How Should EMEs Manage Rapid Inflows?


Kristin Forbes
MIT-Sloan School of Management

May 27, 2011
White and Keynes
<table>
<thead>
<tr>
<th>Policy</th>
<th>$\pi$?</th>
<th>Financial System?</th>
<th>ER Comp?</th>
<th>Concerns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal tightening</td>
<td>✔️</td>
<td>✔️</td>
<td>✗</td>
<td>Politics, less investment, social, timing</td>
</tr>
<tr>
<td>Monetary Tightening</td>
<td>✔️</td>
<td>✔️</td>
<td>✗</td>
<td>Increases inflows</td>
</tr>
<tr>
<td>Appreciation</td>
<td>✔️</td>
<td>✔️</td>
<td>✗</td>
<td>Competitiveness, Dutch disease</td>
</tr>
<tr>
<td>Accumulate Reserves</td>
<td>✔️</td>
<td>✗</td>
<td>✔️</td>
<td>Costly, inefficient</td>
</tr>
<tr>
<td>Facilitate Outflows</td>
<td>✔️</td>
<td>✗</td>
<td>✔️</td>
<td>Impact limited, raise vulnerability in future?</td>
</tr>
<tr>
<td>Prudential regulations</td>
<td>✔️</td>
<td>✔️</td>
<td>❔</td>
<td>Complex, impact on efficient lending?</td>
</tr>
<tr>
<td>Capital controls</td>
<td>❔</td>
<td>✔️</td>
<td>❔</td>
<td>Effectiveness (especially over time), distortions, spillovers</td>
</tr>
</tbody>
</table>
Remaining Questions

I. Is the correct goal to limit inflows from abroad?

II. Are controls effective?

III. Do the benefits outweigh the costs?
Is the correct goal to limit inflows from foreigners?
Recent Surge of Capital (bn$)

Source: IMF, Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework, Feb, 2011
Thailand: Gross Inflows & Outflows

(2q averages)

Foreign flows

Domestic flows
Thailand: Net and Gross Flows
(2q averages)

Diagram showing the net and gross flows over time, with separate lines for foreign and domestic flows.
Thailand: Gross Inflows & Outflows (2q averages)

- Foreign flows
- Domestic flows
Canada: Net Flows
(2q averages)

Surge from foreigners?
Canada: Net and Gross Flows
(2q averages)

- **Net Flows**
- **Gross Inflows**
- **Gross Outflows**

Foreign flows

Domestic flows
Are Controls Effective?
Are Controls Effective?

• Forbes and Warnock (2011) explains “waves” of capital flows
  • Including “surges” or “stops” in inflows driven by foreigners relative to trend

• Test for role of:
  – **Global factors**: global risk, global liquidity, global interest rates, global growth
  – **Contagion**: through financial links, trade, and geographic location
  – **Domestic factors**: financial system, fiscal situation, domestic growth, financial integration/capital controls, income
Share of Countries with a “Surge” of Capital Inflows from Abroad
Share of Countries with a “Stop” of Capital Inflows from Abroad
Results & Implications

• Key Results
  – Global factors (risk, global growth) most important factors driving “surges” and “stops” of inflows from abroad
  – Contagion important in driving slowdowns in capital flows
  – Domestic factors play minimal role – only domestic growth
  – No significant effect of capital controls on the probability of having a “surge” of net inflows or gross inflows from abroad

• Implications
  – Countries have limited ability to stop the “waves” of capital flows
  – Countries should focus on strengthening ability to adjust to changes in inflows and outflows
  – Important role for multilateral institutions and cross-border cooperation
Was the IOF Effective?:
Results from Investor Surveys

• Range of views
• Equity investors
  – Minimal effect
  – Expect high returns and size of taxes is too small
• Bond investors—mixed reactions
  – Can make country more attractive
  – Increases country risk so shift to shorter-term
  – Harder to make a profit, will invest less in future
• Numerous ways to minimize tax
  – Shift to FDI vehicles, ADRs, derivatives
  – Bonds—harder—but different structures of investment to minimize tax that cost something and add risk
Key Issue: The New World Order

Not a temporary phenomenon

Source, *Economist* cover, 09/11/10
Do the Benefits Outweigh the Costs?
Costs of Controls

• Academic literature has identified numerous microeconomic costs
  – Increase financial constraints for small firms, important engine of jobs and growth
  – Less efficient pricing in financial markets
  – Less efficient allocation of resources as reduce market discipline
  – Numerous distortions to firm & individual behavior as use resources to avoid controls

• Multilateral effects?
  – Preliminary results: Forbes, Fratzscher, Straub & Widelz (2011)
  – Some, but weak and limited to limited investors & countries
Costs vs. Benefits

• Do the benefits of controls outweigh these costs?
  – Cross-country literature: unclear
  – Cline (2010) argues no
  – Ostry et al (2011) and Jeanne argue yes

• My sense
  – Answer will depend on country situation
  – Costs grow over time as evasion increases

• Must consider both costs and benefits
• Can you achieve the same benefits through prudential regulations without the costs of controls?
Final Thoughts

• No magic bullet for a country with an overvalued ER, inflation, and financial system concerns
  – Should start with standard macroeconomic responses & macroprudential regulations
  – IMF has laid out situations when capital controls can be included as part of this “toolkit”

• But, key questions must be answered before using capital controls more widely
  – What is the role of domestic investors? Is targeting inflows from abroad the appropriate goal?
  – Do capital controls work?
  – Do the benefits outweigh the costs?
    • Can you achieve the same benefits more efficiently through prudential regulations (without additional costs)