Macro-Prudential Policies: Asian Perspectives
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Session III: Macro-prudential measures and capital flows

This session was concerned with the macro-prudential toolkit for managing capital inflows in a manner that preserves financial and macro stability. A broader context related to the need to anticipate and counteract wider risks to financial stability stemming from credit and asset price cycles. These were particularly thorny issues because, while the overall toolkit for macro-financial stability was well known, the policy levers were typically widely dispersed across institutions within national jurisdictions, with corresponding implications for responsibility and accountability. Although there was a wide spectrum of arrangements, they were clearly not all equally effective in anchoring expectations of market participants and the broad public that financial stability would be the overriding objective when inevitable conflicts arose. A key issue, therefore, was to determine whether optimal institutional configurations could be established that respect local governance expectations, and how these configurations might vary with a variety of country characteristics.

Participants discussed the broader context of surging capital inflows to the Asian region, and how policy makers saw the challenges—which included both macro-economic (overheating, inflation) and financial stability challenges (surging credit and asset prices, and the risk of banking and currency crisis). Though periods of surging capital inflows were nothing new for emerging markets, today's global context was different, as it reflected the extremely easy monetary conditions in the countries at the epicenter of the global crisis, which were pushing liquidity toward emerging markets (search for yield and carry trades). As such, the capital flow cycle was due to forces beyond the control of emerging markets and, with global markets more integrated than ever before, the consequences of boom turning to bust would be correspondingly more serious for emerging market countries.

Participants considered that a flexible deployment of all the available policy instruments was necessary to address the challenges posed by surging inflows. The relevant instruments included monetary and exchange rate policy, fiscal policy, and of course macro-prudential policy in which capital account management may have a role to play. Structural reforms to improve the resilience of the financial system and its ability to intermediate inflows effectively were also essential to minimize vulnerabilities.

The Thai experience was viewed as combining a number of these elements, including effective use of selected macro-prudential tools (e.g., regulations to curb the rise in real estate prices, especially for high-end condominiums; tightening of rules on credit cards and personal loans) to supplement monetary policy in reducing the risks of excessive credit and overheating, and careful communication to the public of the role of the different measures and the distinctions between macro-prudential tools and capital account management regulations (e.g., the recent steps to equalize the tax treatment of fixed income instruments between residents and nonresidents). Broader efforts to improve monitoring and identify tipping points were essential and were being implemented in Thailand in the context of its enhanced macro surveillance system of key economic sectors. The challenges for Thailand and other emerging markets were greater now than in the past given monetary policy divergences across the globe, which raised the issue of potential gains from international policy coordination to reduce adverse spillovers for emerging markets (and of a multilateral approach to resolving the problems).

Other country representatives stressed the need to achieve resilience by strengthening domestic financial markets and infrastructure (creating an "enabling environment" for capital flows). This would reduce the need for other measures, including capital controls.

Participants were of the view that the best protection against the vagaries of a possible boom-bust cycle in capital flows was a robust domestic financial sector. This was especially the case for flows driven by purely financial factors rather than a demand for real investment capital in the domestic economy. Another key issue, some participants considered, was of potential nonlinearities in the response of foreign investors to the imposition of measures that restricted inflows. Given the integration of global markets, investors' decisions could be quite abrupt, and jurisdictions that were seen as excessively risky could wind up starved of international capital even for relatively small changes in the rules that destabilized expectations. Country representatives stressed the progress that had been made across the region in strengthening the financial sector's resilience to adverse shocks, including as evidenced by stress scenarios described in recent FSAP or FSAP updates. It was important to recognize how difficult it was, for a small emerging market economy that was open to foreign capital, to "choose" or "tilt" the composition of inflows toward a safer structure. Investors had lots of choices, and sometimes less desirable flows were a necessary evil alongside more desirable flows that benefited the real economy. In that regard, shock-proofing the economy to a withdrawal of hot money was the best defense.

Participants discussed the capital account regime in China. It was noted that the de facto regime was considerably more liberal than de jure and, from the point of view of market participants, the restrictions were not seen as having a huge impact. The key remaining restrictions were on portfolio investment in China and foreign borrowing by Chinese enterprises (limits on foreign-funded enterprises were much less restrictive).

Participants were of the view that the destabilizing impact of the boom bust cycle in capital flows could be more acute in the present environment because highly stimulative monetary policies in advanced economies was likely to push even more funds to the emerging market countries, risking an even bigger outflow when conditions in the advanced economies eventually normalized. As a result, exchange rate overshooting—given the "original sin" in many emerging market countries—had the potential to cause real problems for financial stability when flows reversed and local currencies depreciated. Participants felt that this situation meant that controls on inflows were likely to be justified as a component of the toolkit to manage the risks to financial stability associated with surges, under certain conditions, and they considered that the taxonomy of conditions put forward in the recent IMF staff policy note seemed reasonable and objective.

This being said, over the medium term, it made sense for emerging countries like China to strive for greater liberalization of the capital account, to improve the ability of firms and households to engage in inter-temporal trade and reap the benefits of financial globalization. Capital account restrictions were viewed as adversely affecting "the good guys", that is firms that could benefit from greater financing to fund profitable investment domestically. Administrative complexity of the restrictions tends to be cumbersome, and could result in corruption and rent seeking behavior. In addition, over time, restrictions tended to lose effectiveness due to circumvention. Reflecting these realities, China would move over time to full capital account convertibility, making the environment fully transparent for both businesses and households, and administrative measures would gradually give way to more transparent price-based measures.

A wide-ranging discussion among participants revealed a spectrum of views regarding how to design capital controls, with some favoring broad restrictions against flows that had little tangible benefit for the real economy (that is all flows except FDI), and others emphasizing the need for harmonization of approaches across countries to avoid flows being displaced to jurisdictions that were less able to absorb them. Some participants noted that circumvention was not in itself an argument that controls were of little benefit, since if the result was reduced intermediation through the domestic banking system (even if inflows came in through other channels), the vulnerability of the domestic economy was reduced.

Participants also engaged on the issue of sequencing, and stressed the dilemma that capacity to absorb inflows improved with the development of the domestic financial sector, but such development was itself facilitated by greater openness to foreign capital.