Managing Economy under volatile capital flows

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BI rate and US Funds Rate: spreads remain high

Source: CEIC
Foreign Reserves steadily increases
## Capital Inflows to Emerging Markets

*(Percent of GDP, mostly Q2 2010, 4Q moving average, z score)*

<table>
<thead>
<tr>
<th>Country</th>
<th>FDI, net</th>
<th>PI, net</th>
<th>Equities, liabilities</th>
<th>Debt, liabilities</th>
<th>OI, liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>1.1</td>
<td>0.8</td>
<td>1.7</td>
<td>1.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1.3</td>
<td>0.2</td>
<td>1.0</td>
<td>1.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Korea</td>
<td>0.6</td>
<td>-1.7</td>
<td>2.0</td>
<td>0.8</td>
<td>1.4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.0</td>
<td>-1.6</td>
<td>1.4</td>
<td>-1.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Taiwan ROC</td>
<td>1.4</td>
<td>-0.2</td>
<td>-1.2</td>
<td>-0.7</td>
<td>0.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.2</td>
<td>-1.2</td>
<td>0.5</td>
<td>0.6</td>
<td>-1.0</td>
</tr>
<tr>
<td>Argentina</td>
<td>-0.4</td>
<td>-0.8</td>
<td>0.5</td>
<td>0.8</td>
<td>0.2</td>
</tr>
<tr>
<td>Brazil</td>
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<td>-0.5</td>
<td>2.0</td>
<td>3.1</td>
<td>2.8</td>
</tr>
<tr>
<td>Chile</td>
<td>-0.9</td>
<td>-0.6</td>
<td>-0.8</td>
<td>-2.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.5</td>
<td>-2.1</td>
<td>0.9</td>
<td>-0.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Peru</td>
<td>0.2</td>
<td>0.1</td>
<td>0.7</td>
<td>-0.5</td>
<td>-0.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>-0.9</td>
<td>-1.4</td>
<td>-0.2</td>
<td>-0.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>Poland</td>
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<td>-0.8</td>
<td>2.5</td>
<td>1.0</td>
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<tr>
<td>Russia</td>
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<td>-1.4</td>
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<td>Israel</td>
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<td>-3.6</td>
<td>-1.4</td>
</tr>
<tr>
<td>South Africa</td>
<td>1.1</td>
<td>0.3</td>
<td>-1.0</td>
<td>0.4</td>
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<tr>
<td>Turkey</td>
<td>1.1</td>
<td>0.1</td>
<td>0.4</td>
<td>0.3</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Sources: Haver, IFS, and IMF staff estimates.

Note: The heat map measures the amount of capital flows in percent of GDP (four-quarter moving average) relative to the period average. The deviation is expressed in terms of standard deviations. No color signifies a standard deviation under 1, yellow between 1 and 1.5, orange 1.5 and 2, red 2 and 3, and dark red greater than 3 standard deviations. PI is portfolio investment, OI is other investment.
Capital Inflow

- Demand driven or supply driven?
- If demand driven:
  - Current account deficit → exchange rate appreciation will worsen the situation

- Supply driven: looking for higher return → allow appreciation (not much on Fiscal and monetary policy)
Good problem: managing capital inflow

A: Allow inflow of money (shifts LM right) → Can be inflationary
B: Sterilize inflow by building reserves, OMO (stay at B) → Can prolong inflows by keeping interest rates high
C: Allow appreciation (shifts IS and BP left) → Exports lose competitiveness
D: Impose capital controls (moves BP upward, steeper slope) → Lose efficiency; have to finance investment through higher cost domestic funds rather than borrowing from abroad at lower cost
E: Fiscal contraction (shifts IS left) → Can be recessionary; politically difficult

World Bank, 2010
Impossible Trinity

• Inflation: keep exchange rate at the expense of monetary policy?

  - Exchange rate: nominal or real appreciation

  - Capital Mobility: macro prudential, supply side
Good problem: managing capital inflows

Push and pull factor:
- Low interest rate (negative interest rates) push capital to EM → supply driven vs higher return at EM, including Indonesia, but local absorptive capacity is limited

Policy options
- Exchange rate appreciation vs sterilization
- Restriction on capital inflow, more on macro prudential (SBI)
- Tighter fiscal policy? Not possible due problem of infrastructure
- Accelerate debt repayment
- Trade liberalization
- More IPOs
- Infrastructure development. THIS IS the most important
- IF we do not handle this capital inflow issue carefully, there is a potential for economic bubble:
Risk of oil price

Do nothing scenario:

✓ Higher oil price $\rightarrow$ pressure on budget $\rightarrow$ inflation overhang $\rightarrow$ fisher effect $\rightarrow$ expected inflation $\rightarrow$ bond market $\rightarrow$ reverse capital outflow

Fuel price adjustment:

✓ Adjust gasoline price $\rightarrow$ inflation increase $\rightarrow$ realized expected inflation $\rightarrow$ no more inflation overhang $\rightarrow$ macrostability, though inflation maybe higher