MANAGING CAPITAL FLOWS

Yılmaz Akyüz
South Centre, Geneva

Capital Account Regulations and Global Economic Governance
Workshop Organized by UNCTAD and GEGI,
Geneva, Palais des Nations, 3-4 October 2013

www.southcentre.int

OUTLINE

- Why manage capital flows? Boom-bust cycles and financial fragility
- Key options in managing inflows
- Managing outflows
- Policy conclusions

SOUTH CENTRE

Research Paper 37
March 2011

CAPITAL FLOWS TO DEVELOPING COUNTRIES IN A HISTORICAL PERSPECTIVE: WILL THE CURRENT BOOM END WITH A BUST?

Yılmaz Akyüz

SOUTH CENTRE

Research Paper
June 2013

48

WAVING OR DROWNING: DEVELOPING COUNTRIES AFTER THE FINANCIAL CRISIS

Yılmaz Akyüz

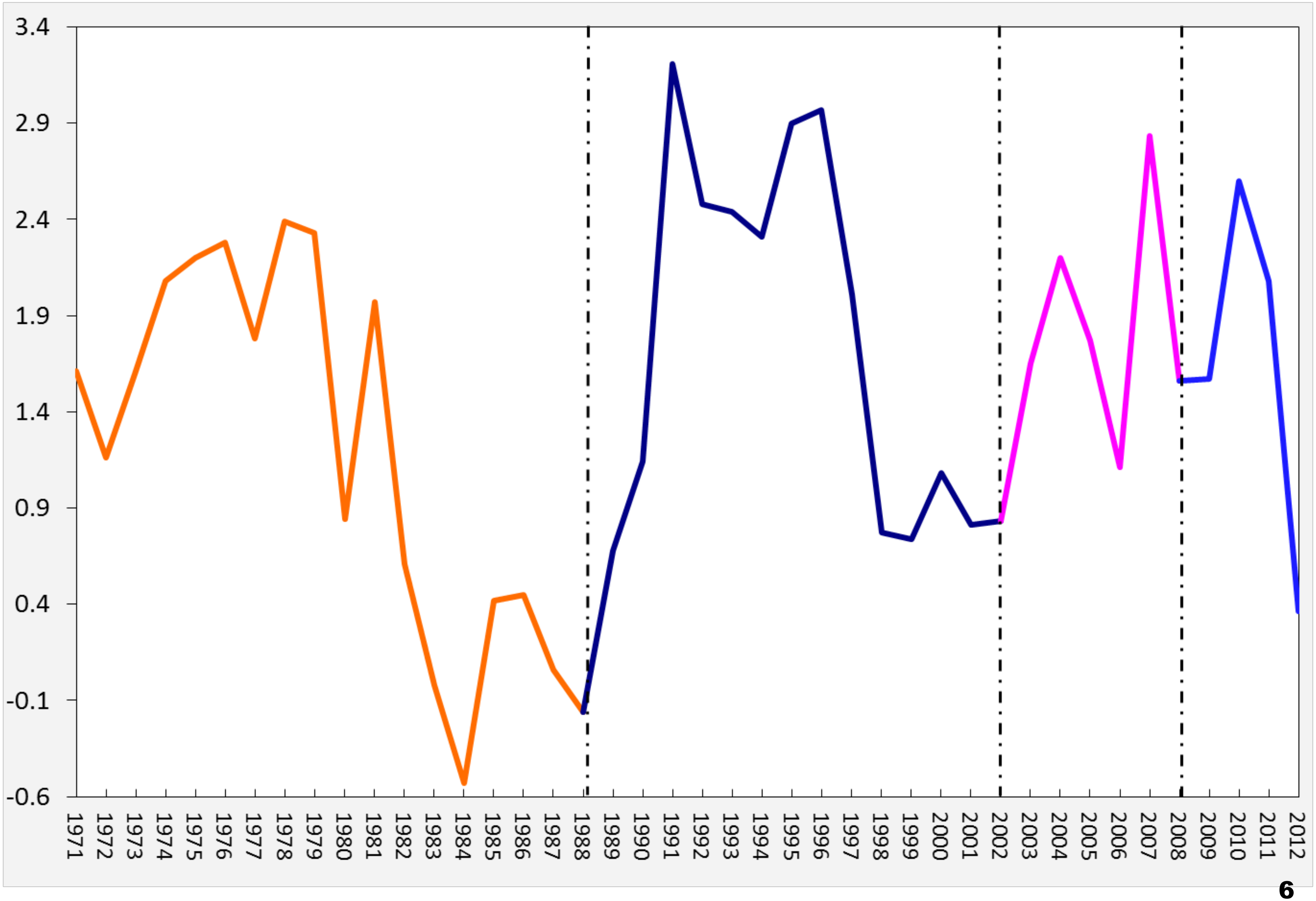
POST-WAR GLOBAL BOOM-BUST CYCLES IN CAPITAL FLOWS

- Five boom-bust cycles

1. First boom started in late 1970s, ended with debt crisis in 1980s in LA.
2. Second started in early 1990s, ended with crises in EA, LA, TR etc.
3. Third started in early 2000s, ended with collapse of Lehman in Sept. 2008
4. The Lehman bust was short-lived, quick recovery in the second half of 2009.
5. Boom now ending due to loss of risk appetite and prospects of exit from ultra-easy money in US (QE and zero-bound rates).

- These cycles differ in nature, composition, destination and effects of capital flows; but they also share some common features.

Net private capital flows to EEs as per cent of GDP



SOME COMMON FEATURES OF GLOBAL CAPITAL CYCLES

- Booms: Liquidity expansion and low interest rates in main reserve issuers and favourable global risk:
  - 1970s: Petrodollars and US deficits. Commodity boom/low interest rates
  - 1990s: Low interest rates in US and Japan in response to contraction
  - 2000s: Low rates in US/EU/Japan; subprime bubble and search-for-yield
  - 2010s: Zero-bound rates and QEs

- Busts:
  - Tightened financial conditions in reserve issuers: rising dollar interest rates and strong dollar.

  - Deterioration in macroeconomic conditions in recipient countries, mostly due to effects of capital inflows themselves.

  - Build-up of imbalances and fragility are not difficult to identify, but trigger and timing are difficult to predict

CAPITAL INFLOWS AND FINANCIAL FRAGILITY

1. Unsustainable appreciations and CA deficits- FDI has same affect as other inflows
2. Liability dollarization, maturity and currency mismatches; exposure to IR/XR risks.
3. Domestic credit expansion; banks borrowing abroad to fund lending or inflows lowering long-term rates or interventions not sterilized. Also adds to CA deficits.
4. Asset bubbles: greater foreign presence in securities markets of EEs. Foreign liabilities are now more in local currency (70%). Investors and lenders assume IR and XR risks (original sin?) but impact on securities markets amplified. Strong BOP and reserves do not protect against adverse spillovers to asset markets (as seen in Asia after Lehman).
5. All these happen independent of the exchange rate regime. Floating does not insulate and allow monetary policy autonomy.

OPTIONS IN MANAGING SURGES IN CAPITAL INFLOWS

- Four main options in dealing with surges in capital flows
  1. Macroeconomic adjustment
  2. Currency market intervention and sterilization
  3. Liberalization of resident outflows
  4. Capital controls

- These are not equally effective in dealing with the main problems associated with surges:
  1. Impact on the currency and the CA.
  2. Build up of currency and maturity mismatches in balance sheets
  3. Impact on asset and credit markets (bubbles)

MACROECONOMIC ADJUSTMENT

- IMF's favourite: "a key role needs to be played by monetary, fiscal, and exchange rate policies." Controls seen as last resort and temporary. Intervention and reserve build-up also seen as part of macroeconomic adjustment (though until recently IMF believed it to be ineffective).

- Limits of macro policy in dealing simultaneously with currency, BOP, credit and asset market impact of inflows.

- No practical or theoretical reason to alter policies judiciously designed for growth and stability, and debt and BOP sustainability when faced with a surge. Controls can be the best response.

- IMF position not step forward. Sets limits to "acceptable" controls. Could force borrowers (in BOP crisis) to roll-back measures beyond these limits (as in Korea in 1997). Advocates premature liberalization: "a country could make progress towards greater capital flow liberalization before reaching all the necessary thresholds, and indeed doing so may spur progress in these dimensions."

CURRENCY MARKET INTERVENTIONS

- Allow money in, buy them up, put in CB reserves as self-insurance, issue domestic debt, create fiscal surplus or raise bank reserve ratios to sterilize it.
- Can prevent appreciation and CA deterioration. But full sterilization is often difficult (even in China), leading to liquidity expansion and overheating.
- It is costly. Borrowed reserves now around 40% of total reserves (some $7tr) of DCs at a carry cost of $130b-150b p.a.
- Interventions do not prevent mismatches in private balance sheets – provide public insurance for private risks.
- Lack of strong rationale: allow hot money in, do not use it but put it in low-earning reserves as insurance against exit!

RESIDENT OUTFLOWS

- Liberalize (even encourage) investment abroad by residents to ease pressure on the currency. Done extensively in recent years in Asia and RSA.

- FDI abroad may earn more than reserves. But that would also mean leverage and maturity mismatches (borrowed money financing FDI abroad as in India and Brazil – unlike China where own money is invested.

- Exposure of portfolio investment to losses (though not much during subprime).

- Does not prevent currency mismatches in private balance sheets

- One way traffic: no guarantee that money allowed to exit during good times will come back during bad times (as in CIS during 2009).

CAPITAL CONTROLS

- Control by source countries? US used interest equalization tax in 1960s to stem capital flight. Then it suited US due to fixed gold convertibility. Now it doesn't.
- No multilateral constraint, but some DCs tied their hands in BITS/FTA.
- Prudential rules appropriately extended to forex positions and transactions (limits, special loan-loss provisions, liquidity, reserve and capital requirements) can help mitigate/discourage maturity and currency mismatches and exchange-related credit risks. But not enough since most inflows (75%) not intermediated by banks.
- Low taxes do not work when rate differentials are large and exceptions are made
- Need for direct/administrative restrictions over private borrowing and entry of non-residents to domestic securities (money, bond and equities) markets.
- Are controls effective? Yes if permanent not sporadic, particularly if institutions needed are created and strong sanctions attached.

RECENT RECORD AND PROSPECTS

1. Poor management of inflows in Inflation-targeting EEs (Brazil, RSA, Turkey). Asia more successful in stabilizing currency and BOP, mainly through interventions.

2. Half-hearted, ad hoc, occasional controls; walls neither high nor wide enough to deliver the task (Brazil). Korea much more successful in preventing appreciations *via* several control measures despite being in OECD (***Waving or Drowning***).

3. Almost all EEs (including Asians) welcome asset bubbles inflows help to form.

4. Little attention to corporate as against sovereign borrowing (up 50% in last 5 years)

5. Now funds exiting from local securities, EEs relying on external debt. $600b since 2012. Interbank lending to EEs highest ever; off-shore bond issues by EEs firms exceed those from AEs. Serious risks since credit flows are more sensitive to US monetary conditions (creditors are also leveraged – carry trade) and long-term rates are rising (exit from ultra-easy monetary policy). Will know when tide is out

CAPITAL OUTFLOWS

- Zero-bound rates and QE benign for EEs despite complaints about currency war. Risk appetite has changed and prospects are for reversal at a time when most EEs are in desperate need to meet rising CA deficits despite slowing growth.
- Macroeconomic response is pretty useless at times of sudden stops and reversals. Hike in interest rates could even accelerate exit.
- Leaving currency to float might help. Worked after Lehman because external conditions improved quickly. But can also lead to a free fall notably if CA deficits and debt are large (1997 Indonesia without a large deficit).
- Reserves can run out quickly particularly if borrowed (Korea 1997-98).
- IMF contingency credit lines: remedy worse than disease.
- Rollback involving IMF (Korea 98; Turkey 2001)? Unilateral restrictions/standstills could work if CA is in structurally solid and export response is strong (Malaysia)

POLICY CONCLUSIONS

- Emerging Economies:

1. Need strategic integration; roll-back liberalization of portfolio flows; a permanent control regime, cyclically adjusted. Attention to asset/credit bubbles not just BOP
2. Reduce dependence on foreign capital (LA)
3. Manage booms better using **all** instruments judiciously.
4. S-S crisis lending facilities? Fashionable but symbolic (CMI and BRIC $100b).

- Global:

1. Cannot just have a global regime for capital flows. Need a reform of entire architecture (reserves and exchange rates systems, regulation of systemically important institutions, temporary standstills, crisis lending and debt workouts) to discipline financial markets and policies in key reserve issuers. Lessons from BW.

2. No mandate to IMF to sanction and even advise control over inflows in EEs. No change in Articles on capital convertibility. Leave it alone (also GATS)– otherwise DCs can end up with loss of more policy space.