# Managing Economy under volatile capital flows

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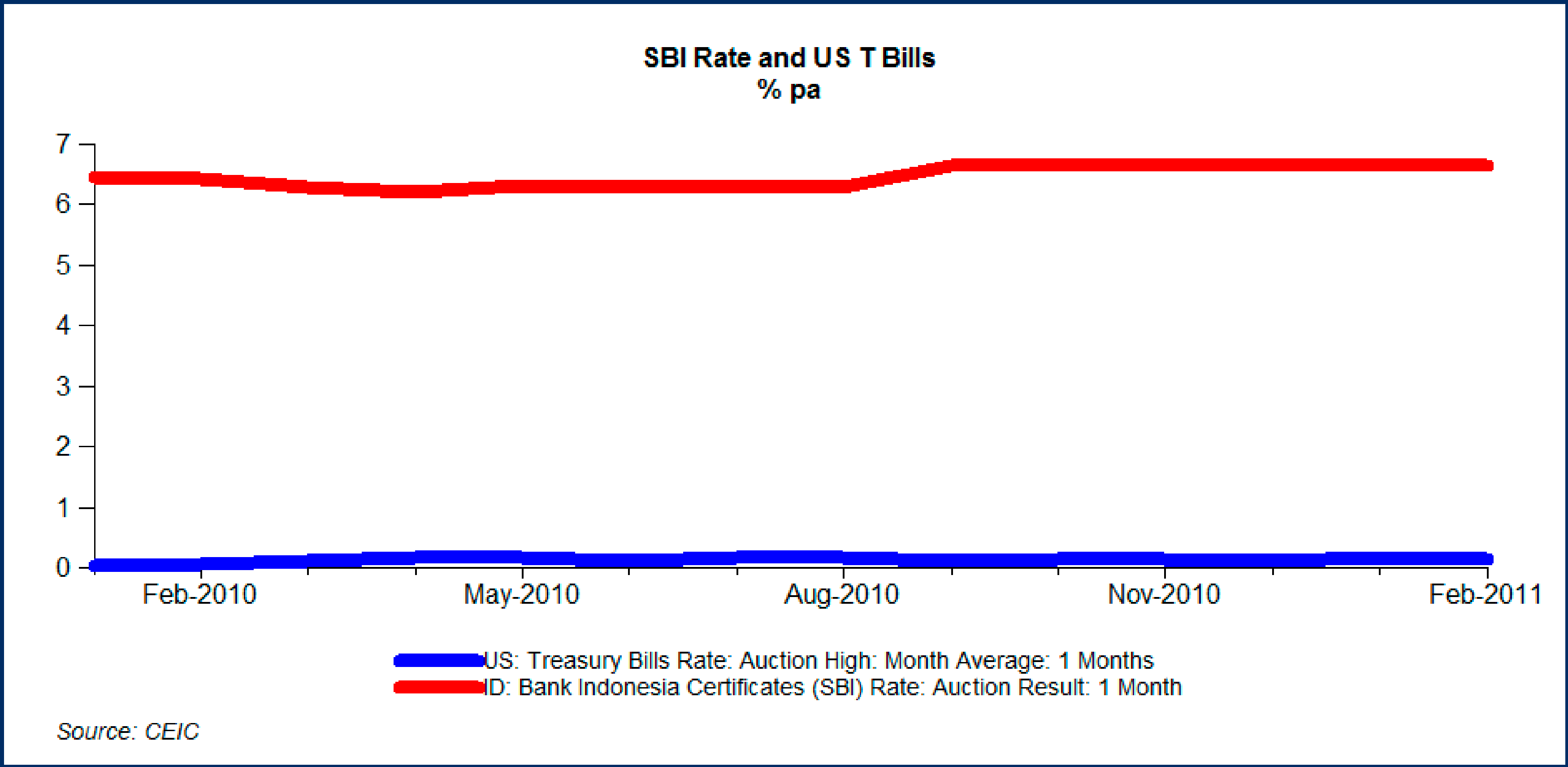
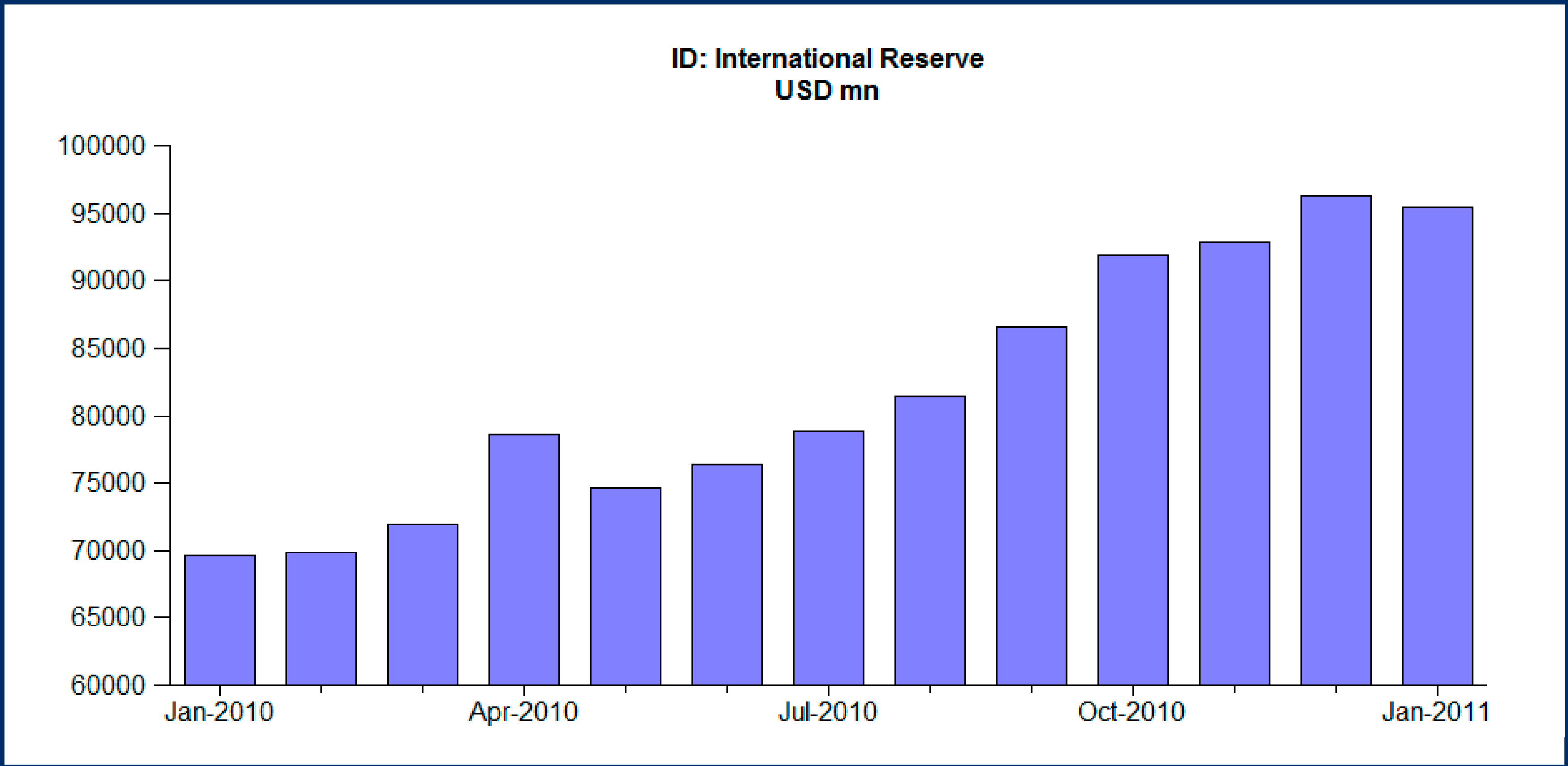
# BI rate and US Funds Rate: spreads remain high



# Foreign Reserves steadily increases



# Capital inflows to EM

## Capital Inflows to Emerging Markets

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

| | Net capital inflows | FDI, net | PI, net | Equities, net | Equities, liabilities | Debt, net | Debt, liabilities | OI, net | OI, liabilities |
|---|---|---|---|---|---|---|---|---|---|
| India | 1.1 | 0.6 | 1.7 | ... | 1.4 | ... | ... | 0.2 | 0.4 |
| Indonesia | 0.9 | 0.4 | 1.0 | ... | 0.2 | 1.6 | ... | 0.5 | 0.7 |
| Korea | 0.6 | -1.7 | 2.0 | 0.8 | 1.2 | 1.4 | 1.0 | -0.7 | -0.4 |
| Malaysia | 0.0 | -1.6 | 1.4 | -1.3 | 0.2 | 1.9 | 2.0 | -1.1 | 0.8 |
| Taiwan POC | 1.4 | -0.2 | -1.2 | -0.7 | 0.6 | -0.4 | 0.5 | 2.3 | 0.9 |
| Thailand | 0.2 | -1.2 | -0.5 | ... | 0.6 | ... | -1.0 | 0.6 | 0.5 |
| Argentina | -0.4 | -0.8 | 0.5 | 0.8 | -0.2 | 0.2 | 0.1 | 0.6 | 0.4 |
| Brazil | 1.1 | -0.5 | 2.0 | 3.1 | 2.8 | 0.8 | 0.8 | 0.2 | 0.8 |
| Chile | -0.9 | -0.6 | -0.8 | -2.3 | 0.2 | 1.6 | 0.2 | 0.2 | 1.7 |
| Mexico | 0.5 | -2.1 | 0.9 | ... | -0.1 | 1.2 | 1.3 | 0.7 | 0.8 |
| Peru | 0.2 | 0.1 | 0.7 | -0.5 | -0.2 | 1.1 | 1.1 | -0.2 | -0.2 |
| Hungary | -0.9 | -1.4 | -0.2 | -0.4 | -0.3 | 0.0 | -0.2 | 0.2 | -0.4 |
| Poland | 2.0 | -0.8 | 2.3 | 1.6 | 2.5 | 1.8 | 1.6 | 0.4 | 0.3 |
| Russia | 0.4 | -1.4 | 0.3 | 0.1 | 0.2 | 0.8 | 0.5 | 0.4 | -0.5 |
| Israel | 0.1 | -0.8 | -0.9 | -3.6 | -1.4 | 3.0 | 6.6 | 0.8 | 0.1 |
| South Africa | 1.1 | -0.3 | 1.0 | 0.4 | 0.2 | 1.5 | 1.5 | 0.1 | -0.7 |
| Turkey | 1.1 | -0.1 | 0.4 | 0.3 | 0.3 | 0.4 | 0.4 | 1.6 | 0.0 |

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

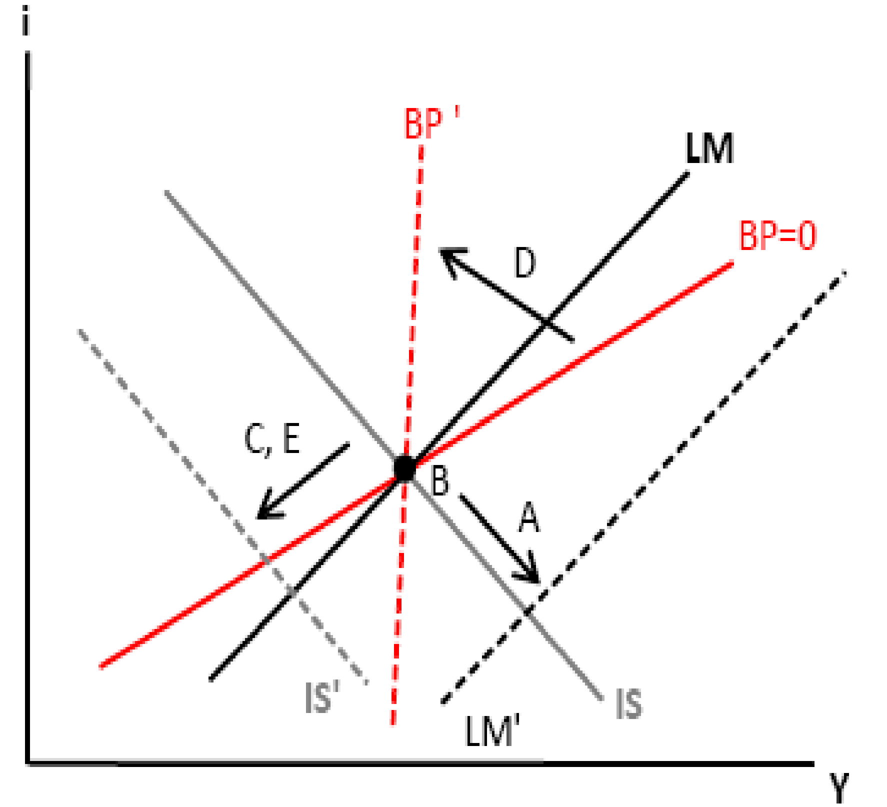
A : Allow inflow of money (*shifts LM right*) → Can be inflationary

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 → pressure on budget→ inflation overhang→ fisher effect→ expected inflation → bond market → reverse capital outflow

Fuel price adjustment:

Adjust gasoline price → inflation increase → realized expected inflation → no more inflation overhang → macrostabilty, though inflaton maybe higher