Managing Economic Stability Under Volatile Capital Flows

by

Chalongphob Sussangkarn
Distinguished Fellow
Thailand Development Research Institute

(Former Chair of the Advisory Panel of
The ASEAN+3 Macroeconomic Research Office, AMRO)

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Main Topics

1. Stresses from Volatile Capital Flows
2. Self-Protection from Volatile Flows
3. Liquidity Support Safety Nets
   Bilateral
   Global
   Regional

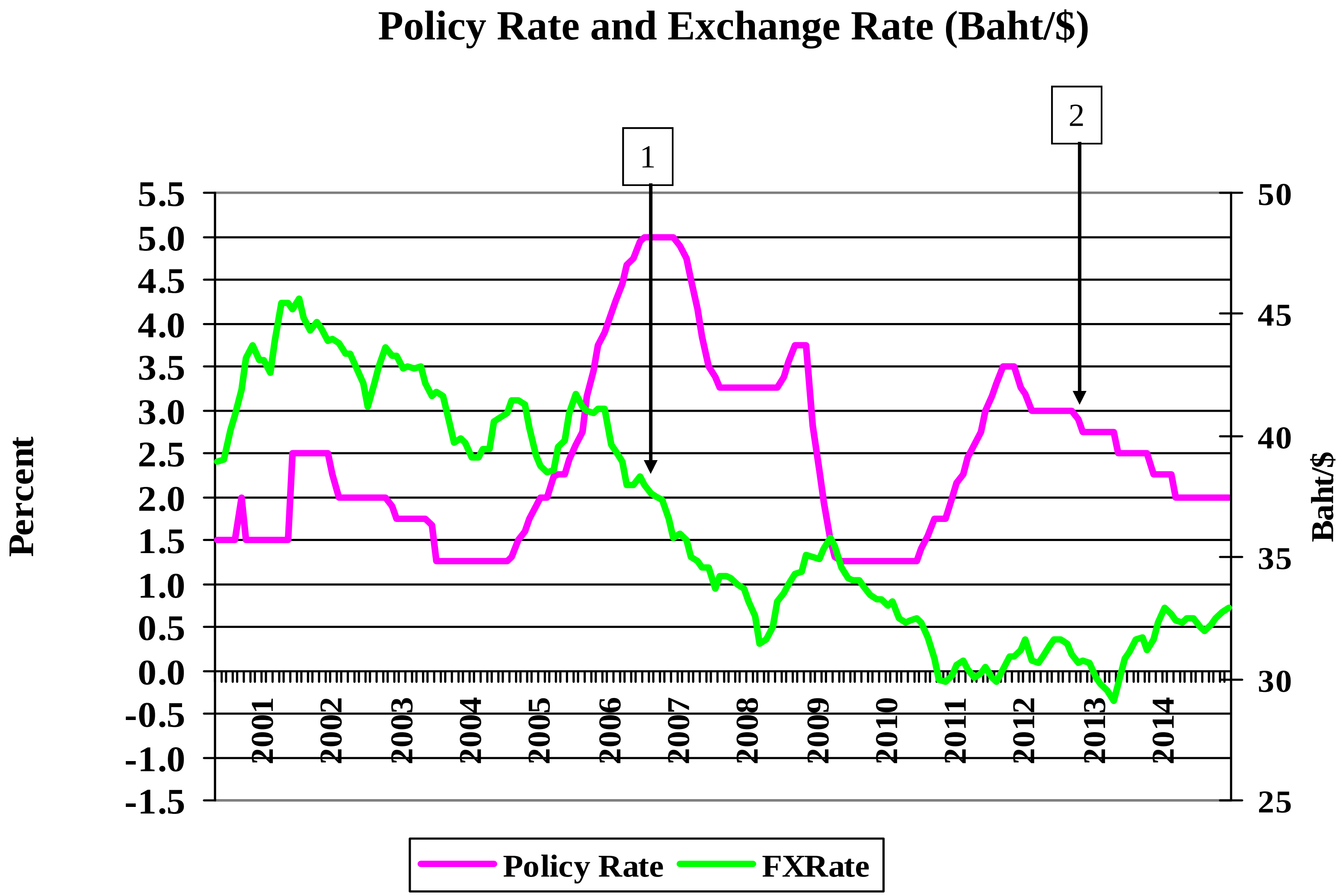
Stresses From Volatile Capital Flows

- The extent of financial globalization and volatilities of short-term capital flows create many challenges for policies of individual economies as well as challenges to global and regional mechanisms that should provide effective safety nets for countries to maintain financial stability.
- East Asia: Large inflows of short-term debt in the first half of 1990's + macro policy mismanagement -- economic bubble -- burst of the bubble and rapid capital flow reversal -- Asian financial crisis + painful crisis resolution measures.
- After the crisis, there have been other periods of large and rapid short-term capital inflows (mostly portfolio) coming from advanced economies, driven by search for higher yields and plenty of liquidity, whether from high leveraging or quantitative easing policies of various advanced economies.

Stresses From Volatile Capital Flows (2)

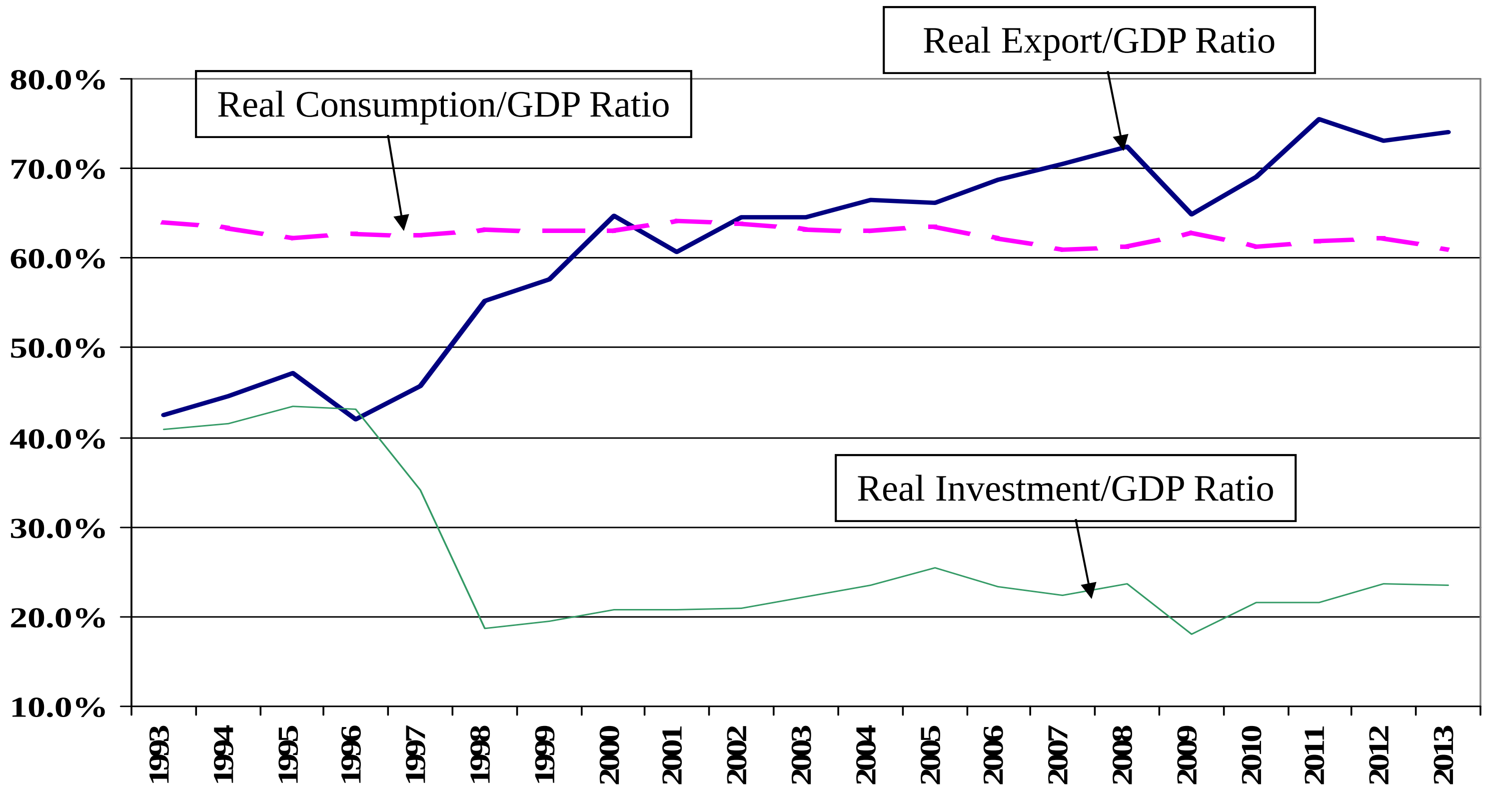
- There have also been periods of large and rapid capital outflows, such as after the closure of Lehman Brothers or at signs of tapering from quantitative easing.
- Both the inflows and outflows pose challenges for macroeconomic policy to maintain economic stability. Pressures on emerging markets from volatilities are particularly large, particularly those with relatively open capital account. Moderate flows can lead to large changes in exchange rates and asset prices.
- The volatilities in capital flows can also lead to volatilities among exchange rates of country groups that are closely integrated or are close competitors, creating difficult challenges for exchange rate management.
- Exchange rates movements can lead to serious political conflicts on the conduct of monetary policy, especially for countries where export is the main growth driver, such as Thailand.

Capital Inflows, FX Rate and Policy Conflicts



Thailand: Export is the Main Growth Driver

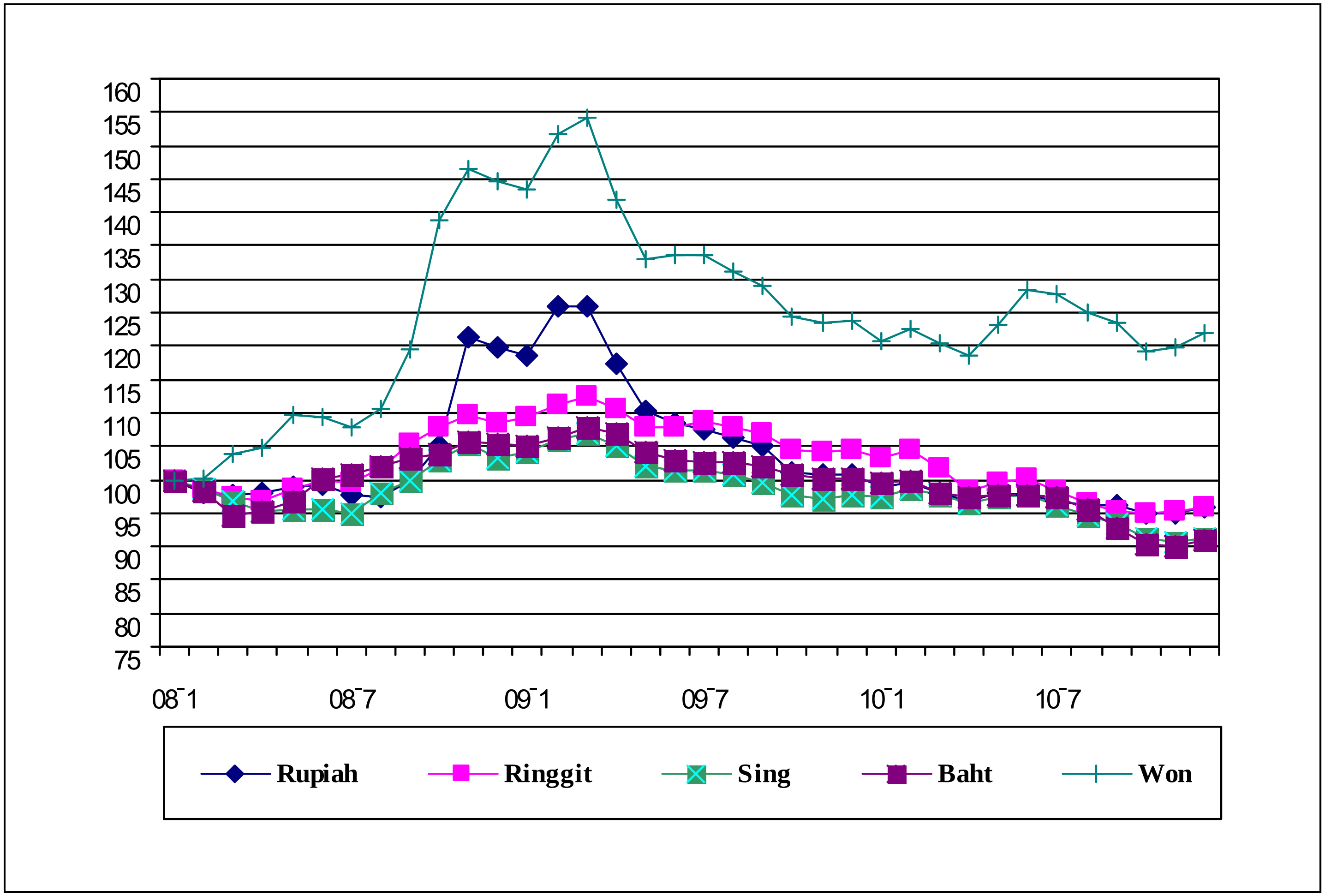
- Since 1997 crisis, export has been main growth driver. Investment has collapse.



Source: NESDB

Stress From Global Financial Crisis Outflows

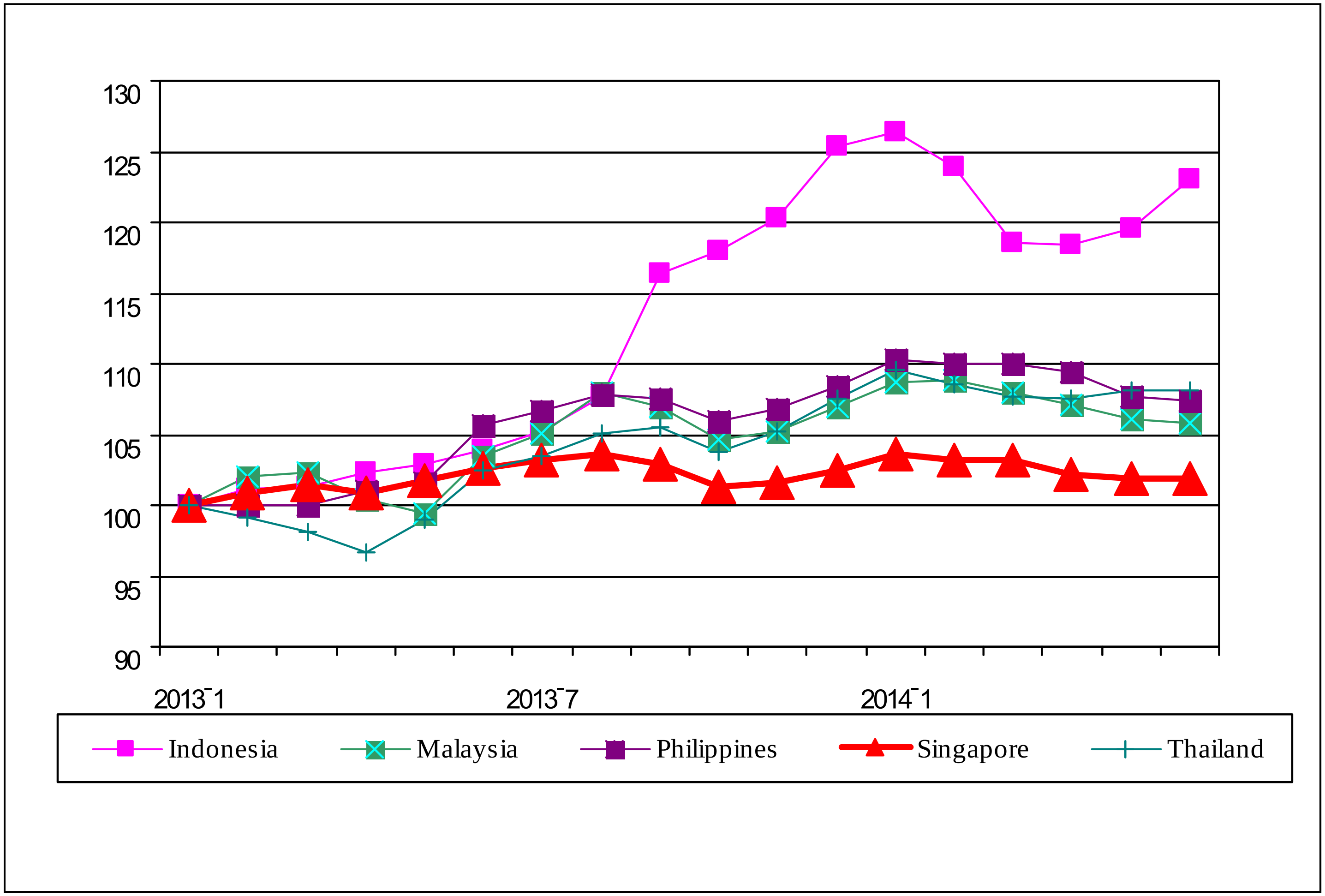
Trends in Exchange Rate Indices (Jan. 2008 = 100)



Source: Bank of Thailand

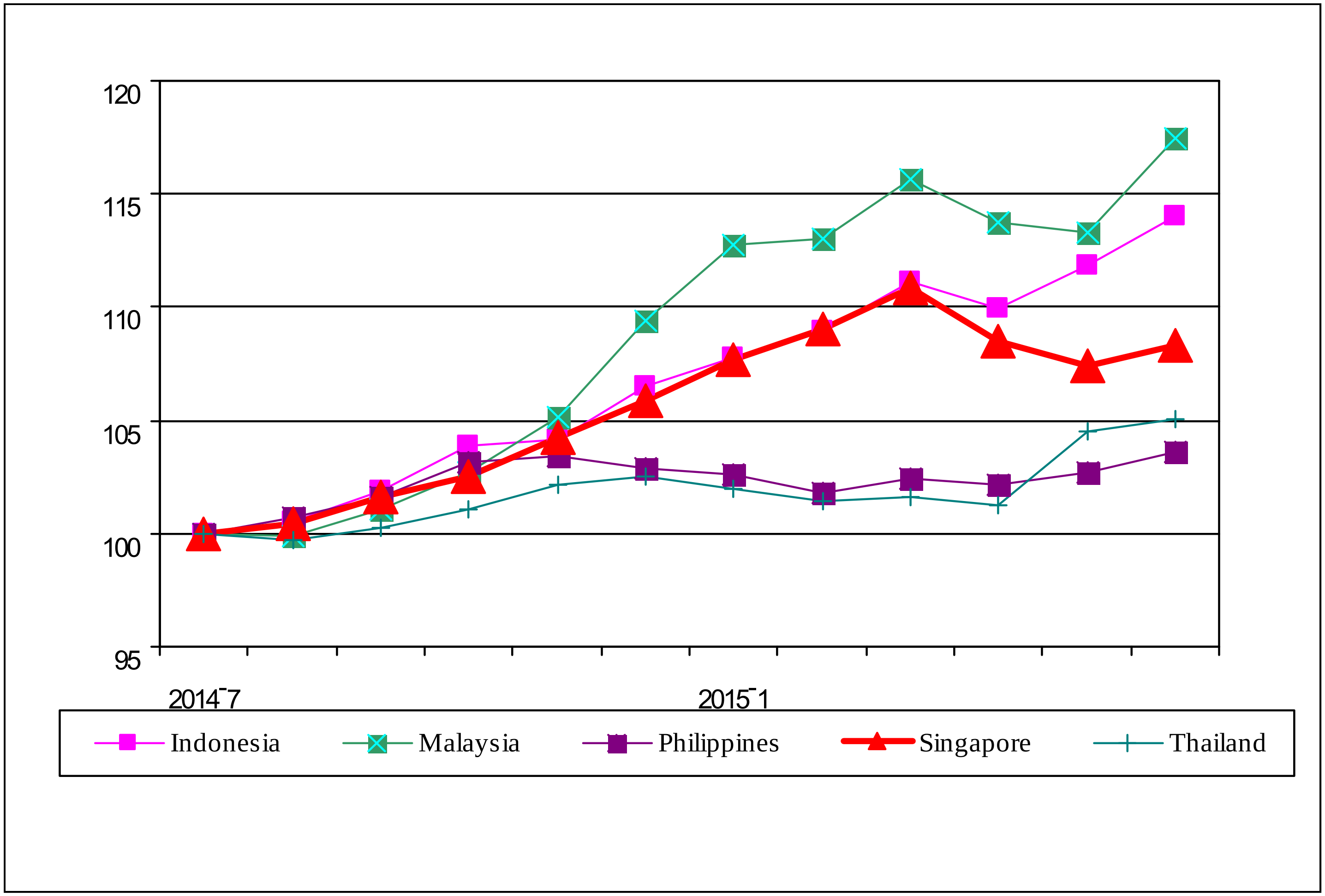
Tapering Impacts on Exchange Rates

(Jan. 2013 = 100)



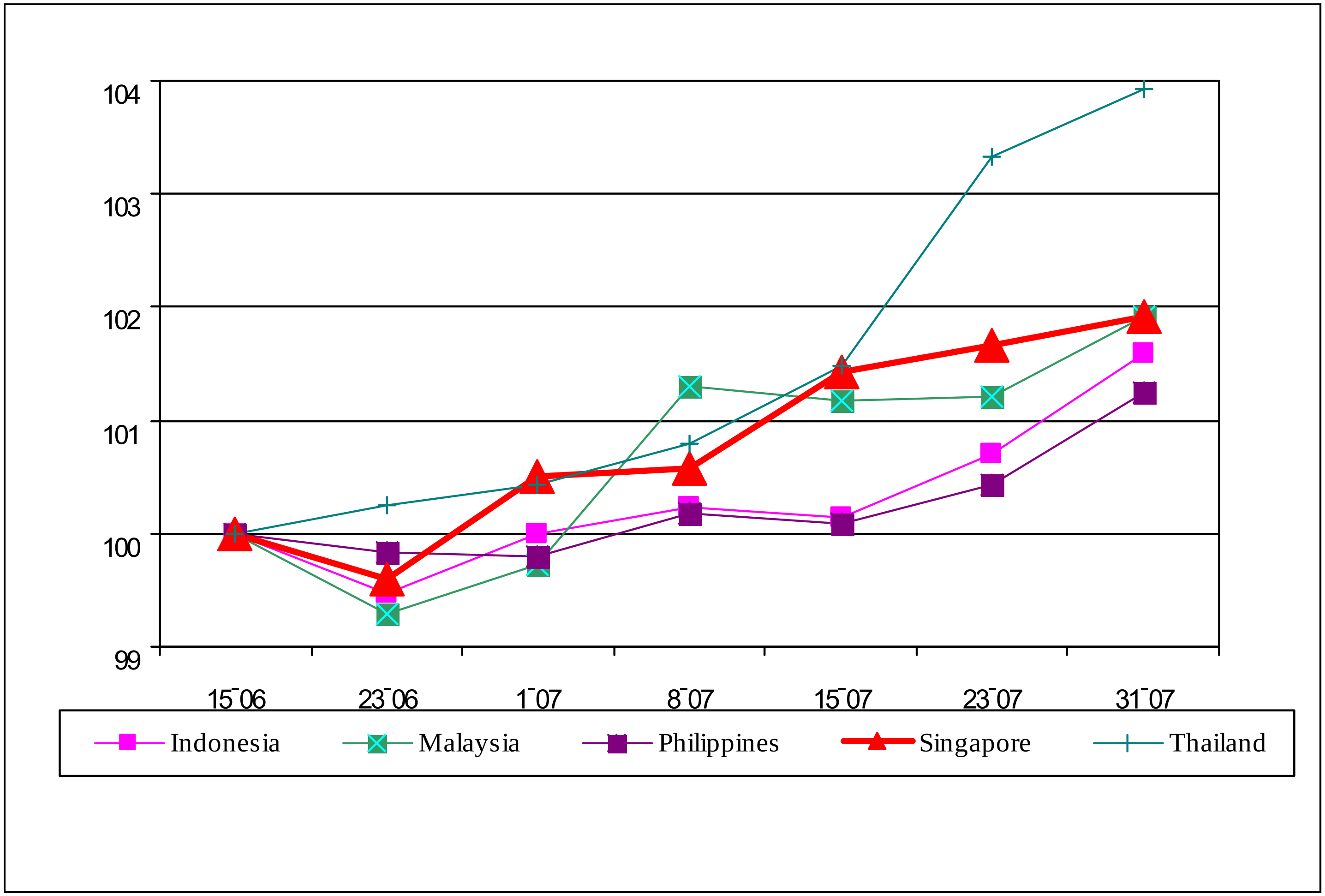
ECB QE Impacts on Exchange Rates

(July. 2014 = 100)



Signals on Impending Fed Rate Hike

(June 15, 2015 = 100)



Self Protection From Volatile Flows

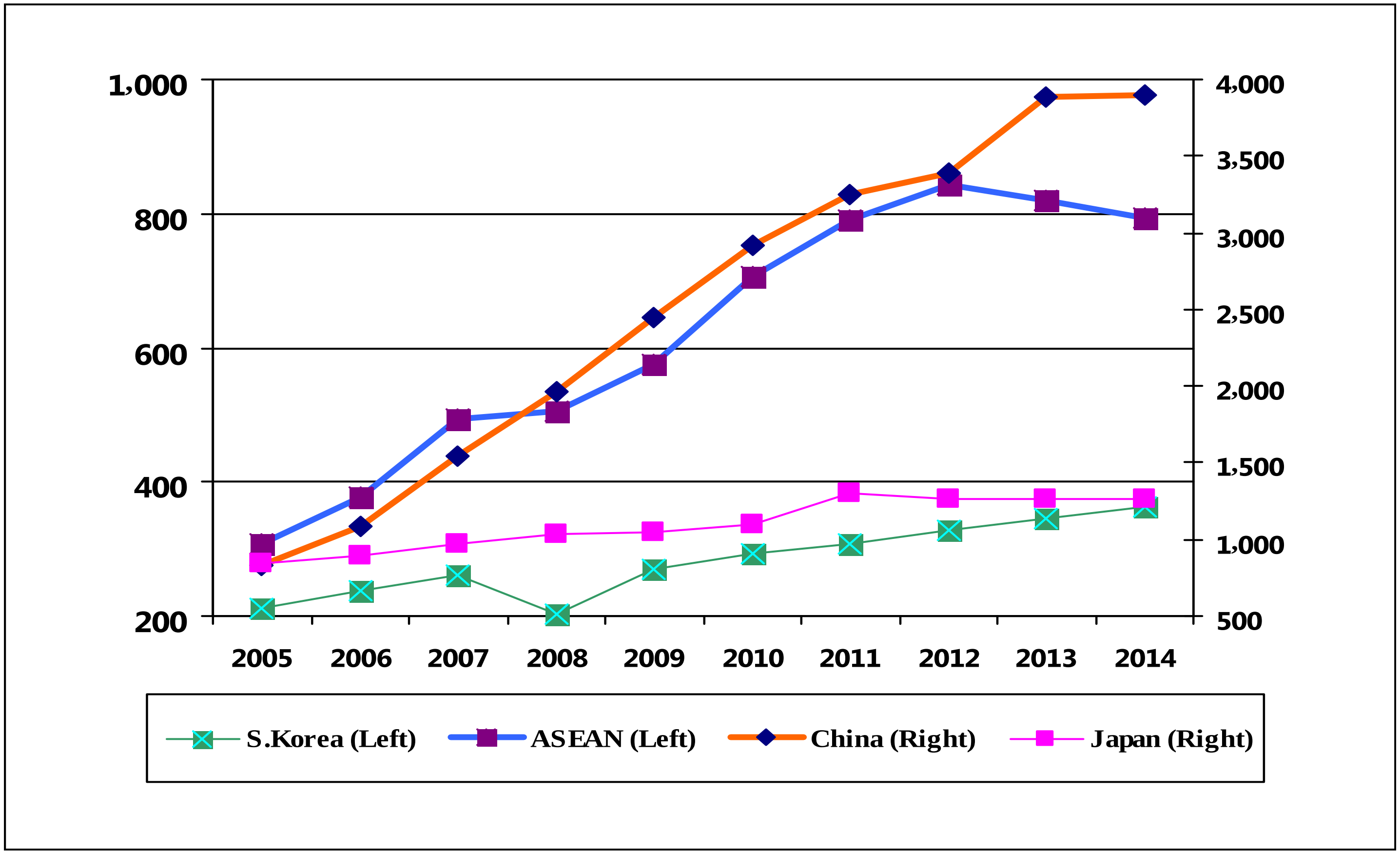
- Most effective protection from volatile capital flows is self protection through appropriate macroeconomic policies. But -- Many constraints.
- Rapid appreciation of the exchange rate -- Loss of export competitiveness.
- Exchange rate intervention can ease the appreciation and also increase reserves to insure against capital flow reversal. However, sterilization can have large costs when domestic interest rates are much higher than foreign rates (particularly US$ rates). Also when the exchange rate appreciates from the inflows, another valuation loss occurs. These can have significant fiscal implications (certainly in Thailand and recent Swiss example).
- Exchange rate appreciation trend attracts even more inflows to speculate on increases in asset prices as well as exchange rate. Inflows also reduce the effectiveness of using interest rate as the instrument of monetary policy to cool down the economy as increasing interest rate will attract even more inflows.

Self Protection From Volatile Flows (2)

- Other macro-prudential tools, such as reserve requirement, can work in combination with interest rate and can ease the cost to the central bank from sterilization (although there will be costs to overall financial intermediation) . Institutional setups in specific countries will dictate the feasibility of such combinations, particularly if financial institution supervisory authority is separate from monetary policy.
- Capital control measures can also be utilized including some macro-prudential measures that have elements of capital controls (i.e. some discrimination between domestic and foreign entities).
- As outflows can also be very rapid and unexpected, such as after Lehman Brothers' closure, smoothly managing outflows to maintain stability can also be challenging.
- Of course, it is critical to have sufficient reserves to (more than) cover the country's potential short-term foreign currency liabilities. The danger of short-term foreign borrowing is clear from experiences of the East Asian financial crisis. However, foreign holdings of stocks and bonds can also be quickly liquidated so reserves should also cover these.
- East Asian economies have generally accumulated huge reserves.

Reserves Accumulation in East Asia

Foreign Exchange Reserves (Billion US$)



Source: IBRD, World Development Indicators.
Note: ASEAN excludes data from Myanmar.

Ratio of Foreign Reserves to GDP (%)

	2005	2008	2011	2014
China	36.6%	43.1%	43.4%	37.6%
Japan	18.5%	21.3%	21.9%	27.4%
South Korea	23.4%	22.4%	34.2%	40.4%
Brunei Darussalam	5.2%	5.2%	15.5%	21.1%
Cambodia	18.4%	25.5%	31.7%	36.6%
Indonesia	12.1%	10.1%	12.3%	12.6%
Lao PDR	11.3%	16.1%	14.2%	10.4%
Malaysia	49.1%	39.9%	46.2%	35.5%
Myanmar	n.a.	n.a.	9.8%*	n.a.
Philippines	17.9%	21.5%	33.5%	28.0%
Singapore	92.7%	92.4%	88.5%	85.0%
Thailand	31.7%	43.3%	59.7%	48.2%
Vietnam	15.7%	24.1%	10.0%	18.4%

Source: Calculated from IBRD, World Development Indicators and ADB, Key Indicators for Asia and the Pacific.
* 2012.

Self Protection From Volatile Flows (3)

- However, reserves accumulation can be costly and even with large reserves, rapidly liquidating sufficient reserves to meet requirements of the capital outflows may be problematic and can lead to capital market disruptions.
- Foreign exchange liquidity problems may occur leading to rapid currency depreciation, loss of confidence, and impacts on the real economy.
- So in addition to self protection, additional liquidity support safety nets can be very helpful.

Bilateral Safety Nets

- During the severe global US$ liquidity shortages after the closure of Lehman Brothers, bilateral safety nets helped to stabilize foreign exchange markets, particularly for South Korea (with the Fed) and Indonesia (with China and Japan) in East Asia.
- Possibly because the bilateral swaps seemed to be effective during the global financial crisis, countries have been moving to do more bilateral swaps with each other.
- However, bilateral swaps are inevitably **political** as demonstrated by the reduction of the swap between Japan and Korea following territorial disputes between the two countries.
- Bilateral swaps should therefore not be seen as the best approach to providing safety nets for volatile capital flows.

Global Liquidity Safety Nets

- At the global level, the IMF has been developing new liquidity support facilities since the global financial crisis.
- Countries with very strong fundamentals as judged by the IMF may try to qualify for the “Flexible Credit Line (FCL)”, while those with strong fundamentals but with some policy vulnerabilities may qualify for the “Precautionary and Liquidity Line (PLL)”, which will have some ex post conditionality.
- So far (as of mid-April 2015), only Poland, Mexico and Colombia have applied and qualified for the FCL, though none have drawn on it. Only Morocco and the Republic of Macedonia have applied and qualified for PLL.
- The very small demand for what are meant to be global facilities is clearly a major problem.
- In a January 2014 review of the FCL, PLL, IMF staff admitted that IMF stigma is still a major issue for many emerging market economies.

Global Liquidity Safety Nets (2)

- There is also the risk that countries may apply but not qualify for FCL or PLL, which will be a severe loss of face and could have market implications if the information became known, so countries are likely to avoid taking the IMF exam.
- A rethink of how to design the IMF (global) facilities so that it is more widely useable is clearly necessary given that risks from capital flow volatilities are integral parts of the global financial markets and are likely to increase more and more in the future.

Regional Safety Nets

- At the regional level in East Asia is the Chiang Mai Initiative Multilateralization (CMIM), which since July 2014 totals US$ 240 billion of self-managed reserve pooling. No real money is paid into a central pool but real money is paid to support the ASEAN+3 Macroeconomic Research Office (AMRO), which was established in April 2011, based in Singapore, to carry out surveillance on the ASEAN+3 region and each individual economies (plus Hong Kong) to support the CMIM mechanism. The Finance and Central Bank Deputies of ASEAN+3 perform the role of the Executive Committee (EC) of AMRO.
- AMRO is now transforming into an International Organization (IO) from currently a non-profit Singaporean entity.

Regional Safety Nets (2)

- CMIM is linked to the IMF based on the percentage of a country's borrowing quota that is needed. Currently 30% of the quota is unlinked.
- There are to be two types of facilities. A crisis resolution facility called CMIM Stability Facility (CMIM-SF) and a crisis prevention facility, called the CMIM Precautionary Line (CMIM-PL).
- Qualification criteria for CMIM-PL based on various policy areas are being worked on but currently they seem to mirror the IMF's qualification criteria for its liquidity facilities. This is a worry as the IMF facilities has been unable to generate demand from member countries. If the crisis prevention facility of CMIM is going to be similar, what will be the value added of CMIM?
- Generally, progress in developing the CMIM has been very slow. Agreement to set up the CMI (network of bilaterals) was reached in 2000, so it has already been 15 years to evolve from CMI to the current CMIM.

Regional Safety Nets (3)

- The main priority at present should be to develop the CMIM-PL to be an effective crisis prevention facility and provide value-added to the global mechanism. However the CMIM should take a different approach to current IMF liquidity facilities.
- It should be designed to be; 1) **Objective**, 2) **Transparent**, and 3) **Automatic**.
- Clear objectively measurable criteria, which are publicly available, for access to various levels and lengths of liquidity support can be established. Countries would qualify automatically, and know that they qualify, for these liquidity supports based on these criteria.
- The criteria can vary depending on the amount and maturity of liquidity support, and dependent mostly on the likelihood of repayment. For example, the ability of any country to draw upon such an IMF liquidity facility for an amount of say 1% of its current foreign reserves for a period of 3 months should be basically automatic, unless data shows a high probability of large capital outflows that will run down almost all of the reserves in a short period of time.

Regional Safety Nets (4)

- For larger amounts and longer maturities (there could be a number of levels for these), qualifying criteria would gradually become more stringent, but again these need to be transparent and automatic.
- In principle, regional facilities should have easier access criteria than global facilities. This is because contagions within the region tend to be larger than those from outside, so regional members should be willing to take more risks (in terms of default risks) from providing liquidity support to regional members. Also, the sense of ownership for the regional facility should be much stronger than for the global facility, so the sense of obligation to avoid default in repayment tend to be very high.
- Can look at the experience of another regional fund that has been operating for almost 35 years.

Regional Safety Nets (5)

- The Latin American Reserve Fund, or Fondo Latinoamericano de Reservas (FLAR) started in 1978. It now has 8 member countries; Bolivia, Colombia, Costa Rica, Ecuador, Peru, Paraguay, Uruguay and Venezuela. The size is relatively small, with paid in capital of about US$ 3.6 billion (but this is real money compared to the self-managed reserve pooling of CMIM).
- FLAR has no operational link to the IMF.
- The experiences of FLAR are highly relevant to CMIM and AMRO.
- The fact that FLAR has no operational links to the IMF and member countries frequently borrow from it with no conditionality, and there have been no defaults on loans from FLAR show that members are given the benefit of the doubt, and the importance members attach to ownership of the fund.

Regional Safety Nets (6)

- CMIM should draw from this experience.
- When members request drawing from the CMIM-PL (IMF unlinked part), the approval should be almost automatic. The only exceptions are when i) it is clear that the member is or will shortly be insolvent in terms of foreign currencies, and ii) the likelihood of the member being able to repay the swap amount (with interest) within a reasonable period of time is very low. To cover such cases, objective and transparent criteria can be developed to limit the amount of drawing that a country can access automatically.
- However, it should be noted that even when Thailand became insolvent in mid-1997, with remaining net foreign reserves of only about US$ 2.8 billion compared to short-term foreign debt totaling about US$ 40 billion, the country was able to quickly accumulate foreign reserves through currency depreciation so that within two years, no further drawing was needed from the IMF, and full repayment was made in 2003. Therefore, CMIM-PL should lean toward giving members the benefit of the doubt.

Regional Safety Nets (7)

- The amount of drawing available to members without linking to the IMF need to be increased as sufficient size and quick disbursement are important to generate market credibility. For drawing of relatively short maturities (say 6 or 9 months) the IMF link should be removed. If problems persist after a specified period, the likelihood that the problem is not a temporary one, but one of solvency, becomes much higher, with need for fundamental changes in policy, and a crisis resolution mechanism is called for. In such a case, the link to the IMF can be invoked.
- So CMIM crisis prevention facility (temporary liquidity support) should be similar to FLAR, with no links to the IMF, but crisis resolution will be carried out with the IMF, so be more like what has been happening in Europe over the past few years.

Thank you for your attention.