Managing Stop-Go Capital Flows in EM Asia: So Far, So Good

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* The views are those of the authors and do not necessarily represent those of the Bank for International Settlements
Introduction

● EME capital flows in an increasingly integrated world represent a key challenge

● Today, I’d like to highlight some lessons from EM Asia

● Recent experience point to both good luck and good policy
  – The good luck – ‘no wall of liquidity’
  – The good policies – ‘stress-testing’ of policy tools generally considered a success
  – But must be vigilant to tail risks, which are still serious
Outline

- Why is EM Asia more confident about ability to manage capital flows?
- Why do I remain worried about significant tail risks?
- What lessons can we draw at this early stage?
Capital Flows And Reality

- **Dealing with EM capital flows**
  - Inherent instability in EMEs, ie damned if you do and damned if you don’t

- **Despite this, outcomes in EM Asia have been encouraging**
  - Search for yield has been selective, not broad based

The good luck view
Stress-Testing Policy Frameworks

- Monetary policy...accommodative and pre-emptive to possible spillovers

The good policy view
Asymmetric Monetary Policy Response To The Crisis

Monetary policy rates

In per cent

1 Policy target rates or their proxies. For Australia, RBA cash target rate; for China, average of the one year household saving deposits and the one-year best lending rate; for Euro area, ECB main refinancing repo rate; for India, reverse repo rate; for Indonesia, one-month SBI rate; for Japan, uncollateralized overnight call rate; for Korea, overnight call rate; for Malaysia, overnight policy rate; for New Zealand, official cash daily rate; for Philippines, overnight reserve repo rate; for Thailand, 14-day repo rate before 17 January 2007; overnight repo rate thereafter; for US, fed funds rate.

Sources: Bloomberg, Datastream, BIS, national data.
## EM Asia Response To QE
### Interpreting QE Impact on Asian Financial Markets

<table>
<thead>
<tr>
<th></th>
<th>Announcement period</th>
<th>Total amounts (billions)</th>
<th>Gov’t 2-year yields (bps)</th>
<th>Gov’t 10-year yields (bps)</th>
<th>Corp bond yields (bps)</th>
<th>Sov’gn CDS premia (bps)</th>
<th>Equity prices (%)</th>
<th>FX against USD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US QE1</strong></td>
<td>Nov 08 to Nov 09</td>
<td>$1,400</td>
<td>-45.37</td>
<td>-79.70</td>
<td>-52.90</td>
<td>-46.92</td>
<td>10.75</td>
<td>4.49</td>
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<tr>
<td><strong>QE2</strong></td>
<td>Aug 10 to Nov 10</td>
<td>$600</td>
<td>-9.06</td>
<td>-9.16</td>
<td>-14.84</td>
<td>-4.80</td>
<td>1.53</td>
<td>-0.36</td>
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</tbody>
</table>

Chen, Filardo, He and Zhu (2012)

**Endogenous Asian Central Bank MP Channel Activated**
Preferred Exchange Rate Regime

- Monetary policy…accommodative and pre-emptive to possible spillovers
- Resisted FX appreciation through FX reserve accumulation

The good policy view
Resisting FX Appreciation

Reserves and exchange rates

FX market pressure on EM Asia\(^1\)

Change in reserves and REER\(^3\)

Foreign reserve adequacy, 2011\(^4\)

<table>
<thead>
<tr>
<th>Contribution from:</th>
<th>FX</th>
<th>Reserves</th>
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<tbody>
<tr>
<td>Market pressure index(^2)</td>
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<tr>
<th>08</th>
<th>09</th>
<th>10</th>
<th>11</th>
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<tbody>
<tr>
<td>BR</td>
<td>CL</td>
<td>CN</td>
<td>HK</td>
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<tr>
<th>Change in reserves</th>
<th>BR</th>
<th>ID</th>
<th>JP</th>
<th>MY</th>
<th>PH</th>
<th>RU</th>
<th>TH</th>
<th>TW</th>
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<tr>
<td>Delta</td>
<td>10</td>
<td>-20</td>
<td>-10</td>
<td>-5</td>
<td>-10</td>
<td>-15</td>
<td>-20</td>
<td>-25</td>
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<th>Foreign reserve adequacy, 2011</th>
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<tr>
<td>3-month imports</td>
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<tr>
<td>Asia-Pacific</td>
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</table>

BR = Brazil; CL = Chile; CN = China; HK = Hong Kong SAR; ID = Indonesia; IN = India; KR = Korea; MX = Mexico; MY = Malaysia; PH = Philippines; RU = Russia; SG = Singapore; TH = Thailand; TR = Turkey; TW = Chinese Taipei.

\(^1\) China, Hong Kong SAR, Indonesia, India, Korea, Malaysia, Philippines, Singapore and Thailand.  
\(^2\) Defined as sum of normalized change in nominal exchange rate against US dollar and ratio of normalized change in international reserves to narrow money.  
\(^3\) Vertical axis: percentage change in real effective exchange rate (REER) from 2009 Q1 to 2010 Q3 (increase = appreciation); horizontal axis: change in foreign reserves from 2009 Q1 to 2010 Q3 as a percentage of GDP.  
\(^4\) In per cent: average of the economies in the region.  
\(^5\) Australia, China, Hong Kong SAR, Indonesia, India, Japan, Korea, Malaysia, New Zealand, Pakistan, Philippines, Singapore and Thailand.  
\(^6\) Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.  
\(^7\) The Czech Republic, Hungary and Poland.  
\(^8\) Short-term external debt measured as consolidated international claims of BIS reporting banks with a maturity up to and including one year, plus international debt securities outstanding with a maturity up to one year.

Sources: IMF \(IFS\); Datastream; BIS; national data.
Other Measures To Manage The Flows

- Monetary policy...accommodative and pre-emptive to possible spillovers
- Resist FX appreciation through FX reserve accumulation
- Developed a multilateral backstop – Chiang Mai initiative
- Intensified surveillance and monitoring of capital flows
- Renaissance in use macroprudential/capital control tools

The good policy view
Example: Hong Kong

Figure 1. The LTV policy, real property prices and mortgage delinquency ratio in Hong Kong

- Max. LTV of 70% has been adopted as a long-term regulatory policy in 1995
- Since 1991, max. LTV ratio of 70% evolved as an industry standard
- PV<=HK$12mn
- PV>HK$12mn
- PV>=HK$20mn
- HK$8mn <= PV < HK$12mn
- PV>HK$12mn or non-owner occupied properties

Source: HKMA
Should We Revise Our View On Capital Flow Risks?

- Have we overestimated the risk of heavy capital flows to the region?

- Many have commented that the flows have been a challenge at times in past years... *but have been manageable*

- But not so fast...
US Hot Money Flows – Not As Bad As We Thought?

US capital outflows

In billions of USD

Total outflows

Outflows to emerging Asia

1 US-owned private assets vis-à-vis emerging Asia-Pacific; 2012 figure based on annualized Q1 and Q2 data.

Sources: IMF IFS; US Bureau of Economic Analysis.
Why? International Financial Crisis And Risk Aversion

Research shows most of this driven by shifts in risk aversion, not the probability of default.
CDS Spreads And Net Capital Flows In EM Asia

CDS spreads and net capital flows in Asia
Q1 2007 - latest

Horizontal axis is net capital flows to the economy (positive [negative] indicates net flows [outflows]) in billions of USD; vertical axis represents 5-year on-the-run sovereign CDS spreads in basis points.

Sources: CEIC; IMF IFS Markit
Capital Flows And Global Risk Aversion

- Why didn’t this ‘wall of liquidity’ show up on the shores of Asia? Were analysts’ expectations wrong in assessing this risk?

- Rather, it was not possible to expect the extent of the *vicious circle arising from sovereign risk concerns*, especially in Europe. These risks have multiplied and lingered far longer than expected. What happens when they truly abate?

- There is a need to understand this process better in EM Asia - and elsewhere.
Less Policy Space in EM Asia Going Forward

- The ‘policy space’ appears to have shrunk

- Unwanted side-effects from past actions building
  - Domestic credit booms and asset prices
  - Offshore FX currency credit booms
  - CBBS and financial stability concerns
New Round Of Bubbles And Inflation In EM Asia?

Monetary policy, credit growth, housing prices and inflation in Asia

In per cent

<table>
<thead>
<tr>
<th>Real policy rate</th>
<th>Growth of private credit</th>
<th>Real housing price</th>
<th>Commodity price and inflation</th>
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<tbody>
<tr>
<td>07 08 09 10 11 12</td>
<td>07 08 09 10 11 12</td>
<td>06 07 08 09 10 11 12</td>
<td>07 08 09 10 11 12</td>
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<tr>
<td>0.5 1 2</td>
<td>17.5</td>
<td>120</td>
<td>800</td>
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1. Policy target rates or their proxies corrected by forward- and backward-looking inflation components (equally weighted 12-month backward-looking CPI inflation and 12-month forward-looking consensus expectations); average of China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines and Thailand.
2. Annual change; average of China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.
3. End 2005 = 100; average of China (three tier-one cities), Hong Kong SAR, Indonesia, Korea, Malaysia and Singapore.

Source: IMF, International Financial Statistics; Bloomberg; CEIC; national data.
Offshore USD Lending Boom – A New Credit Channel?

Offshore USD flows to Asia

In billions of USD

Assets of non-US banks vis-à-vis Asian residents

Liabilities of non-US banks vis-à-vis Asian residents

1 2012 figure based on annualised Q1 data
2 Estimated exchange rate adjusted changes of total positions of BIS reporting banks vis-à-vis all sectors in emerging Asia-Pacific.
3 The term “non-US banks” indicates banks outside the US

Source: BIS locational banking statistics
Limits From Soaring Central Bank Balance Sheets

Central bank total assets (2001=100)

China

EM Asia x CN

AU = Australia; HK = Hong Kong SAR; ID = Indonesia; IN = India; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand.

1 Sum of listed economies.

Sources: Datastream, IMF, International Financial Statistics; BIS, national data.
Asset Side: Foreign Reserve Accumulation

Change in the composition of central bank assets in Asia, Dec 2001 – June 2012

As a percentage of change in total assets

- **Foreign assets**
- Claims on government and public enterprises
- Claims on private sector

CN = China; HK = Hong Kong SAR; ID = Indonesia; IN = India; JP = Japan; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TH = Thailand;

Source: IMF IFS.
Activating A Financial Instability Channel?

- Foreign asset accumulation by sterilised intervention soaring
- So far, so good. Evidence of resisting appreciation
- Extensive use of central bank paper and reserve requirements
- Initial impact – crowding out; but, ‘lazy assets’ growing in the banking sector – sowing seeds of the next crisis?

Lessons

- For Asia, destabilising capital flows remain an important concern...now it is ‘slow-go’, not ‘stop-go’.
- Shifts in global risk aversion important.
- At the same time, ‘excessive’ liquidity and Asian CB balance sheets are now an independent source of risk.
- EMEs can buy some breathing room with temporary measures to get one’s fiscal, monetary and financial houses in order...not a new idea but still important!
- Policy mix: ensure price stability, implement new international financial regulatory norms, strengthen fiscal positions & limit reliance on 1-sided FX intervention!
Thank you
Selective References


Chen, Qianying, Andrew Filardo, Dong He and Feng Zhu (2012) "The impact of central bank balance sheet policies on the emerging economies." BIS Papers no 66, October.


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