Capital Flows and Macro-Prudential Measures in Korea

Feb.7, 2012

Sung-Soo Eun
Ministry of Strategy and Finance
ROK

MINISTRY OF STRATEGY AND FINANCE

Contents

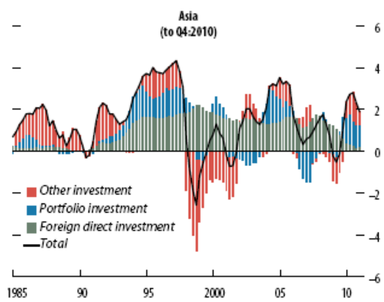
MINISTRY OF STRATEGY AND FINANCE

Ⅰ. Volatility of Capital Flows

Net Capital Flows to Asia

% of aggregate GDP, four-quarter moving average

- Fluctuations in capital flows have deepened.

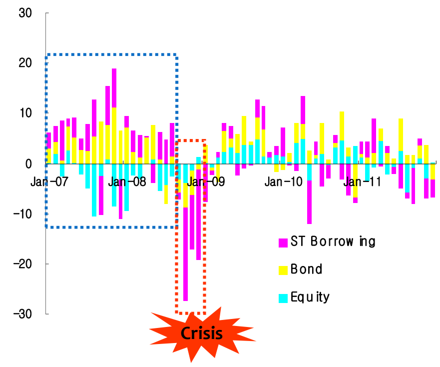


Source: IMF

Capital Flows to Korea

Billion USD

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

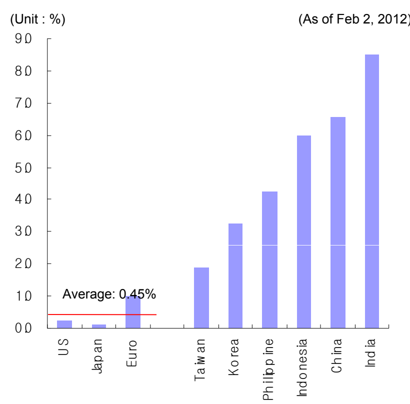


MINISTRY OF STRATEGY AND FINANCE

2

Inflow to EMEs: Low interest rate and QE in AEs

Low Interest Rate



Quantitative Easing

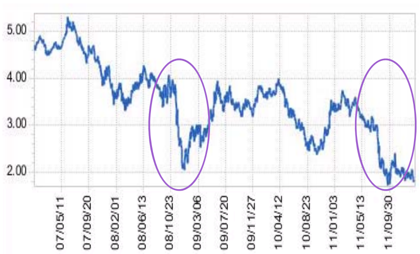
- QE (Nov 2008) and QE2 (Nov 2010)
- On Jan 2012, U.S. FOMC is likely to keep exceptionally low levels for the federal funds rate at least through late 2014.

MINISTRY OF STRATEGY AND FINANCE

Outflow from EMEs: Flight to Quality & Deleveraging

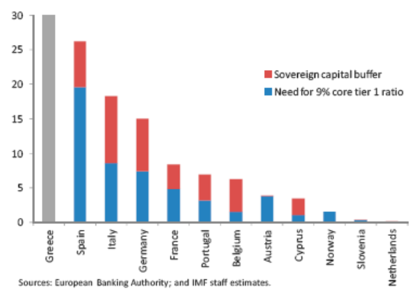
Demand for "safe" assets & Home bias

(%, U.S. 10-year Treasury)



European Bank Capital Needs

In billions of euros



MINISTRY OF STRATEGY AND FINANCE

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***.

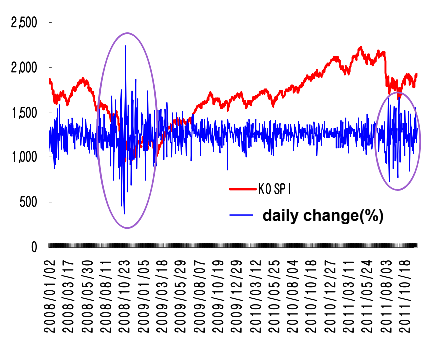
- *The interaction between capital inflows and monetary policy can create a* ***vicious circle*** *that encourage destabilizing carry trade inflows.*

(Hyun song Shin, Princeton University)

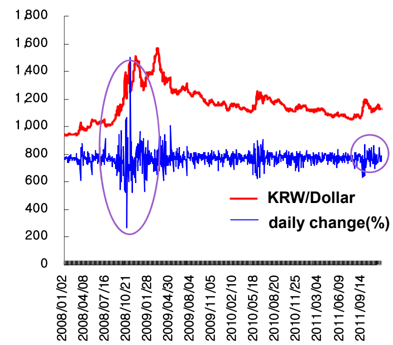
MINISTRY OF STRATEGY AND FINANCE

Impact of Capital Flow Volatility: Stock & FX market volatility

Stock Market Volatility (Korea)



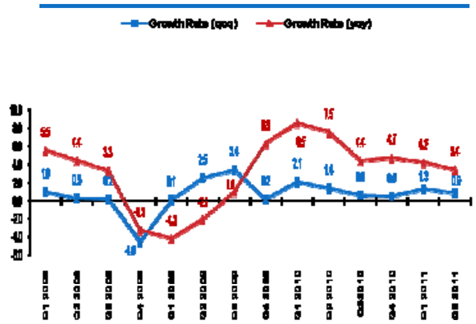
FX Rate Volatility (Korea)



MINISTRY OF STRATEGY AND FINANCE

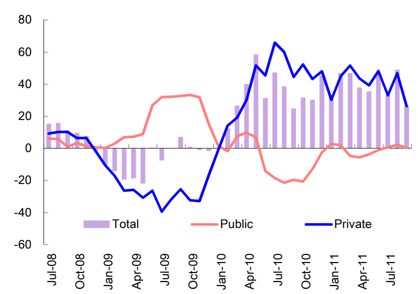
Impact of Capital Flow Volatility: Macroeconomic performance

Decrease in Growth (Korea)



Decrease in Employment (Korea)

(yoy; unit: 10,000)



MINISTRY OF STRATEGY AND FINANCE

Impact: Sudden capital outflow in Korea

Structural Problem

High dependence on trade

Fully open capital market

Excessive ST external debt, particularly in ST overseas borrowings

Sharp swings of capital flows

Vulnerable to external shocks

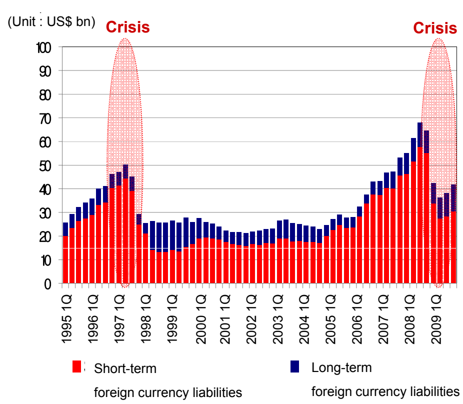
crisis

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

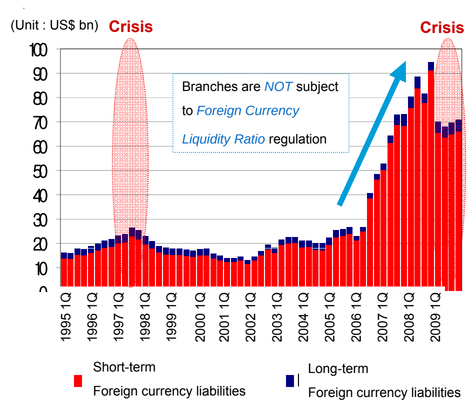
MINISTRY OF STRATEGY AND FINANCE

Impact: Sudden capital outflow in Korea

Korean Domestic Banks



Branches of Foreign Banks



MINISTRY OF STRATEGY AND FINANCE

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*

MINISTRY OF STRATEGY AND FINANCE

Macro-prudential Measures: Basic approach

The Need For Macro-Prudential Policies

Structural Problems → The Need For Surgical Approach ← Limitations of Macro Economic Policies

↓

Introduce Macro Prudential Measures in Line with the Communiqué of G20 Seoul Summit

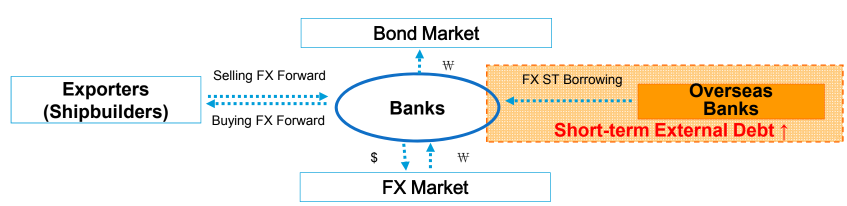
MINISTRY OF STRATEGY AND FINANCE

<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 Requlations*
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



Ceilings on Banks' FX Derivatives Position

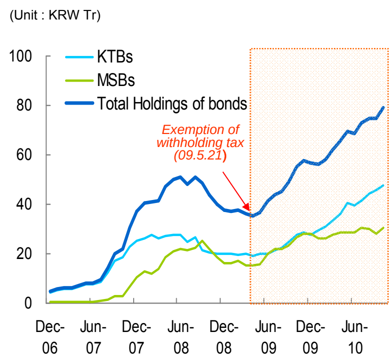
	Previous month's capital	
Domestic Banks	50%	40%*
Branches of Foreign Banks	250%	200%*

* *Note: Lowering of the cap ceilings on FX derivatives positions (After a grace period of 1month)*

MINISTRY OF STRATEGY AND FINANCE

Macro-prudential Measures
2) Restoring Withholding Tax

Surge in Foreign Holdings



Surge in Foreign Holdings

- ***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***

MINISTRY OF STRATEGY AND FINANCE

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

MINISTRY OF STRATEGY AND FINANCE

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

- 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

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

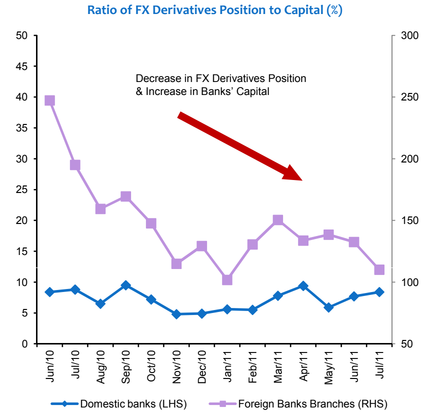
- The G20 agreed that capital flow management measures that do not discriminate on the base of residency can be employed.
- IMF also agreed that such measures have the benefit of targeting directly the risk at hand and avoid the burdens associated with measures that discriminate based on residency.

MINISTRY OF STRATEGY AND FINANCE

Ⅳ. Effectiveness: Change in composition

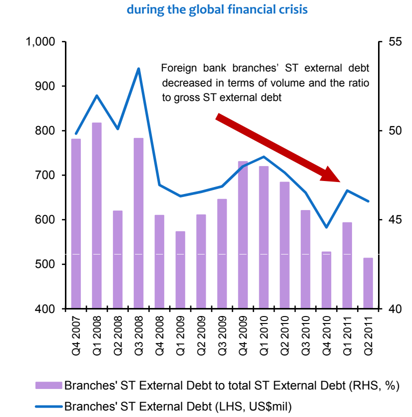
Decrease in the ratio of FX derivatives position to capital

Ratio of FX Derivatives Position to Capital (%)



Lower dependence on foreign branches

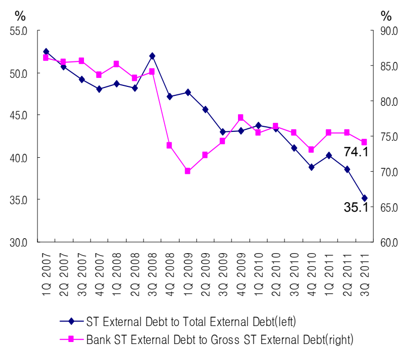
Foreign branches were the major channel of capital outflows during the global financial crisis



MINISTRY OF STRATEGY AND FINANCE

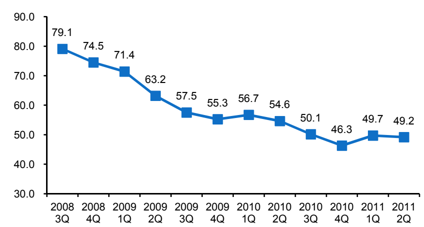
Effectiveness: Enhancing external debt soundness

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 (%)



MINISTRY OF STRATEGY AND FINANCE

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.

MINISTRY OF STRATEGY AND FINANCE

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.

MINISTRY OF STRATEGY AND FINANCE

Thank you!

MINISTRY OF STRATEGY AND FINANCE