Press Points for Chapter 3: *Managing Large Capital Inflows*

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Key Points

- **While opening opportunities for long-term benefits if well used, heavy capital inflows may pose significant challenges to macroeconomic stability.**

- **Drawing on experience with over 100 episodes in the past twenty years, the chapter concludes that greater fiscal restraint during the inflow period has helped to contain aggregate demand and to limit real appreciation, and thus to increase the likelihood of a soft landing.**

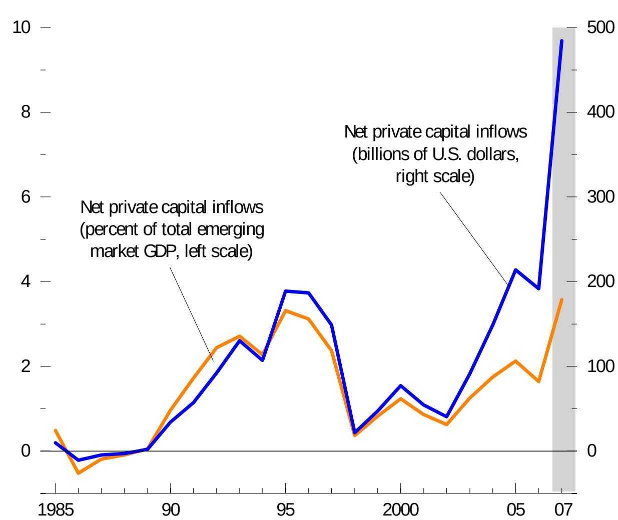
- **By contrast, resisting nominal exchange rate appreciation through intervention is unlikely to moderate real appreciation in the face of a persistent surge in capital inflows, and may lead to more serious adverse macroeconomic consequences when the surge eventually ends.**

- **There is little evidence that tightening capital controls is able to limit real exchange rate appreciations, or reduce macroeconomic vulnerabilities associated with a sharp reversal of inflows.**

The wave of capital flows sweeping through many emerging market economies since the early 2000s has brought renewed attention to how macroeconomic policies should respond (Figure). Chapter 3 of the WEO examines the effectiveness of various policy responses in over 100 episodes of large net private capital inflows in a group of emerging market countries and advanced economies since 1987. It concludes that:

- **The recent wave of private capital inflows to emerging markets is different from the one in the mid 1990s because it involves a larger set of countries,**

Net Private Capital Inflows to Emerging Markets[1]



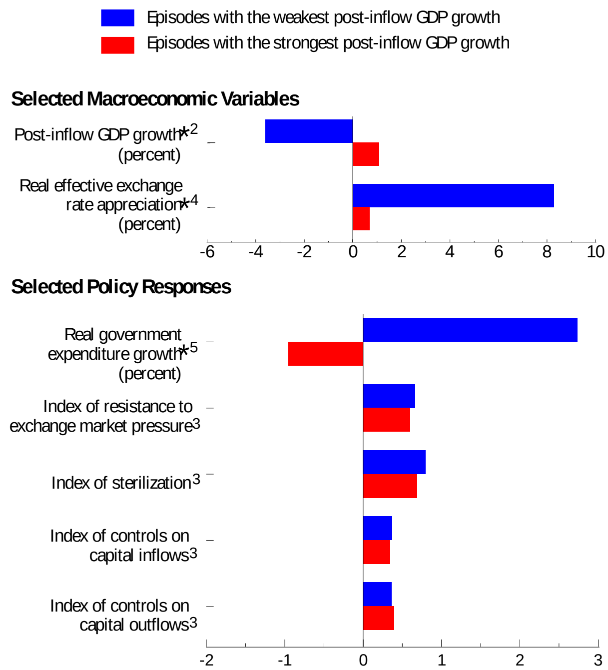
Sources: IMF, *Balance of Payments Statistics;* and IMF staff calculations.
[1]Values for 2007 are IMF staff projections.

is underpinned by generally more solid current account positions (with the notable exception of emerging European countries), and is taking place in a more financially integrated world economy.

- **Countries that experienced more volatile macroeconomic fluctuations—including a sharp reversal of inflows—tended to have higher current account deficits and faced stronger increases in both aggregate demand and the real value of the currency during the period of capital inflows.**

- **Keeping government spending along a steady path—rather than engaging in excessive spending during inflow episodes—appears to mitigate the adverse effects of large inflows.** "Hard landings" in the aftermath of capital inflows have been associated with a strong increase in government spending during the inflow period, whereas expenditure restraint helped reduce upward pressures on both aggregate demand and the real exchange rate, and facilitated a soft landing (Figure).

Post-Inflow GDP Growth, Selected Macroeconomic Variables, and Policy Indicators[1]



Sources: IMF, *Balance of Payments Statistics;* IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions;* and IMF staff calculations.

[1] Values reported are medians for the two groups of episodes. Episodes with the weakest (strongest) post-inflow GDP growth are those with below (above) median difference between average GDP growth in the two years after the episode and the average during the episodes. The asterisk (*) indicates that the difference between medians is significant at a 10 percent confidence level or better.

[2] Average real GDP growth in the two years after episode minus average during episode.

[3] Average during episode.

[4] Cumulative change during episode.

[5] Average deviations from trend of real government expenditures (excluding interest) during the episode minus average in the two years before the episode. The trend component of real government expenditure is obtained through a Hodrick-Prescott filter.

- **In contrast, other common policy responses to capital inflows, such as sterilized intervention and capital controls, appear to have been unable to prevent a real appreciation of the currency, and were generally unsuccessful in achieving a soft landing**. A higher degree of resistance to exchange rate pressure during the inflow period and a greater degree of sterilization of the resulting increase in money supply were not associated with lower real appreciation or with better post-inflow growth performance. Episodes characterized by tighter controls on inflows have not contained real appreciations during the inflow period, or supported better post-inflow GDP growth.