Capital Flows and Macro-Prudential Measures in Korea

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I. Volatility of Capital Flows

Net Capital Flows to Asia

- Fluctuations in capital flows have deepened.

Capital Flows to Korea

- During 2007 to Aug 2008, $84.2 billion flowed into Korea.
- During Sept-Dec 2008, $69.6 billion flowed out.

Inflow to EMEs: Low interest rate and QE in AEs

Low Interest Rate

Quantitative Easing

- QE (Nov 2008) and QE2 (Nov 2010)
- On Jan 2012, U.S. FOMC is likely to keep exceptionally low levels for the federal funds rate at least through late 2014.
Outflow from EMEs: Flight to Quality & Deleveraging

Demand for "safe" assets & Home bias
(U.S. 10-year Treasury)

European Bank Capital Needs
In billions of euros

II. Impact of Capital Flow Volatility: Pro-cyclicality

Global Carry Trade Flows Threaten the Stability of Emerging Economies

Global Carry Trade’s Influence on EM

- For emerging economies, the interaction between domestic monetary policy and capital inflows can pose particularly difficult challenges in cooling an overheating economy.

- The interaction between capital inflows and monetary policy can create a vicious circle that encourage destabilizing carry trade inflows.

(Hyun Song Shin, Princeton University)
Impact of Capital Flow Volatility: Stock & FX market volatility

Stock Market Volatility (Korea)  FX Rate Volatility (Korea)

Impact of Capital Flow Volatility: Macroeconomic performance

Decrease in Growth (Korea)  Decrease in Employment (Korea)

(yoy; unit: 10,000)
Impact: Sudden capital outflow in Korea

Structural Problem

- High dependence on trade
- Excessive ST external debt, particularly in ST overseas borrowings
- Sharp swings of capital flows
- Fully open capital market
- Vulnerable to external shocks

Reversed capital flows caused by Global de-leveraging after LM collapse

Impact: Sudden capital outflow in Korea

Korean Domestic Banks

Branches of Foreign Banks

(Unit: US$ bn)
III. Macro-prudential Measures: Basic approach

Within the Current Framework of the Open and Liberalized Economy

Problem to Solve

Capital inflows and outflows...

- Scale: Massive
- Composition: Mainly STs
- Volatility: High

Two Options of Policy Response

- Macro-economic policies
- Macro-prudential measures

Macro-prudential Measures: Basic approach

The Need For Macro-Prudential Policies

- Structural Problems
- Limitations of Macro Economic Policies

The Need For Surgical Approach

Introduce Macro Prudential Measures in Line with the Communiqué of G20 Seoul Summit
<Micro-prudential measures>
Enhancing FX Soundness of Financial Institutions

Foreign Currency Liquidity Risk Management
- Newly Implemented
  - Foreign bank branches as well as domestic banks are subject to the regulation
  - This regulatory system for branches is similar to that of the UK.

Foreign Currency Liquidity Ratio
- 3-month foreign-currency liquidity ratio
- 7-day maturity mismatch ratio, 1-month maturity mismatch ratio
- Reflecting the Recoverability of FX Assets

Mid-to Long-term Funding Resources Ratio
- Tighter Regulations

FX Derivatives Trading Risk Management
- Newly Implemented

Mandatory Minimum Holdings of Safe Foreign Currency Assets
- Newly Implemented

Macro-prudential Measures
1) Leverage Caps on Banks’ FX Derivatives Position

Close Link between Export Practices and Increase in Banks’ ST Debt

Banks

Exporters (Shipbuilders)
Selling FX Forward
Buying FX Forward

Bond Market

FX ST Borrowing
Overseas Banks
Short-term External Debt ↑

FX Market

Ceilings on Banks’ FX Derivatives Position

| Domestic Banks | 50% | 40%* |
| Branches of Foreign Banks | 250% | 200%* |

* Note: Lowering of the cap ceilings on FX derivatives positions (After a grace period of 1 month)
Macro-prudential Measures
2) Restoring Withholding Tax

- **Surge in Foreign Holdings**

  (Unit: KRW Tr)

  - Foreign investors as well as domestic investors are subject to withholding tax
  - This is not a discriminatory measure based on residency
  - This took effect on Jan 1, 2011

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Macro-prudential Measures
3) Imposing Bank Levy

**Purpose of Bank Levy**
- To Reduce Capital Flow Volatility
- To Encourage Long-term and Stable Sources of Funding
- To Help Economy Cope with External Shocks

**Characteristics of the Levy**
- **Levy Base**: Banks’ Non-Deposit Foreign Currency Liabilities
- **Levy Rate**: Varies According to Debt Maturity (Limited to 50bp)
- **Proceeds**: Liquidity Injection to Failing Financial Institutions
Key Features

Measures are pre-emptive and precautionary, carried out within the framework of a liberalized economy

- **Minimum Safety Devices**
  - Within the Framework of Capital Account Liberalization

- **Surgical Approach**
  - Targets Specific Types of Capital Flows

- **Flexibly Applied Measures**
  - Prepared for Rapid Policy Response

- **Non-Discriminatory Measures**
  - Not a Discriminatory Measures Based on Residency

- **Tax rate on foreign bond buyers can be lowered down to zero if necessary to promptly stabilize financial markets**
- **Ceiling on banks’ FX derivatives position will be adjusted every 3 months**
- **Bank levy rate varies according to debt maturity**

The G20 agreed that capital flow management measures that do not discriminate on the base of residency can be employed.

IMF also agreed that such measures have the benefit of targeting directly the risk at hand and avoid the burdens associated with measures that discriminate based on residency.

### IV. Effectiveness: Change in composition

**Decrease in the ratio of FX derivatives position to capital**

- **Decrease in FX Derivative Position** & Increase in Banks’ Capital

**Lower dependence on foreign branches**

Foreign branches were the major channel of capital outflows during the global financial crisis

- **Decrease in Foreign branches’ ST external debt** in terms of volume and the risks to gross ST external debt
Effectiveness: Enhancing external debt soundness

Decrease in short term external debt

Short-term external debt has declined rapidly while reserves continue to provide insurance against volatility

Gross Short-Term External Debt to Foreign Exchange Reserves (%)

Effectiveness: Views from outside

The set of measures targeting the excess buildup of FX leverage appears to have prevented banks’ outstanding short-term debt from returning to pre-crisis levels.

(Republic of Korea—Staff Report for the 2011 Article IV Consultation)

The technical move should be regarded as the latest gambit in the currency wars. Compared with Switzerland’s blunt defense of the franc, a small tax hike from one of the most experienced currency warriors seems barely a speed bump in the path of capital inflows. … Seoul (Korea) partially accepts currency strength.
V. To be Discussed

While enjoying the benefits of capital account liberalization, efforts also focus on addressing the accompanying risks

1. To firmly establish a perception of the necessity and role of macroprudential measures
   - The international community reached a consensus that capital flow volatility could undermine financial stability and sustainable growth.
   - The leaders at the G20 came to "Coherent Conclusions for the Management of Capital Flow" to mitigate capital flow volatility.
   - The revision of the OECD Liberalisation Codes needs to be considered to reflect the recent changes in the financial environment.

2. To find the way that macroeconomic, macroprudential and microprudential policies could act in concert

3. Other Issues: Financial Transactions Tax, etc.

Thank you!