The Role of Capital Control in Dealing with the Surge of Capital Inflows in EMs

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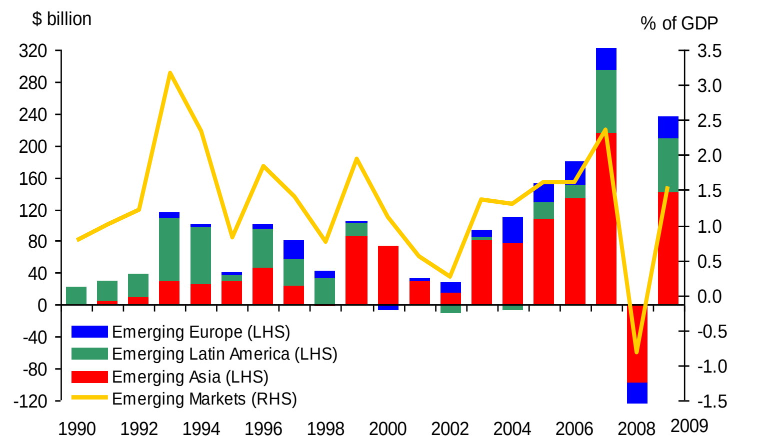
- **The Nature and Risks of the Surge of Capital Inflows in EMs**

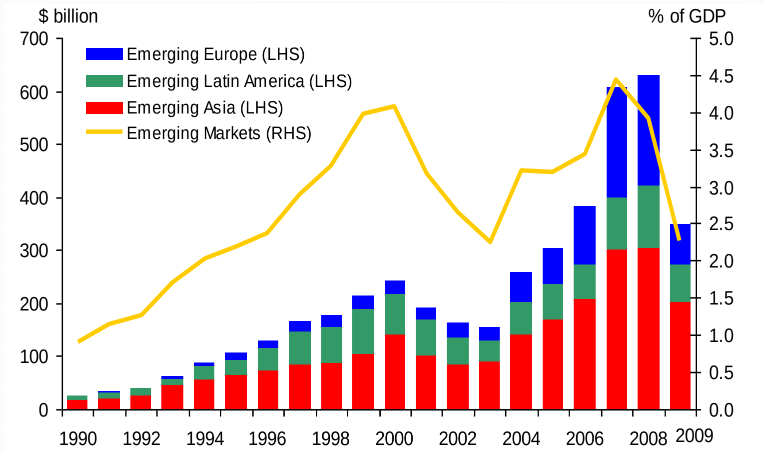
  – Since 2004, the capital flows to the EMs have increased rapidly. Though it was some slowdown during the US financial crisis in 2008-2009, the trend has strongly rebounded over the past two years partly due to the QE and QE2 by Feb.

VOLATILE FINANCIAL FLOWS (Emerging Markets)

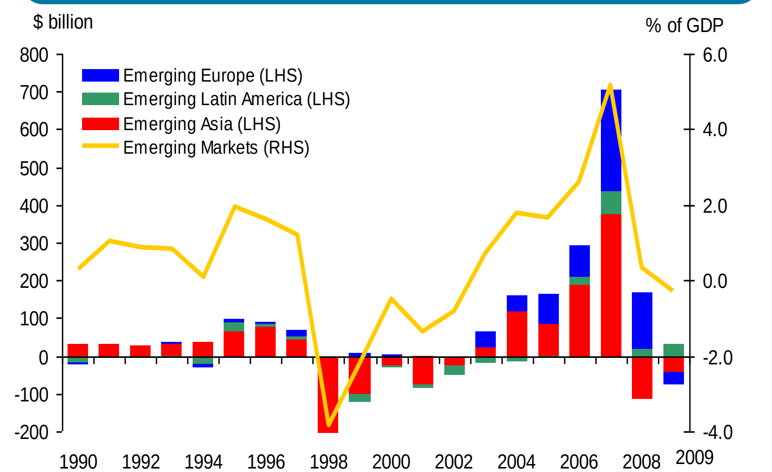
Foreign Portfolio Investment Inflows



Foreign Direct Investment Inflows



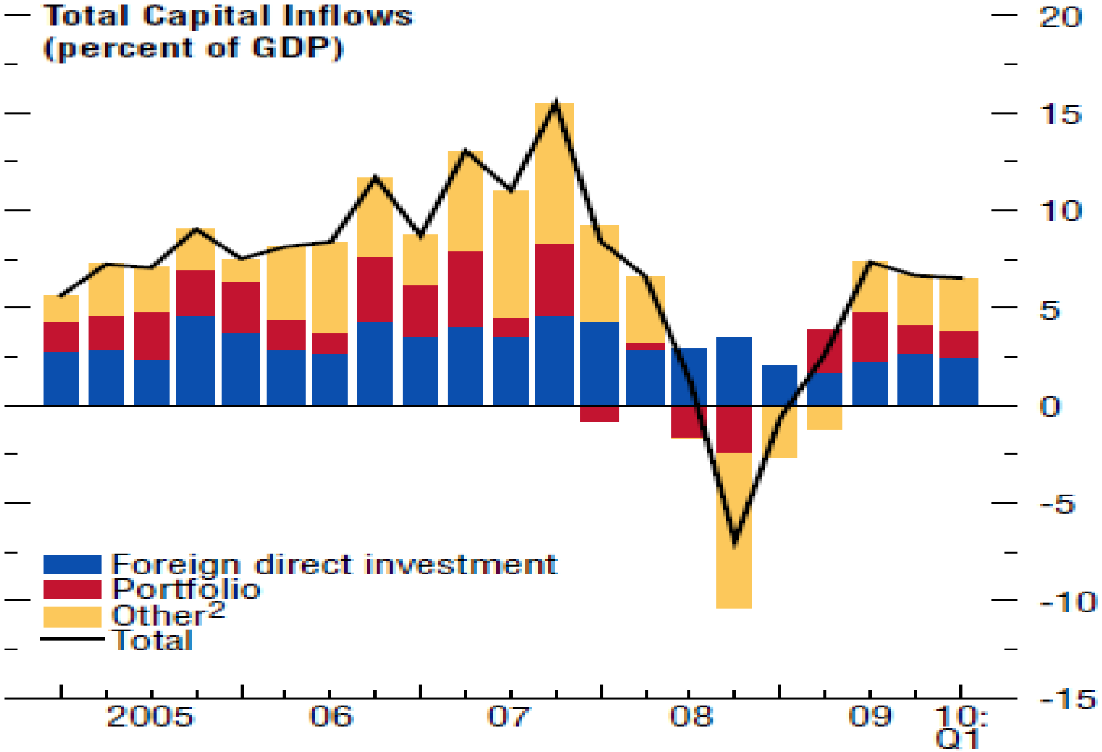
Other Investment Inflows



Emerging market economies: Emerging Asia (People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam), emerging Europe (Belarus; Bulgaria; Czech Republic; Estonia; Hungary; Latvia; Lithuania; Moldova; Poland; Romania; Russian Federation; Slovak Republic; and Ukraine), and emerging Latin America (Argentina; Brazil; Chile; Colombia; Dominican Republic; Ecuador; Guatemala; Mexico; Peru; Venezuela).
ASEAN-5: Indonesia; Malaysia; Philippines; Thailand; and Viet Nam.
NIEs: Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.

Source: Author's calculations using data from International Financial Statistics, and World Economic Outlook Database, International Monetary Fund.

Emerging Asia: Recent Experience with Capital Inflows[1]



Sources: CEIC Asia database; Haver Analytics; IMF, *International Financial Statistics;* and IMF staff calculations.

[1]Emerging Asia: China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.

[2]Other investment includes financial derivatives.

- The massive inflows, particularly the one over the past two years, have resulted in economic overheating, inflation, over-expansion of credit and assets bubbles in many EMs.
- Note that in some countries, the real currency appreciation has caused or may cause current account deficits, which may finally trigger currency crises.
- The recent situation is somehow similar to the situations in history, i.e. in the end of 1970s and early 1990s. If failing to deal with it, some countries will be very likely to repeat the crisis in the early 1980s and late 1990s.

- **The Reasons Behind the Surge of Capital Inflows**
  - Among various ones, the main factors include:
    - ➢ Push factor, such as the economic recession and almost zero interest rate in developed countries;
    - ➢ Pull factor, the strong economic growth in EMEs due to successful structural reform (i.e. trade liberalization and deeper integration into the global economies, typically in the case of China);
    - ➢ The rapid increase of primary good price in some countries that has created stimulating business opportunity and therefore triggered lot of foreign capital inflows;
    - ➢ The change of market sentiments.

- For the recent surge of the capital inflows, the two-speed economic recovery and the QE policy clearly have played the key role.

- And looking forward, very likely, it may continue.

- **What Policy Alternatives Do We Have?**

  – There are mainly three kinds of instruments: (1) Macroeconomic policies (including interest rate hike and other monetary policies), (2) financial regulatory measures and (3) capital controls.

  – Theoretically speaking, if the first two work well, the capital control may not be needed since it is often considered costly.

- However, in many cases, currency appreciation, sterilization and tighten monetary and fiscal policy are not always going well and often have unwelcoming by-products.
  - Currency appreciation and sterilization may cause more capital flows (case: interaction between appreciation and capital inflow in China)
  - In some cases, there is a strong fear of allowing currency appreciation and raising interest rate owing to the concern on slowdown of export and growth;
  - Regulatory measure: it is certainly good, but usually does not cover the informal financial transaction.

- Capital control may play an important role in dealing with the capital inflows. But, there are two interesting questions:

  - *Whether it should be the last resort?*
  - *How much difference between the prudential regulation and the capital control we can see?*

- **More Reasons or Appropriateness for Capital Control and Financial Regulation in EMEs**
  - Market failure and irrational market sentiments (we have learned too much from the boom-bust circle in EMs over the past decades);
  - Given the exchange rate stable is an important policy target, the capital control will be useful and could be necessary supportive instrument. It is simply reflects the insights of "triangle dilemma";

    It is interesting to point out that, capital control is legally supported by the article six of IMF agreement that came into being in 1945, and was a pillar of the Breton Wood system.

- **How should we think about the costs and effectiveness of capital control?**
  - It could be a rational cost of safety if there is. However, it is not very clear whether capital control is so costly, ***because there is quite limited evidence showing that there is a strong relation between the capital account liberalization and economic growth.***

Some empirical studies on the correlation between "liberalization of capital account and economic growth"

Studies	(Countries) Sample	Year	Correlation
Alesina, Grilli, and Milesi-Ferretti (1994)	20	1950–89	no
Grilli and Milesi-Ferretti (1995)	61	1966–89	no
Quinn (1997)	64	1975–89	yes
Kraay (1998)	117	1985–97	no
Rodrik (1998)	95	1975–89	no
Klein and Olivei (2000)	92	1986–95	yes
Chanda (2000)	116	1976–95	yes
Arteta, Eichengreen, and Wyplosz (2001)	59	1973–92	unclear
Bekaert, Harvey, and Lundblad (2001)	30	1981–97	yes
Edwards (2001)	62	1980s	yes

Source：IMF（2001）

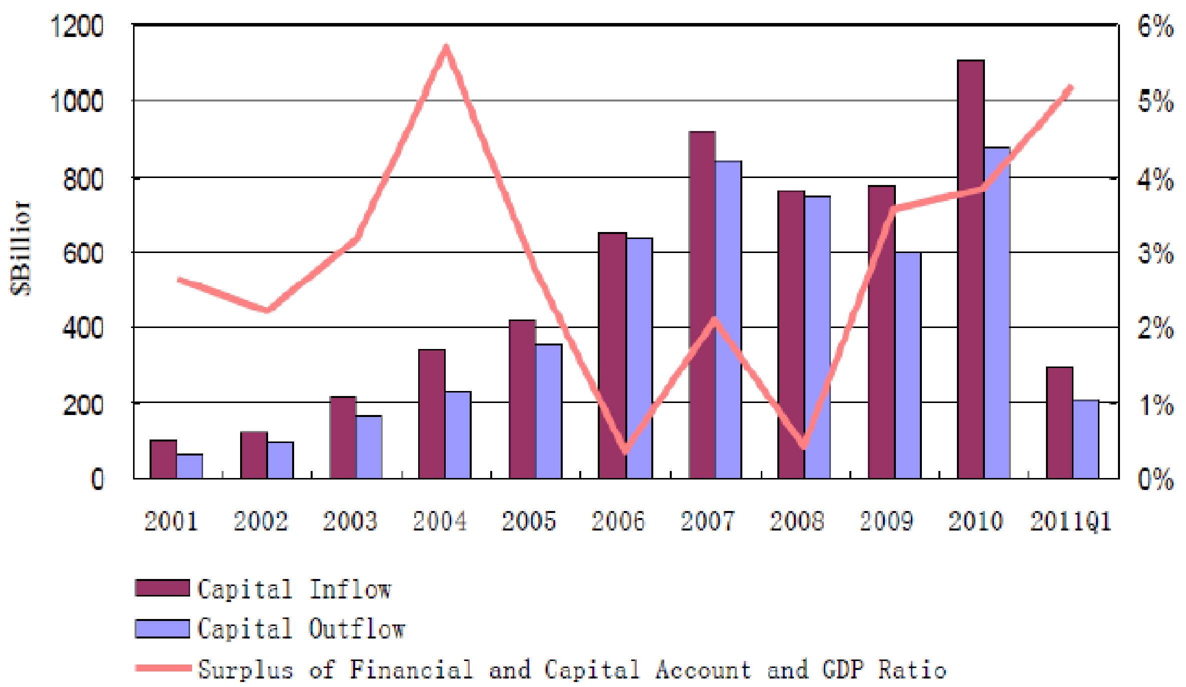
– As to the effectiveness, China’s experience in 1997 and recent years indicates that it is basically effective. As long as a country does not sophisticated financial market, capital control can always be effective although leaky in some degree.

- **What the source countries should do in dealing with the recent surge of capital inflows in EMEs?**

  – US should be more responsible,--avoid QE3 and pay more attention to its structural problem;
  – US (and EU) should consider having Tobin tax. They can kill two birds with one stone. It can increase the cost of overseas investment so as to reduce the capital flows to EMEs while improving their weak fiscal position, which is big problem currently;
  – More international policy coordination is needed(G20 and the Mutual Assessment Process).

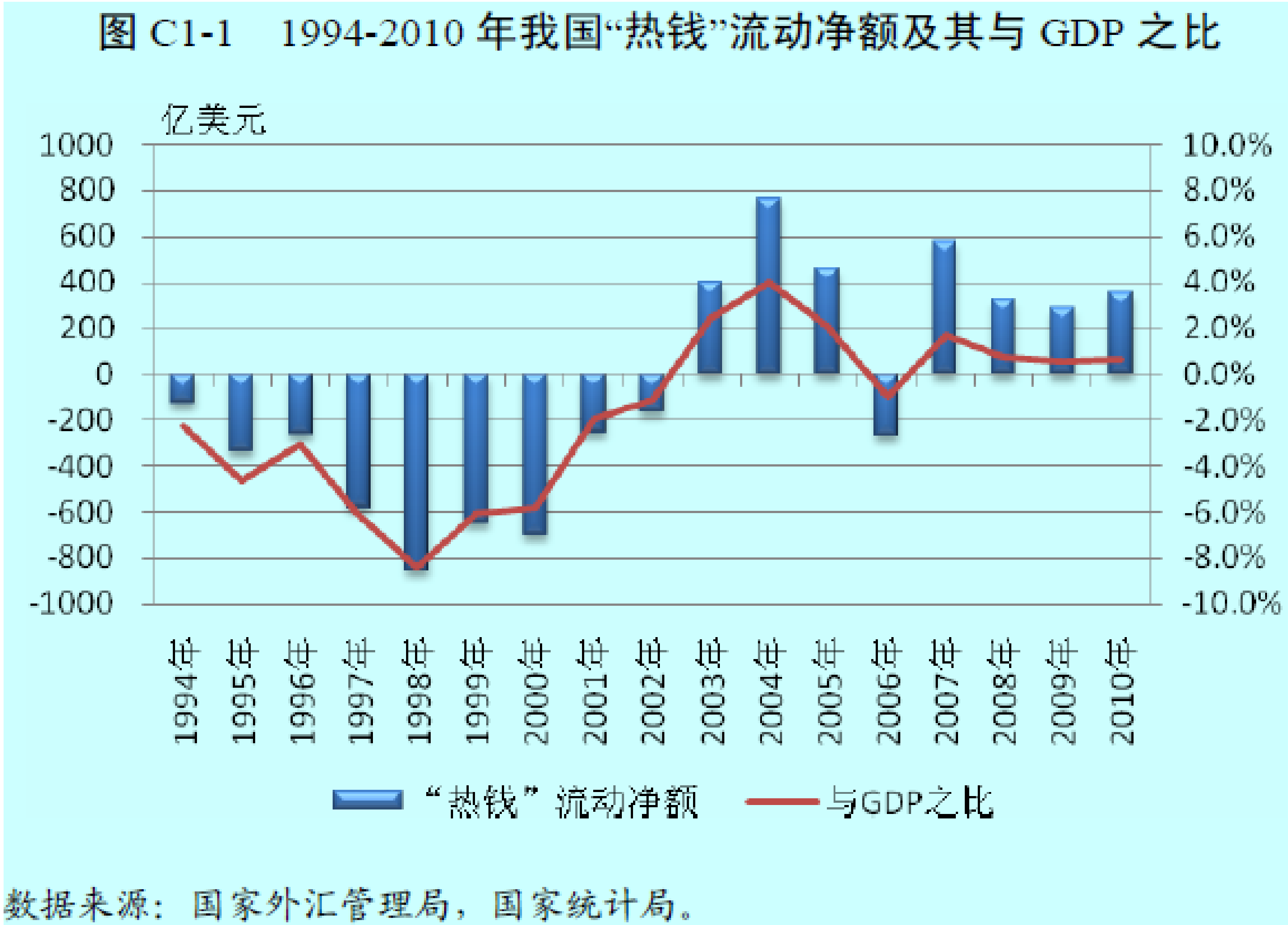
- **The surge of capital inflow over the past decade in China and the regulatory measures**

Figure 1: China's Capital and Financial Account: 2001-2011



– The capital inflows have rapidly increased since 2002, mainly owing to the *Pull Factor.* Of course, *Push Factor* also plays some role.
– The capital and financial surplus became an increasingly important source of the increase of the FX reserve over the past year. *In the first quarter of this year, China had nearly a balanced trade account, but the FX reserve still increased greatly.*
– The increase of the FX reserves is one of the important source of the economic overheating and asset bubble.

Hot Money in China and its Ratio to GDP: 1994-2010



- Main channels of the **Hot Money** inflows
    - *Channel 1: Mis-invoice in trade transaction*
    - *Channel 2: Abnormal short-term borrowing*
    - *Channel 3: Illusive FDI inflows*
    - *Channel 3: Abjuration of FDI's profit repatriation*
    - *Channel 4: Individual Remittance*

- As policy responses, together with currency appreciation and tightening monetary supply, the authorities have decided to strengthen the FX related financial regulation and capital control. Mainly,
  - Strengthen the overall monitoring and surveillance of cross-border capital flows via the reporting system.
  - Strengthen control on short-term borrowing by banks.
  - Strengthen the control on the advance payment by the foreign importers.
  - Strengthen the regulation on the housing purchase by non-residence.
  - Loosen control on capital outflows.