Bank of Indonesia and IMF Joint Conference on
Coping with Asia's Large Capital Inflows in a Multi-Speed Global Economy

"How Should Emerging Market Countries Respond?"

Korea's Experience

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Overview

- Post-Crisis Capital Flows & Outlook
- Policy Perspectives on Capital Flows
- Policy Responses & Assessment

Post-Crisis Capital Flows & Outlook (1)

Foreign capital inflows led by portfolio investment

End-2010

Stock 31.2%

Bond 6.6%

Foreign Investor Holdings

• Stocks: +USD47.9 billion

• Bonds: +USD42.5 billion

• FDI: +USD2.1 billion

End-2008

Stock 27.4%

Bond 4.3%

Foreign Investor Holdings

✓ **Cause:** Two-speed post-crisis recovery between developed and emerging economies

- Quantitative easing in developed economies + economic recovery in emerging economies
- Higher interest rate + current account surplus (possibility of currency arbitrage)

➡ Korea's high growth (6.1% in 2010) also attracts foreign investors

Post-Crisis Capital Flows & Outlook (2)

Capital inflows likely to continue in 2011

Quantitative Easing
- High unemployment
- Exit strategy unlikely

Korea's Growth
- 5.0% for 2011

Capital Flow Outlook

Low PER
- Korea 10.2; US 14.2
  Japan 15.8; Germany 11.7

Preemptive Rate Hike
- Easing inflation
- Wider rate differential

✓ **IIF's forecast of portfolio investment into emerging market economies:**

- **2009: USD153 billion, 2010: USD199 billion (e), 2011: USD181 billion (f), 2012: USD201 billion (f)**

Policy Perspectives on Capital Flows

Rapidly surging capital flows: risk to the economy

1. Potential for asset bubbles

- 2010: KOSPI up 22%; 3-Yr. Govt. Bond: down 103bp (4.41% to 3.38%)

2. Inflationary pressure & macroeconomic policies

- Two policy rate hikes in 2010, but market rates unmoved
- Less effective monetary policy in the face of large capital inflows

3. Speculative currency trading & short-term foreign borrowings

- Sell dollar forwards, wider swap basis & rising short-term borrowings

Net currency forwards sold in 2007 (+$69 billion from 2005); end-2007 arbitrage: +238 basis points); end-2008 short-term borrowings/FX reserves: +43.2%p

Policy Responses & Assessment (1)

Measures to mitigate the volatility of capital flows

1. Cap on currency forwards
- Domestic banks: 50% of capital
- Foreign bank branches: 250% of capital

July 2010 → **Reduced speculative currency forward trading and short-term external debt**

2. Tax on foreign bond investors
- Interest income 14%; capital gain 20%

Nov. 2010 → **Korean bonds less attractive to foreign investors**

3. Foreign exchange levy on banks
- Non-deposit foreign currency liabilities
- Higher levy rate on short-term borrowings

H2, 2011 → **Reduced short-term foreign currency borrowings**

Policy Responses & Assessment (2)

1 Reducing foreign currency liquidity risk

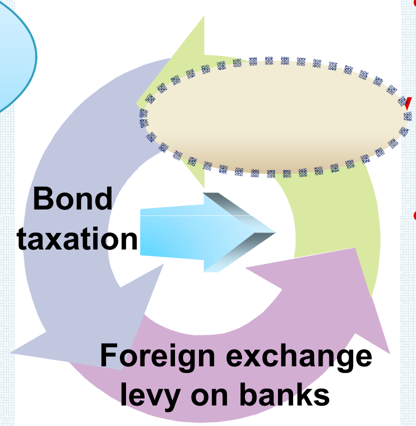
Capital outflows

Aug. 2008
Won/dollar: 1,089
FX Stabilization Bond: 193bp

Dec. 2008
Won/dollar: 1,260
FX Stabilization Bond: 404bp

Foreign currency liquidity → Trade finance

- ✓ Sources of financial instability
- ✓ Drag on the real economy



Policy objectives

- **Curb banks' excessive foreign currency borrowings**
  - Down USD12 billion (H2, 2010)
- **Encourage banks to borrow on a longer-term basis**
  - Ratio of short-term debt to FX reserves: 55.3% → 46.3% (2010)

Macroprudential Stability

Policy Responses & Assessment (3)

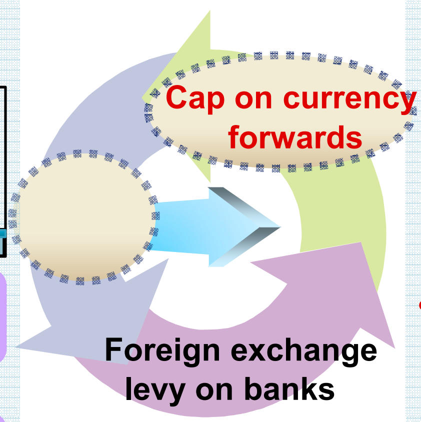
2 Mitigating the impact of sudden capital outflows

Surge in capital inflows

Stronger Won

More capital inflows	Greater demand for won
Easier access to foreign currency	Rises in dollar forwards sold
Surge in external debt	Rises in short-term external debt

Amplifying shocks in the event of a capital outflow



Policy objectives

- **Balanced investment in forwards and govt. bonds**
  - Curb excessive dollar forwards trading
  - Help ensure the effectiveness of monetary policies
- **Mitigate the impact of sudden capital outflows**
  - Less vulnerable to FX risk
  - More resilient banking system

Macroprudential Stability

Policy Responses & Assessment (4)

3 Improving emergency response capabilities

Foreign currency borrowings

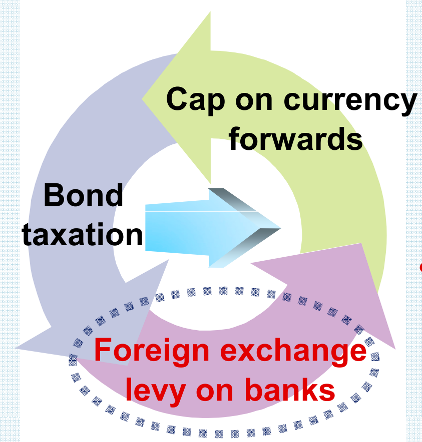
Moral hazard

Weighing on FX reserves?

Investor confidence

Sudden capital outflow

Increased systemic risk



Policy objectives

- **Improve emergency response capabilities**
  - Foreign exchange levy to provide foreign currency liquidity in times of emergency
- **Prevent moral hazard**
  - Foreign exchange levy to be imposed on banks in proportion to foreign currency liquidity risk

Macroprudential Stability

Thank You