- Monetary independence (MI) index based on the correlations between their money market rates; Paper uses the same index.

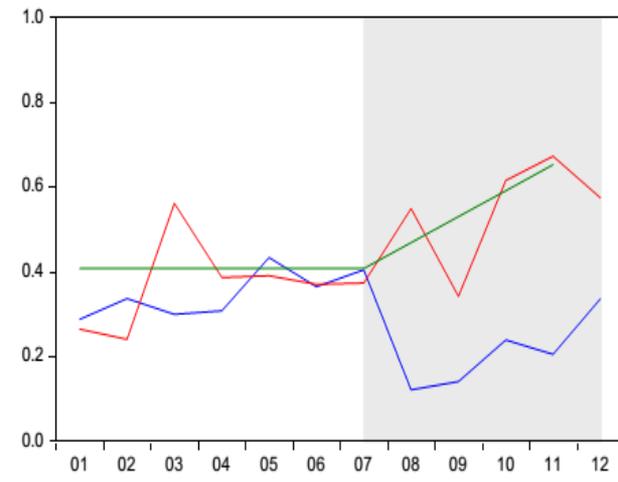
Trilemma Indexes, 2000-2012



India



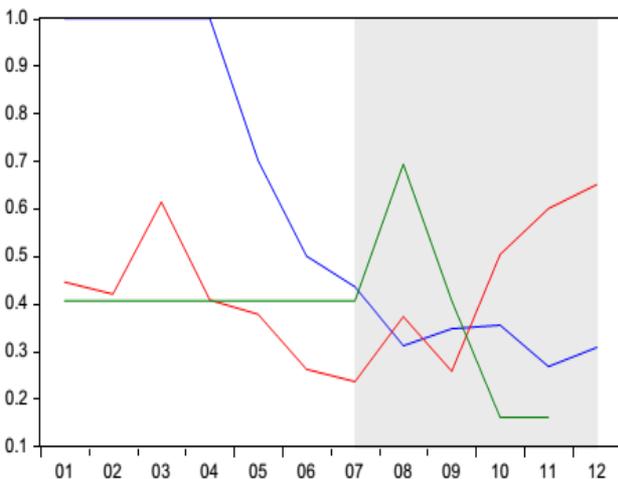
Indonesia



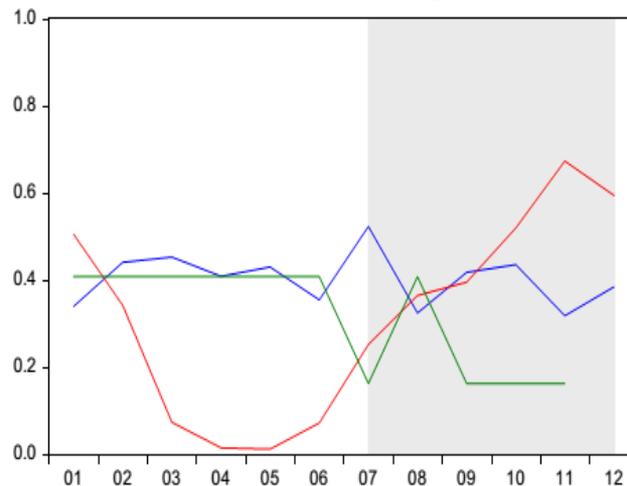
Korea

- India's KO (green line) remained at a low level as capital controls remain in place. ES (blue line) dropped associated with higher mi.
- Indonesia's KO stayed at a high level but dipped post crisis due to CFMs. ES kept similar level except during crisis.
- Korea's KO is the only that trended up from onset of crisis, consistent with Korea's goal of becoming a financial center. ES fell due to greater volatility in the won.

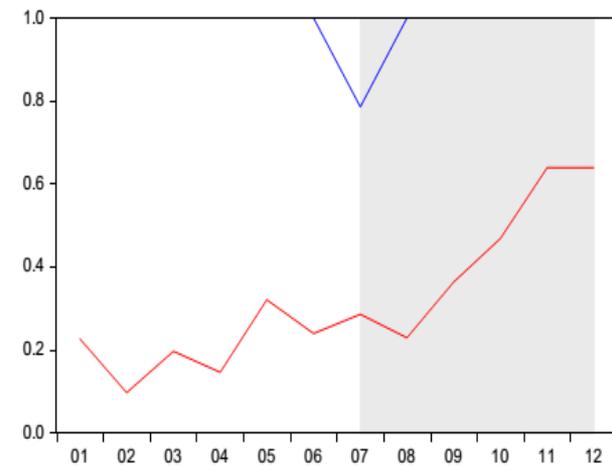
Trilemma Indexes, 2000-2012



Malaysia



Thailand



Hong Kong

- ES plunged for Malaysia as it exited from the peg to USD. Malaysia & Thailand saw their KO index fall post crisis as CFMs were imposed in these countries.
- Hong Kong being a financial center is financially open with KO stay at one through the sample. ES also at one due to USD peg.
- Strangely, we see monetary independence index on an uptrend post-crisis for Korea, Malaysia, Thailand and even Hong Kong post crisis.

What's Happening to the MI Index?

- Monetary independence (MI) index based on the correlations between each country's and its base country's money market rates. MI index values for most countries (including Hong Kong) went up as we move from the pre- to post-crisis period.
- US interest rate was basically close to zero from 2009 onwards. Concomitantly, short-run correlations of interest rates between US and other countries are lowered and this translates to a higher MI index value over this period.
- Hence, care has to be taken when analysis the MI index during the post-crisis period.

Financial Openness Index

- To the extent that we want to gauge policy responses, we can use a *de jure* index instead of a *de facto* index.
- If the decision is to use a *de facto* measure, net capital flows is may not be reflective of financial openness since large inflows will be negated by large outflows.
- An alternative is to use as KO index the sum of total asset and total liabilities normalized as a ratio of GDP. To treat official investment differently from private investment, Hiro & Kawai (2012) replaces numerator by:

total asset + total liabilities – official reserves assets

Testing if Trilemma is Binding

- Since each trilemma index is standardized to lie between 0 and 1, the sum of the 3 indexes should be 2 if the trilemma is binding. Paper uses equation:

$$2 = \alpha MI_t + \beta ERS_t + \gamma CapOpen_t + \mu_t$$

- However, there is a difficulty with using a constant as a dependent variable in the equation. What are the properties of μ_t ? Are inferences of the coefficients valid?
- One way to test is to just add up the indexes and see how the sum evolve over time compared to the value 2. Can't just assume trilemma is binding in view of recent debate on trilemma vs dilemma.

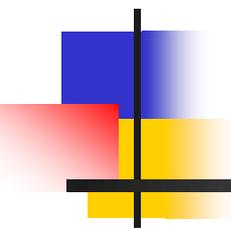
Effectiveness of Capital Flow Measures

Reducing Risk of Sudden Stops

- Paper provides a good summary of capital flow measures of individual economies and formally assesses their impact. Found capital controls have limited success in restricting exchange rate appreciation & stock price increases.
- Imposing target controls only on more risky flows (or liberalizing capital restrictions on in a sequential manner from less risky to more risky flows) influence the composition of capital inflows towards longer term flows.
- Since the composition affects the degree of volatility, the risk of sudden stop is reduced.

Macroprudential Policy

- Asian economies are making greater use of macroprudential policies. Found to be effective in leaning against equity flows, credit growth, bank leverage & house price increases. (Zhang & Zoli, 2014).
- To the extent that macroprudential tools help to safeguard financial stability of an economy, longer term macroeconomic performance is boosted.
- Since CFMs taken unilaterally by one economy affects other economies, there is scope for regional coordination of capital flow measures across countries to reduce policy spillovers that destabilize other economies.



Thank you