High-level Regional Policy Dialogue on "Asia-Pacific economies after the global financial crisis: Lessons learnt, challenges for building resilience, and issues for global reform"

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Current Regional Challenges 2: Managing Capital Flows

Presentation

The Boom in Capital Flows and Financial Vulnerability in Asia

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THE BOOM IN CAPITAL FLOWS AND FINANCIAL VULNERABILITY IN ASIA

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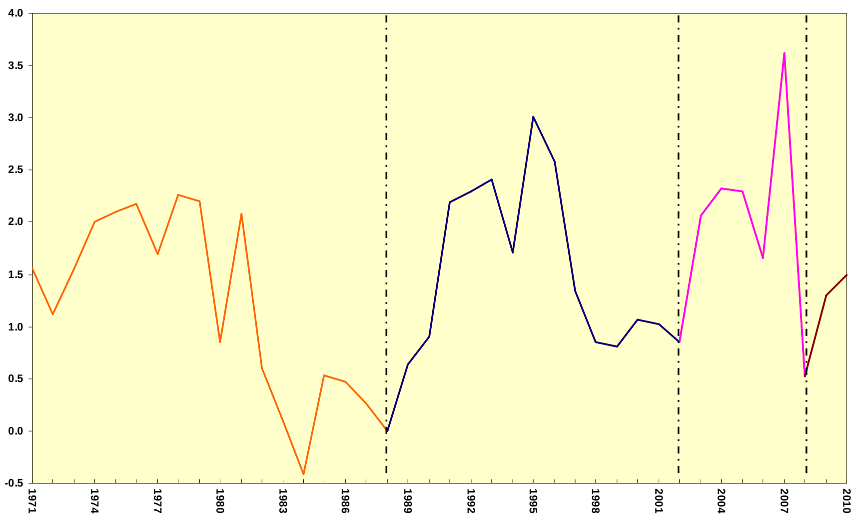
ISSUES AT STAKE

- DEEs have been experiencing a generalized boom in private capital flows as a result of, *inter alia*, policy response of AEs to the crisis (QE and close-to-zero interest rates). Asia is a main recipient.
- This is also accompanied by a boom in commodity prices, driven by similar forces.
- These booms are potentially reversible with significant damages to DEEs.
- Their effective management is thus essential for DEEs to survive the current global economic turmoil. But DEEs, including those in Asia, have not always been successful in this endeavour.

POST-WAR BOOM-BUST CYCLES IN CAPITAL FLOWS

- Current surge is the fourth post-war boom in private capital flows to DEEs
- First boom started in late 1970s, ended with debt crisis in 1980s in LA.
- Second one started in early 1990s, ended with crises in EA, LA etc.
- Third one started in early 2000s, ended with collapse of Lehman in Sept. 2008
- The Lehman bust was short-lived, followed by a quick recovery in mid-2009.
- Booms invariably driven by expansion of international liquidity and low interest rates in reserve currencies.
- Busts come at times of tightened global financial conditions. Deterioration in macroeconomic conditions in recipients, often due to capital inflows.
- Sustainability and build-up of imbalances and fragility are not difficult to identify, but the trigger and timing of reversals and crises are difficult to predict.

NET PRIVATE CAPITAL FLOWS TO DEEs (% of GDP)



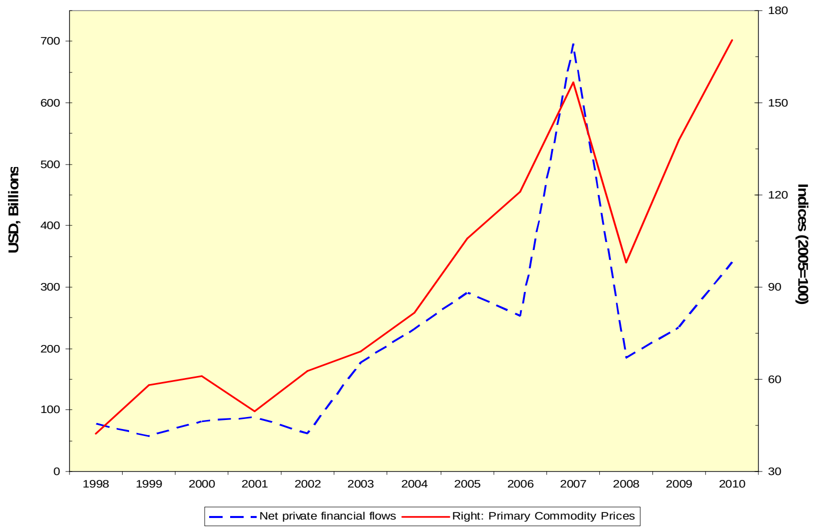
CURRENT BOOM IN CAPITAL FLOWS

- Driven by liquidity expansion (QE) and near-zero rates in AEs, rising rates in DEEs; increased risk of investment in AEs and better growth prospects of DEEs
- Highly volatile portfolio flows and carry-trade dominant. According to SAFE 1/3 of inflows to China is “hot money” and 25% of FDI in property.
- Current boom differs from previous ones in some respects
  - Now DEEs/Asia as a group have CA surplus; net flows added to reserves;
  - Two-way traffic; resident portfolio outflows exceed FDI abroad
  - External liabilities of DEEs are increasingly in domestic currency (70%)
  - Vulnerability to BOP crises smaller, but to asset market instability greater

COMMODITY CYCLES

- Commodity cycles overlapping with cycles in capital flows and dollar
  - Like capital flows to DEEs, commodity prices continued to rise initially in 2008; but started to fall about the same time as capital flows collapsed and the dollar rose with flight to safety.
  - Prices started to recover in Spring 2009 at the same time as the recovery in capital flows and the fall of the dollar.
- Strong growth and demand in DEEs (China) is a major factor. But rapid financialization of commodity markets in the 2000s has also played a key role.

PRIVATE CAPITAL FLOWS AND COMMODITY PRICES



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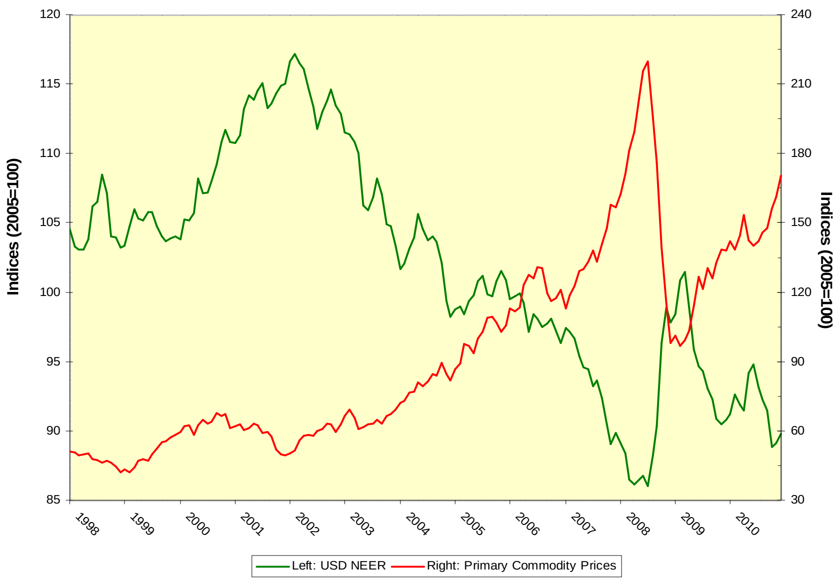
DOLLAR AND COMMODITY PRICES



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BOOMS, IMBALANCES AND FRAGILITY

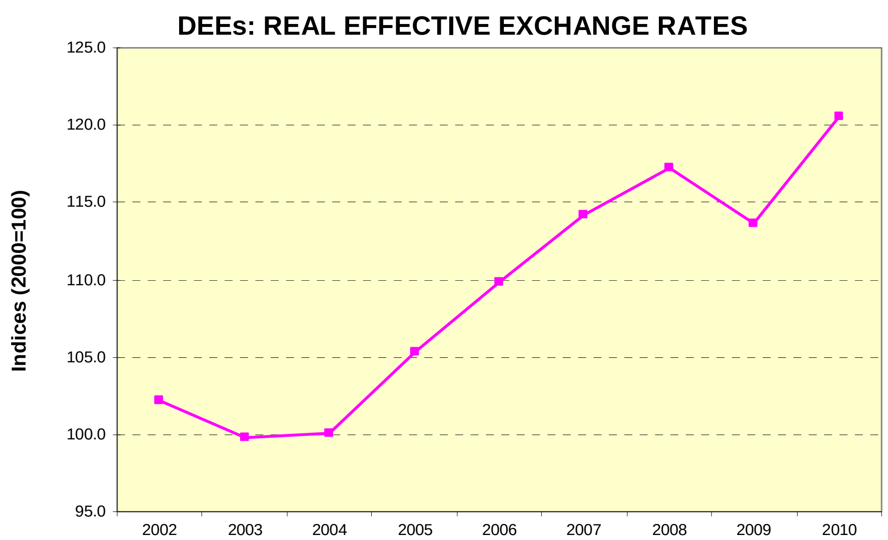
- Fragility and imbalances that could result from surges in capital inflows:
  - Unsustainable currency appreciations and current account deficits
  - Currency and maturity mismatches in private balance sheets: short-term borrowing in foreign currency
  - Credit and asset bubbles and excessive investment:
- With reversal of capital flows these could lead to currency, BOP and financial crises. Access to adequate international liquidity and large stocks of reserves do not always prevent domestic financial instability.

POLICY RESPONSE IN ASIA

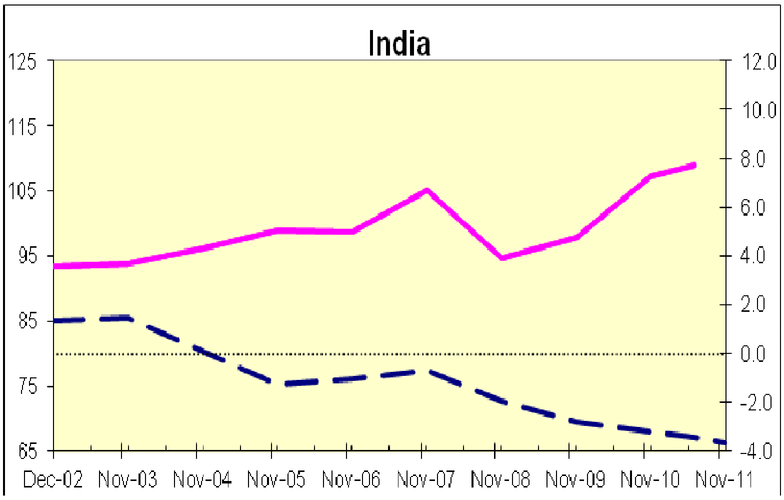
- Liberalization of inflows after 1990s. Increased access of foreigners to domestic securities (equity and bond) markets (India, Korea, Indonesia, Malaysia). Greater foreign presence in financial services. Asian capital accounts are now more open than during the 1997 crisis.
- Build self insurance by pursuing strong payments and reserve positions through currency interventions (lesson from 1997 crisis). But this cannot prevent private sector mismatches and credit bubbles; provides public insurance for private risks. Full sterilization is difficult and reserve accumulation is costly. Makes little sense for short-term flows. .
- Liberalization of resident investment abroad (China, India, Korea, Malaysia, Thailand). Could ease pressure on currency and reduce bubbles, but does not prevent currency mismatches. Could also mean one-way traffic (CIS in 2009).

IMPACT

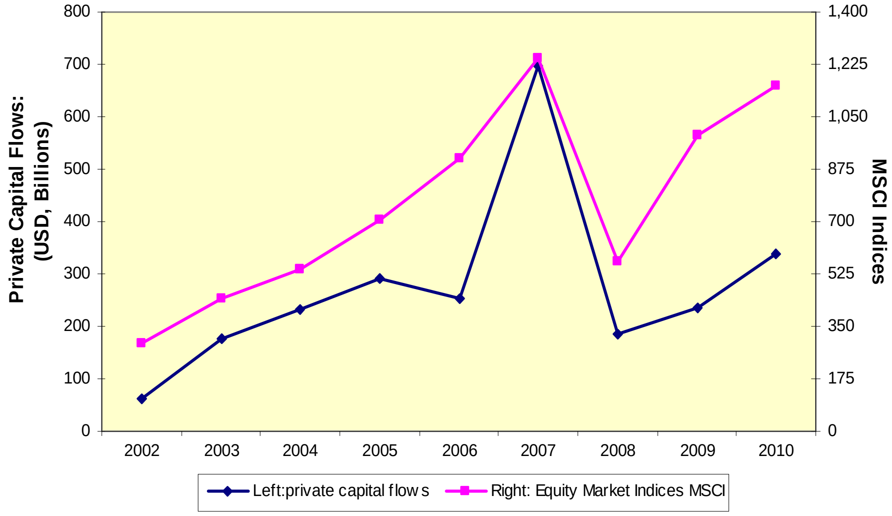
- Major Asian DEEs have avoided CA deficits and unsustainable appreciations both during pre-Lehman and post-Lehman booms (except in India).
- However, credit and asset bubbles in many Asian DEEs both during pre-Lehman and post-Lehman booms; high correlation between capital flows and equity prices. Carry-trade style short-term borrowing (India, Korea, Philippines).
- Lehman collapse caused sharp declines in stock and property markets and put pressure on currencies. But little impact on corporate solvency because capital reversal was short-lived and BOP and reserve positions were strong.
- Now several Asian DEEs again face risk of hard landing in credit and asset markets in the event of global financial stress even though they can avoid a BOP crisis. Instability could be more serious if reversal of capital flows lasts longer and space for policy response turns out to be narrower.



REER AND CURRENT ACCOUNT



CAPITAL FLOWS AND EQUITY PRICES IN DEEs



BOOM-BUST IN ASIAN EQUITY MARKETS

END OF CAPITAL AND COMMODITY BOOMS: SCENARIOS

- Hike in US interest rates – could happen even before full recovery because of inflationary pressures resulting from commodity boom (as in early 1980s).
- But commodity boom cannot be sustained without strong growth in DEEs (China); and strong growth in China cannot be sustained when AEs are stagnant and inflation is a major concern. Cannot rule out a sharp slowdown, end of credit and property bubbles, triggering flight from commodity futures.
- A severe turmoil and default in EU periphery, leading to a flight to safety (as during Lehman); likely if EU/ECB continue to pretend that this is a liquidity crisis.
- A BOP and/or financial crisis in a major DEE and contagion (as in EA)
- Capital and commodity booms likely to end the same time. Most vulnerable are those enjoying both (like Mexico in 80s) and those with large deficits (Turkey).

CAPITAL CONTROLS: THE NEW WASHINGTON WISDOM

- IMF: *"Given the fact that the Fund is charged with providing financing to address crises that may be caused by premature liberalization, it may be particularly appropriate for the Fund to play a central role in determining when liberalization supports – or undermines – stability of members and the overall system."*

- FED (Bernanke) : "*Looking back on the crisis, the United States, like some emerging-market nations during the 1990s, has learned that the interaction of strong capital inflows and weaknesses in the domestic financial system can produce unintended and devastating results. The appropriate response is … to improve private sector financial practices and strengthen financial regulation, including macroprudential oversight. The ultimate objective should be to be able to manage even very large flows of domestic and international financial capital in ways that are both productive and conducive to financial stability."*

HOW WISE IS IT?

- IMF is now looking for a mandate to sanction restrictions on *inflows*. It recognizes the need for controls grudgingly – temporary and as a last-resort. It sees restrictions justified only if a number of conditions are met.

- But many of these conditions are highly controversial (cf. South Centre RP 32)

- DEEs need a permanent regime of control on both inflows and outflows, adjusting their dose as and when required.

- FED does not pay much attention to BOP and exchange rate consequences of capital inflows. Its focus is exclusively on their impact on domestic credit and asset markets. But DEEs cannot afford to ignore BOP and exchange rates.

WHAT KIND OF RESTRICTIONS?

- PR cannot prevent banking crises leave alone BOP and asset market crises. Most inflows (some 70%) are not intermediated by banks. Still, appropriately extended PRs are needed to prevent mismatches and exchange-related credit risks in banks' balance sheets. But no evidence that improved PR rather than strong macroeconomic conditions explain the Asian resilience to sub-prime
- Low taxes on inflows (Brazil, Thailand, Korea) do not work when arbitrage margins are large
- Need to restrict carry-trade style private borrowing abroad and foreign access to and presence in domestic markets
- FDI is not always investment and could also adversely affect BOP

CONCLUSIONS

- Asia needs to manage capital flows much better, focussing not only on their impact on BOP, but also on domestic financial stability. Complete financial openness is not the best policy. Should seek strategic, not full, integration.
- Do not rely on credit, asset and investment bubbles to maintain growth, or allow capital inflows to generate such bubbles.
- China's response to export collapse in 2008-09 should have focussed on consumption rather than creating a debt-driven investment bubble.
- Now with sluggish exports to AEs and excess capacity, China cannot keep pushing investment to fill demand gap. Need to boost household income and consumption (also needed in many countries in SEA). Unsustainable, debt-driven investment bubbles are just as dangerous as US-style debt-driven consumption and property bubbles.