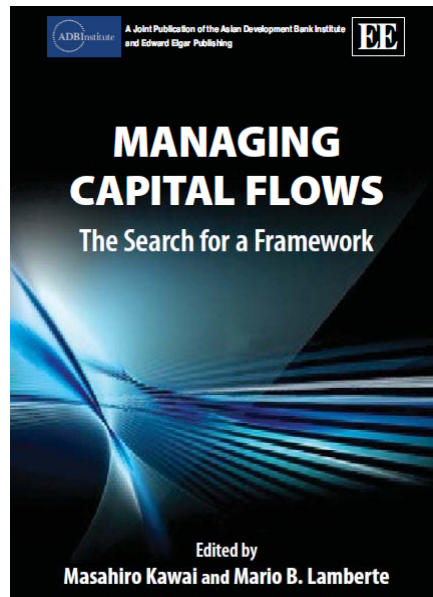


**OECD-ADBI 12th  
Roundtable on Capital  
Market Reform in Asia  
7-8 February 2012, Tokyo, Japan**

**Mario B. Lamberte  
Director of Research  
Asian Development Bank Institute**

Note: The book can be downloaded at:  
<http://www.adbi.org/files/2010.12.22.book.managing.capital.flows.pdf>



## **1. Introduction**

- **Benefits of capital inflows**
  - Greater economic opportunities and cushion against shocks: to expand investment, smooth consumption, and diversify risks
- **Risks of capital inflows**
  - Loss of macroeconomic stability
  - Damage to financial system stability
  - Risk of sudden capital flow reversals

*Procyclicality of global capital flows to emerging and developing economies can aggravate these risks*

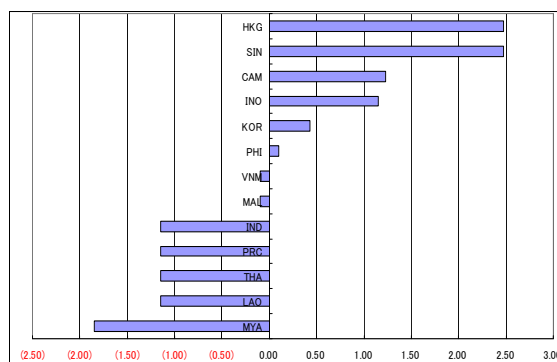
## Introduction (cont'd)

- **Past experience**
  - 15% of the large capital inflow episodes over the last 20 years ended in a crisis
  - Emerging Asia experienced proportionately more episodes of hard landings, with the example being the Asian financial crisis of 1997-98
- **Objectives** of emerging Asia's authorities:
  - Manage these risks well so that they can fully enjoy the benefits of capital inflows

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## 2. Degree of Capital Account Openness

Measure of Capital account openness: *de jure*



Source: Chinn and Ito (2009).

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## Measure of Capital account openness: *de facto*

### External Assets and Liabilities as a Share of GDP in Emerging Asia, 1990-2009 (%)

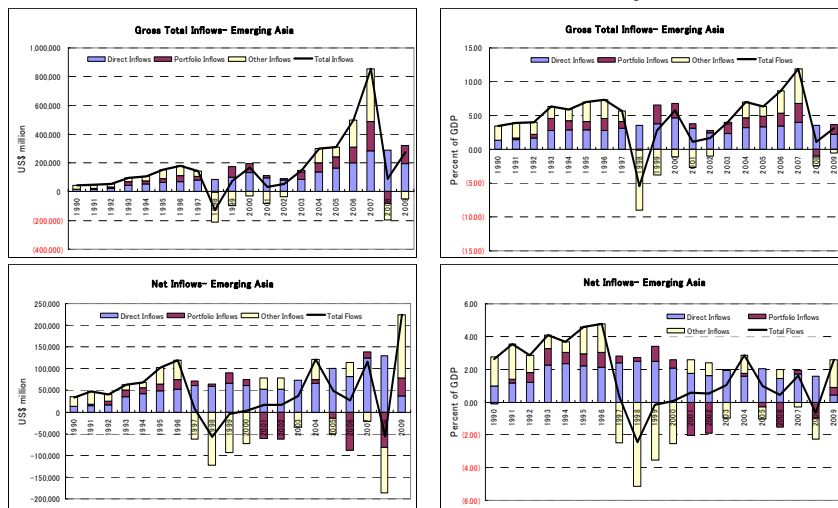
Economies	1990	1995	2000	2005	2009
Cambodia (CAM)		96.3	176.8	145.2	156.0
China, People's Republic of (PRC)	38.9	58.7	84.7	90.6	108.3
Hong Kong, China (HKG)	1462.9	1338.6	1246.5	1434.5	2097.1
India (IND)	30.2	39.7	42.3	49.1	64.1
Indonesia (INO)	80.6	86.2	136.8	86.1	76.9
Korea, Republic of (KOR)	35.4	50.9	82.7	107.5	161.9
Lao PDR (LAO)	215.3	147.5	198.7	148.0	153.2
Malaysia (MAL)	121.6	160.8	185.5	183.9	242.2
Philippines (PHI)	95.0	97.3	143.3	114.7	99.2
Singapore (SIN)	361.3	419.5	809.5	966.7	1216.4
Taipei, China (TAP)	103.4	97.7	132.3	257.0	369.7
Thailand (THA)	68.8	114.4	142.7	135.1	168.0
Viet Nam (VNM)		96.2	110.7	100.2	129.8

Sources: For 1990, 1995 and 2000, the figures came from Lane and Milesi-Ferretti (2006), except for Taipei, China, whose figures were obtained from the China Economic Information Center (CEIC) database. For 2005 and 2009, the figures were calculated using IMF IFS stock data, where available, or capital flow data, where stock data are not available. For Lao PDR and Viet Nam, the latest data are for 2007.

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## 3. Capital Flows in Emerging Asia

Emerging Asian economies have received net capital inflows, which have been volatile over the last 20 years



Notes: Emerging Asia: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand  
Source: CEIC accessed on 15 April 2011

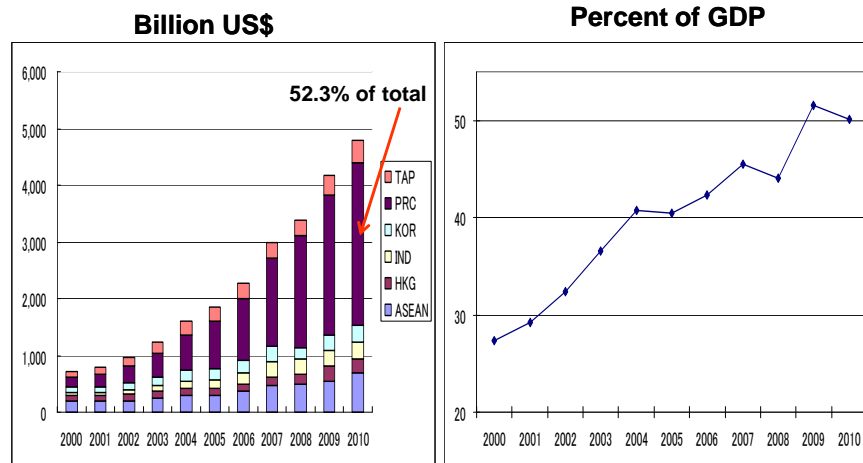
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## 4. Impact of Capital Flows on Emerging Asia

- accumulation of forex reserves due to intervention
- higher increases in money supply, indicating sterilization was incomplete
- rising pressure on prices
- rising equity prices

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## Foreign Exchange Reserves, Emerging Asia



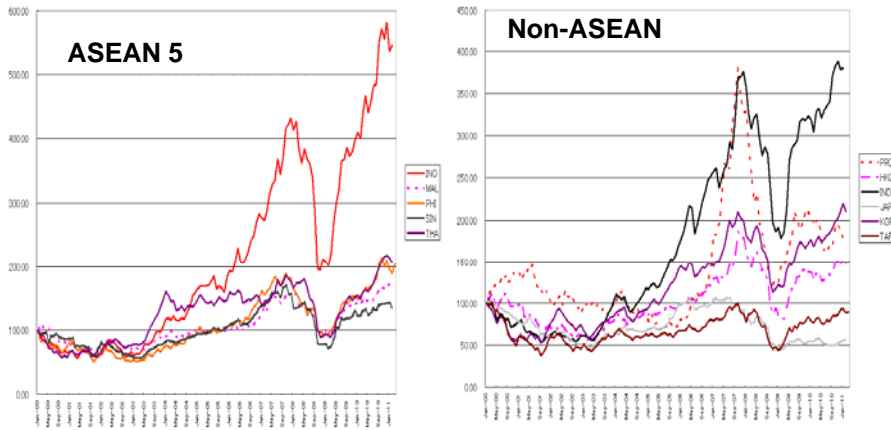
Notes: Emerging Asia: Cambodia, China, Hong Kong, India, Indonesia, Korea, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Taipei, China, Thailand, and Viet Nam  
 Source: World Bank databank accessed on 14 April 2011; CEIC accessed on 14 April 2011; Bloomberg accessed on 15 April 2011

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## Asset Prices

Rose markedly during large capital inflow episodes  
and dropped sharply during capital flow reversal episodes

**Stock Price Indexes, 2000-2011 (Jan. 2000 = 100)**

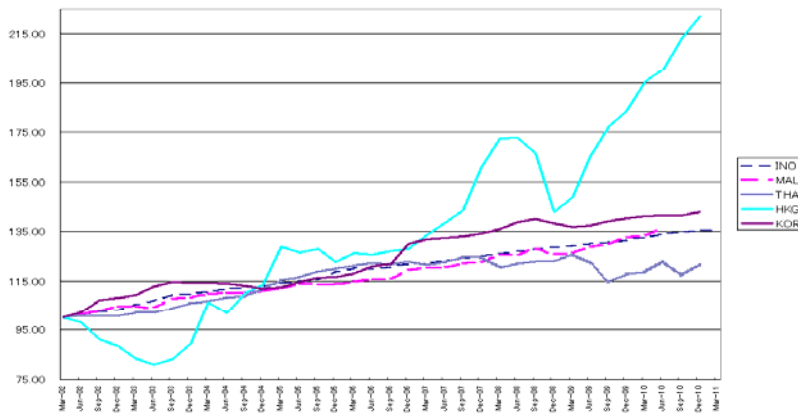


Source: CEIC accessed on 14 April 2011

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## Property Price Index

Selected Asian Economies, March 2002-March 2011  
(March 2002=100)



Notes: (1) INO- Residential Property PR, New Medium-Sized Houses (Big cities), PER DW,NSA  
 (2) MAL- Residential Property PR., All dwellings, PER SQ. M., Q-ALL Y-ALL NSA  
 (3) THA- Residential Property PR., All detached Houses (GR Bangkok), PER SQ.M,NSA  
 (4) HKG- Residential Property PR.,All dwellings, PER SQUARE M., M-ALL NSA  
 (5) KOR- Residential Property Prices, All dwellings, M-ALL NSA

Source: Bank for International Settlements (BIS) accessed on 14 April 2011

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## 5. Policy Responses to Capital Flows

- Intervening in the forex market
- Lowering domestic interest rate to narrow interest rate differential
- Imposing capital controls

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## 6. Managing Capital Inflows in the Post-Crisis Era

- **“Best” policy mix:** Fully flexible exchange rate, capital account openness, and low-inflationary monetary policy
- This is appropriate for **advanced economies** with deep, liquid and broad financial markets
- **Problems** for emerging economies
  - Lack of depth of foreign exchange markets, risk tolerance, and industrial diversification for wide exchange rate swings
  - Shallow financial markets and systems, not resilient enough to large inflows and outflows of capital

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## A. Prudential and Other Regulatory Measures

**In view of limited policy space, EAEs have introduced prudential and other regulatory measures affecting capital inflows and foreign exchange positions (see Table)**

- use of outright capital control (or what the IMF calls residency-based capital flow management measures (CFMs)) is relevant only for a handful of EAEs (Indonesia, Malaysia, Philippines and Thailand)
- purchases by nonresidents of domestic securities are the main target of any potential CFMs
- use of outright capital controls (that explicitly discriminate against foreign investors) is increasingly ruled out as a feasible policy option, especially if it is pursued by individual countries

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## Capital Flow Prudential and Other Regulatory Measures, 2010-2011

Emerging Asian Economies	Measures
India	<ul style="list-style-type: none"> <li>• June 2010: limited the amount of short-term bonds that could be sold to foreign investors (while raising the overall ceiling for FII investment in debt in September 2011)</li> </ul>
Indonesia	<ul style="list-style-type: none"> <li>• June 2010: imposed a one-month holding period for SBIs while announcing the introduction of longer-term (9-12 months) SBIs (from August/September); introduced new regulations on banks' net foreign exchange open positions</li> <li>• January 2011: re-introduced a cap (in relation to capital) on overseas short-term borrowing by banks while requiring banks to set aside a higher percentage of their foreign exchange holdings as reserves</li> <li>• May 2011: lengthened the one-month SBI holding period to six months</li> <li>• July 2011: restricted investment by banks in foreign currency bonds issued in the domestic market in circumvention of measures to restrict foreign currency loans</li> </ul>
Korea	<ul style="list-style-type: none"> <li>• June 2010: placed limits on foreign exchange derivatives positions, in relation to the capital base of financial institutions; further restricted the use of foreign currency loans by banks within Korea; and tightened regulations on the foreign currency liquidity ratio of domestic banks</li> <li>• December 2010: announced the introduction of a tax on banks' foreign exchange borrowing and the re-instatement of withholding tax on interest income from government bonds (from January 2011)</li> </ul>
Thailand	<ul style="list-style-type: none"> <li>• October 2010: re-imposed withholding tax on interest income and capital gains from foreign bond holdings</li> </ul>

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## **b. Scope for Collective Action**

### **Regional financial monitoring**

- A need to step up regional financial market monitoring
- Creation of an Asian financial stability dialogue among the region's finance ministry officials, central bankers and financial regulators

### **Coordinated introduction of prudential and other regulatory measures**

- A country's successful capital inflow controls could drive foreign capital to countries without such controls
- To be effective, coordinated capital controls are desirable

### **Exchange rate policy coordination**

- Asian economies need to work together for collective currency appreciation vis-à-vis the USD while keeping relative currency stability within the region, so as to:
  - (1) maintain national financial & macroeconomic stability,
  - (2) support intra-regional trade and investment
  - (3) minimize loss of national price competitiveness
- This requires greater exchange rate flexibility in the PRC

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## **7. Conclusion**

- Given the robust growth prospects in the region relative to the US and Europe, emerging Asia continues to face capital inflows and, as a result, significant challenges in macroeconomic management and financial sector reform
- Advanced economy view would be to adopt a freely flexible exchange rates and an open capital account
- Textbook policy responses include: greater exchange rate flexibility, financial sector reform, and fiscal policy tightening

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## 7. Conclusion (cont'd)

- A combination of prudential and other regulatory measures, including outright capital, to limit volatile capital inflows
- But it is often difficult to implement these policies at the national level alone because of regional interdependence
- Asia needs to strengthen regional financial and monetary cooperation:
  - Asian financial stability dialogue
  - Coordinated introduction of prudential and other regulatory measures
  - Exchange rate policy coordination for collective currency appreciation, to better achieve each country's macroeconomic and financial sector stability while maintaining intraregional exchange rate stability

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# Thank you

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