Press Points for Chapter 4: *Global Liquidity Expansion: Effects on "Receiving" Economies and Policy Response Options*

Global Financial Stability Report (GFSR), April 2010

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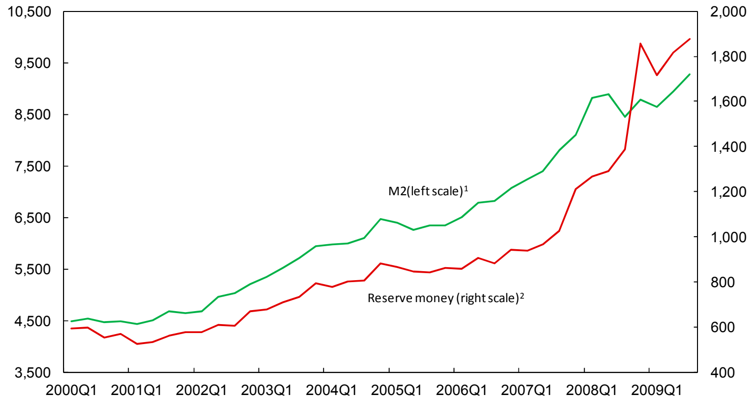
Key points

- The transmission of abundant global liquidity to economies with higher interest rates and stronger growth can pose policy challenges. Although the benefits of capital inflows are manifold, sudden inflow surges may lead to inflation and asset price bubbles.
- The chapter finds that global liquidity pushes up local equity prices and lowers real interest rates in receiving countries, typically by more than domestic liquidity, and that more flexible exchange rates can dampen such effects.
- Liquidity receiving economies have a number of policies with which to respond to capital inflow surges. These are primarily an appropriate mix of macroeconomic policies, including a more flexible exchange rate when conditions permit, as well as reinforcement of prudential regulation.
- When these policy measures are not sufficient and capital inflow surges are likely to be temporary, capital controls may have a role in complementing the policy toolkit. While the evidence on the effectiveness of capital controls is mixed, they can lengthen the maturity of some types of inflows.
- Even if capital controls prove useful for individual countries in dealing with capital inflow surges, they may lead to adverse multilateral effects by encouraging capital controls in other countries.

This chapter assesses the transmission of abundant global liquidity and the accompanying surge in capital flows to economies with comparatively higher interest rates and a stronger growth outlook. It finds that, additional to domestic liquidity, easy monetary conditions in the G-4 (the euro area, Japan, the United Kingdom and the United States) may pose policy challenges to liquidity receiving countries in the form of appreciation pressures and rising asset valuations (Figure 1).

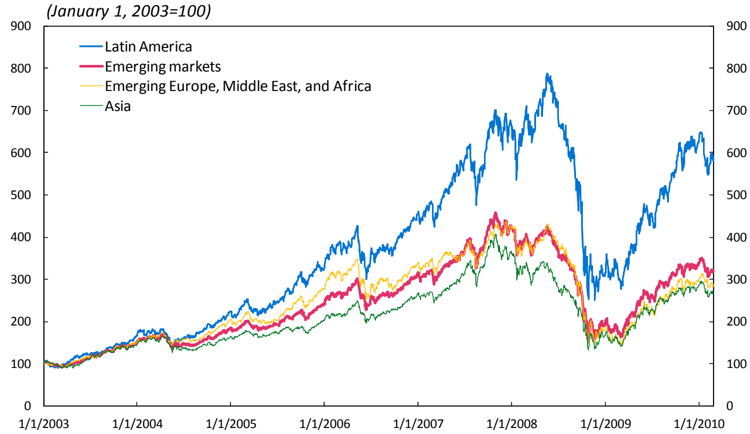
Figure 1. Global Liquidity
(In billions of U.S. dollars; GDP-weighted; quarterly data)



Sources: Datastream; IMF, International Financial Statistics database; and IMF staff estimates.
[1]Sum of GDP-weighted M2 for the euro area, Japan, the United Kingdom, and the United States.
[2]Sum of GDP-weighted reserve money for the euro area, Japan, the United Kingdom, and the United States.

The chapter analyzes and finds strong links between global liquidity expansion and asset prices, such as equity returns, as well as official reserve accumulation and portfolio inflows in the liquidity receiving economies (Figure 2).

Figure 2. Emerging Markets Equity Indices
(January 1, 2003=100)



Source: Bloomberg L.P.

There are a number of policy options available to policy makers of receiving economies in response to surges in global liquidity and capital inflows. The menu of policy responses for mitigating risks related to capital inflow surges includes the following:

- a more flexible exchange rate policy, in particular when the exchange rate is undervalued. The analysis shows that a floating exchange rate provides a natural buffer against surges in global liquidity and ensuing valuation pressures on domestic assets;
- reserve accumulation (using sterilized or unsterilized intervention as appropriate);

- reducing interest rates if the inflation outlook permits;
- tightening fiscal policy when the overall macroeconomic policy stance is too loose; and
- reinforcing prudential regulation in the financial system.

If conditions allow, liberalization of outflow controls can also prove useful. The appropriate policy mix will depend on country-specific conditions.

When these policy measures are not sufficient and capital inflow surges are likely to be temporary, capital controls may usefully complement the policy toolkit. However, more permanent increases in inflows tend to stem from more fundamental factors, and will require more fundamental economic adjustment. Well-formulated macroeconomic policies throughout an economic cycle can help lessen the affects of both surges and abrupt withdrawals of capital inflows.

The evidence on the effectiveness of capital controls is mixed. There is some indication that controls can lengthen the maturity of certain types of inflows—although they do not reduce the volume of inflows—and create greater room for the use of monetary policy independence. The chapter outlines some country case studies to highlight those types of capital controls that have and have not been successful in the past.

Even if capital controls prove useful for individual countries in dealing with capital inflow surges, they may lead to adverse multilateral effects. The adoption of inflow controls in one country, if effective, can divert capital flows to its peers, prompting the introduction of capital controls in those countries as well. A widespread reliance on capital controls may delay necessary macroeconomic adjustments in individual countries and, in the current environment, prevent the global rebalancing of demand and thus hinder global recovery and growth.