

Managing Risks from Volatile Capital Flows: Multi-level Approaches*

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The East Asian financial crisis and the global financial crisis showed that rapid and large capital flow reversals can create tremendous strains on foreign exchange liquidity and even lead to severe financial crises as in 1997/98. On-going sovereign debt problems in the Euro-zone may again pose the risk of another round of capital flow reversals to emerging Asia, so countries need to be vigilant and make sure that they have the understanding and the tools to deal with such a situation if it should arise. Compared to the situation prior to the 1997/98 crisis, lessons should have been learned about the risks associated with capital flows, particularly short-term capital flows, and policies regimes of various countries should have evolved from the lessons learned and now be much more appropriate to deal with these risks. Nevertheless, there could be unanticipated events that create strains on foreign exchange liquidity of various countries in spite of more prudent policy regimes, and there may also be many constraints on the ability of countries to manage the risks from large and volatile capital flows. Because of this, the development of international mechanisms beyond the country level that could help countries ride through episodes of capital flow reversals and prevent them from leading to full blown foreign exchange crises becomes very important. From developments since the East Asian financial crisis through the global financial crisis, mechanisms have been developed or have evolved at three levels beyond the country level; bilateral level, regional level and global level. However, these have created confusions about how mechanisms at these different levels should best relate to each other, are they complimentary or competitive, and what would be the best approach for particular countries to protect themselves from the risks of volatile capital flows.

The most effective way to protect against the risks arising from volatile capital flows is to have appropriate policies at the country level. In the case of Thailand prior to the 1997 crisis, the macroeconomic policy regime was simply based on the wrong paradigm. Macroeconomic policy combination was the

classic Mundell “impossible trinity;” fixed exchange rate (to a basket), liberalized capital flows (hoping to make Bangkok a regional financial center), and attempted independent monetary policy (short-term interest rate about 4 percentage points above US level on average for 5-6 years prior to the crisis). Large short-term capital inflows came into the country (mostly as short-term foreign debt) fueling an economic bubble. As short-term debt increased, reserves increased in line, but because the authorities were viewing the situation from a current account perspective, comparing reserves to months of imports, the increases in foreign reserves were considered to be signs of strengths. The fact that reserves should also cover short-term foreign debt was not considered to be important at that time. Even a bigger mistake was for the central bank to use up almost all of the foreign reserves to try to defend the value of the currency. This led to the country becoming insolvent in terms of not having enough foreign currencies to meet its obligations. The baht had to be floated and Thailand had to enter an IMF assisted program.

Experiences from the East Asian financial crisis and the global financial crisis showed the importance of having adequate foreign reserves to back up a country’s short-term foreign currency obligations. Short-term debt (by remaining maturity) is an important part of these short-term foreign currency obligations, but there are also other obligations that should be taken into account, particularly foreign holdings of stocks and bonds that can be quickly liquidated and the proceeds converted to foreign currencies to take out of the country. This means that it would be safest for a country to absorb as much of the short-term capital inflows into reserves so that if a sudden reversal occurs, for whatever reason, the reserves can be used to prevent large changes in the exchange rate and minimize spillovers into the real economy. This strategy would also reduce exchange rate volatilities from short-term capital inflows and outflows. This seems to be the right approach, as the exchange rate should be based more on fundamental

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factors, such as current account transactions and long-term foreign direct investment, rather than short-term speculative flows.¹ There may, however, be important constraints to pursuing such a strategy, particularly the need to sterilize the inflows that are absorbed into reserves to reduce inflationary pressures may lead to large losses for the central bank, especially in a situation like the present where interest earnings from reserves (say, from investing in US treasuries) is lower than the interest cost from sterilization. There could be significant fiscal implications from the losses of the central bank, and in Thailand the current policy of the government to transfer about US\$38 billion of bonds that were issued to cover losses of financial institutions from the 1997 crisis to the Bank of Thailand is related to past losses incurred by the Bank of Thailand from managing capital inflows and the exchange rate, which meant that the principal cost of these bonds could not be reduced for a number of years now, necessitating an annual budgetary expenditure of about US\$1.5 to 2 billion to cover the interest costs.

Because of constraints of individual country's policies in dealing with volatile capital inflows, cooperation at bilateral, regional and global levels have emerged as additional safety nets. The IMF, of course, is the main global institution for dealing with crises arising from foreign exchange liquidity shortages, and in fact it is now also deeply involved with sovereign debt crises in local currencies (the Euro zone) as well. From the East Asian financial crisis, regional facilities in East Asia have also been developed, the Chiang Mai Initiative (CMI), a system of bilateral swaps among the ASEAN+3, and its more recent evolution, the Chiang Mai Initiative Multilateralization (CMIM), a self-managed reserve pooling mechanism now totaling US\$240 billion with a single contractual agreement.² However, neither the global or regional facilities played any roles for emerging East Asia during the global financial crisis. There were significant US\$ liquidity shortages for some countries in the region, notably Korea and to some extent Indonesia. Both of these were members of the CMI but neither utilized it, mainly because the CMI was still mostly tied to the IMF in that a country using more than 20 percent of its quota under CMI³ had to be under an IMF supervised program and there was (and is) still a stigma attached to the IMF in East Asia from bad experiences with IMF conditionality during the East Asian financial crisis. Instead, Korea got a swap with the US Federal Reserve. Indonesia also requested a swap with the Fed but was refused. Instead she got a swap with China and expanded the swap with Japan under the CMI so the portion unlinked to the IMF would be larger. It was a pity that CMI played no direct role, but the link to the IMF means that the value added the CMI (and currently the CMIM) provides to the IMF is minimal. This is a problem that needs to be sorted out to make an East Asia liquidity support mechanism effective and worthwhile, especially now that the ASEAN+3 Macroeconomic and Research Office

(AMRO) has been set up to do regional surveillance and requires real financial contributions from each of the ASEAN+3 countries.

Possibly because the bilateral swaps seemed to be effective during the global financial crisis, countries have been moving to do more bilateral swaps with each other as part of their defensive mechanism against foreign exchange liquidity shortages. For example: Korea has a total of about US\$70 billion swaps with Japan, a \$30 billion Won-Yen swap, a \$30 billion Won-US\$ swap and a \$10 billion swap under the CMI; Korea also has a Yuan 360 billion (about \$57 billion) with China, which may possibly be convertible to US\$ in the future; Indonesia has a Yen 1.5 trillion (about \$19.5 billion) Rupiah-Yen swap with Japan and a Yuan 100 billion (about \$15.9 billion) Rupiah-Yuan swap with China. Bilateral swaps in the two countries' currencies can help to ease possible liquidity shortages of the two currencies for bilateral trade and investment, and this is an important reason for having these bilateral swaps. However, when the swaps involve a convertible currency, such as the Yen, then they can become means to deal with liquidity shortages of global currencies, particularly the US\$. Even in the case of the Yuan, a policy to make the swap convertible to US\$ could be implemented, particularly given China's huge holdings of the US\$. So these bilateral swaps are actually being developed to deal with potential foreign exchange liquidity shortages in general. It is not clear whether this is the direction that should be encouraged. With bilateral swaps, it is inevitable that political considerations enter the equation in the decision to grant these swaps. How does good country economic policies fit in? Given their huge holdings of foreign reserves, and competition for influence in the region, one can easily envisage a competition between China and Japan to do bilateral swaps with their trade and investment partners to gain political leverage. And given current links between CMIM and the IMF, countries in the Southeast Asia, with strong trade and investment links to both Japan and China, are likely to prefer bilateral deals with Japan and China to the CMIM. What will this mean to the regional and global facilities?

The linkages between the CMIM and the IMF will need to be modified in ways that will make both facilities effective and complimentary. At present, the percentage that can be utilized from CMIM without having to be under an IMF supervised program is 30 percent (increased from 20% to 30% in May 2012). However, the IMF unlinked amount is still too small to be useful for either crisis prevention or resolution. For example, Thailand's IMF unlinked portion is US\$6.828 billion, which is very small compared to the US\$17.2 billion IMF package in 1997, or the US\$30 billion swap that Korea got from the US Federal Reserves to tie it over during the period of US\$ liquidity shortages caused by the global financial crisis.

While the IMF itself has been developing new facilities, such as the Flexible Credit Line (FCL) and

Precautionary Liquidity Line (PLL), it needs to understand the deep stigma attached to it in East Asia and be fully supportive of the regional facility, otherwise countries in East Asia will bypass both the global and regional facilities and develop more and more ad hoc bilateral swaps arrangements. This will not be good for the overall global and regional financial architectures.

At the global level there is also the G20. Being someone from a non-G20 country I am not very knowledgeable about it. As long as the G20 is simply a consultation forum, like, say, the East Asia Summit, then it does not really matter for a country like Thailand. If the G20 is to be something more than simply a non-binding consultation forum, then the question of legitimacy cannot be avoided, and a real global economic governance structure will need to be discussed in detail. If G20 is considered an appropriate level, then membership criteria may need to be reconsidered. Is it just economic size (measured by GDP for example)? What about linkages to the global economies? Should a big country with less links to the global economy than another smaller economy be given

priority? May be it's the linkages to the global economy that should be more important. For example, Singapore is much, much smaller than Indonesia in terms of GDP size, but has much greater external trade and financial linkages to the global economy, so should Singapore replace Indonesia in the G20. Questions like this are of course highly controversial, but cannot be avoided if a global economic governance structure with real teeth is going to be established.

ENDNOTES

- ¹ However, in recent years, many East Asian countries have also been preventing their currencies from appreciating even though they have large current account surpluses and net foreign direct investment inflows.
- ² CMIM came into effect in March 2010. It's size at that time was US\$120 billion. This was doubled to US\$240 billion in May 2012.
- ³ CMIM was not yet implemented at that time.

