How Should EMEs Manage Rapid Inflows?

Conference on Managing Capital Flows in Emerging Markets, Rio de Janeiro

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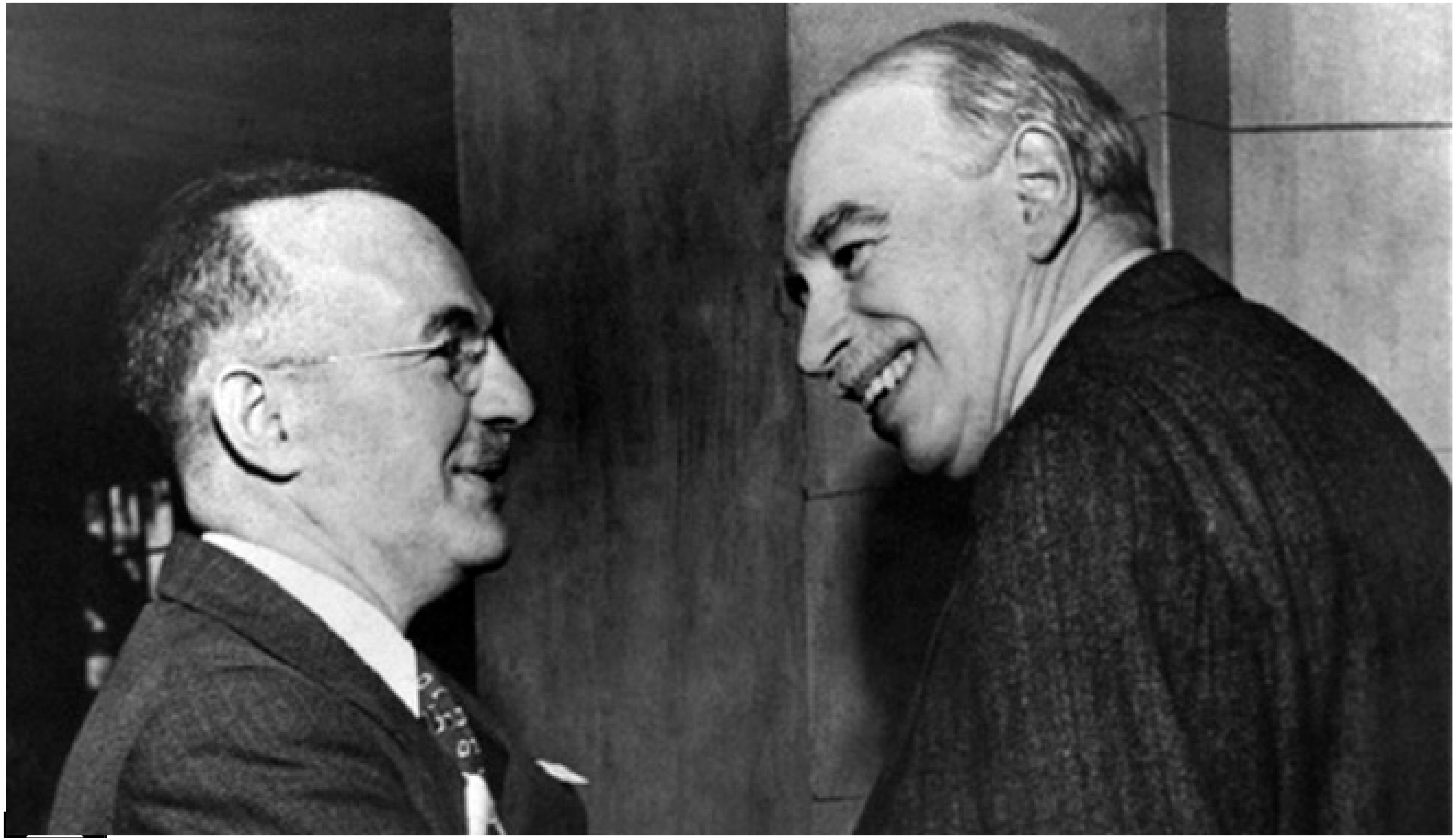
White and Keynes



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GOALS

Policy	π?	Financial System?	ER Comp?	Concerns
Fiscal tightening	✓	✓	✗	Politics, less investment, social, timing
Monetary Tightening	✓	✓	✗	Increases inflows
Appreciation	✓	✓	✗	Competitiveness, Dutch disease
Accumulate Reserves	✓	✗	✓	Costly, inefficient
Facilitate Outflows	✓	✗	✓	Impact limited, raise vulnerability in future?
Prudential regulations	✓	✓	?	Complex, impact on efficient lending?
Capital controls	?	✓	?	Effectiveness (especially over time), distortions, spillovers

Remaining Questions

I. Is the correct goal to limit inflows from abroad?

II. Are controls effective?

III. Do the benefits outweigh the costs?

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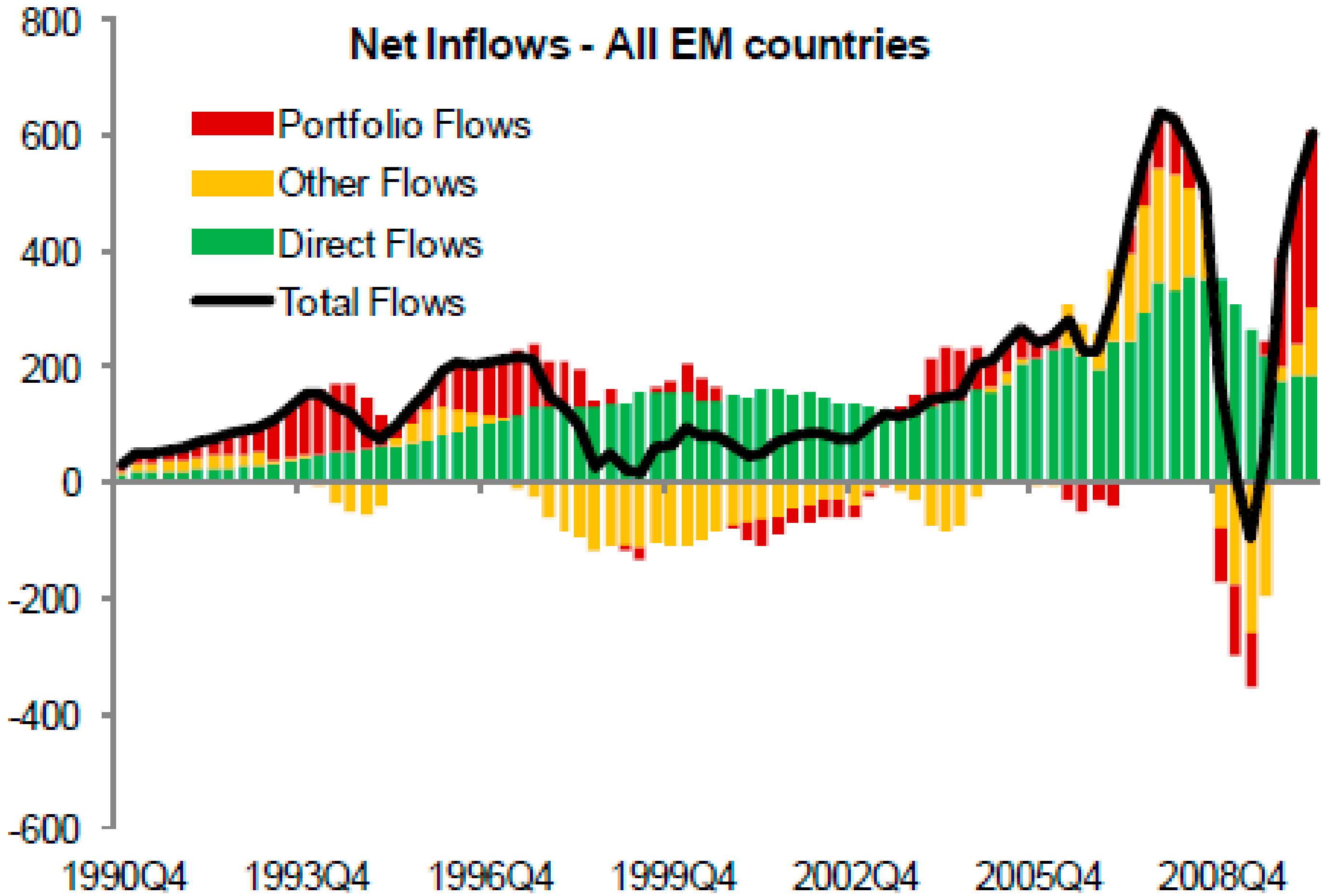
Is the correct goal to limit inflows from foreigners?

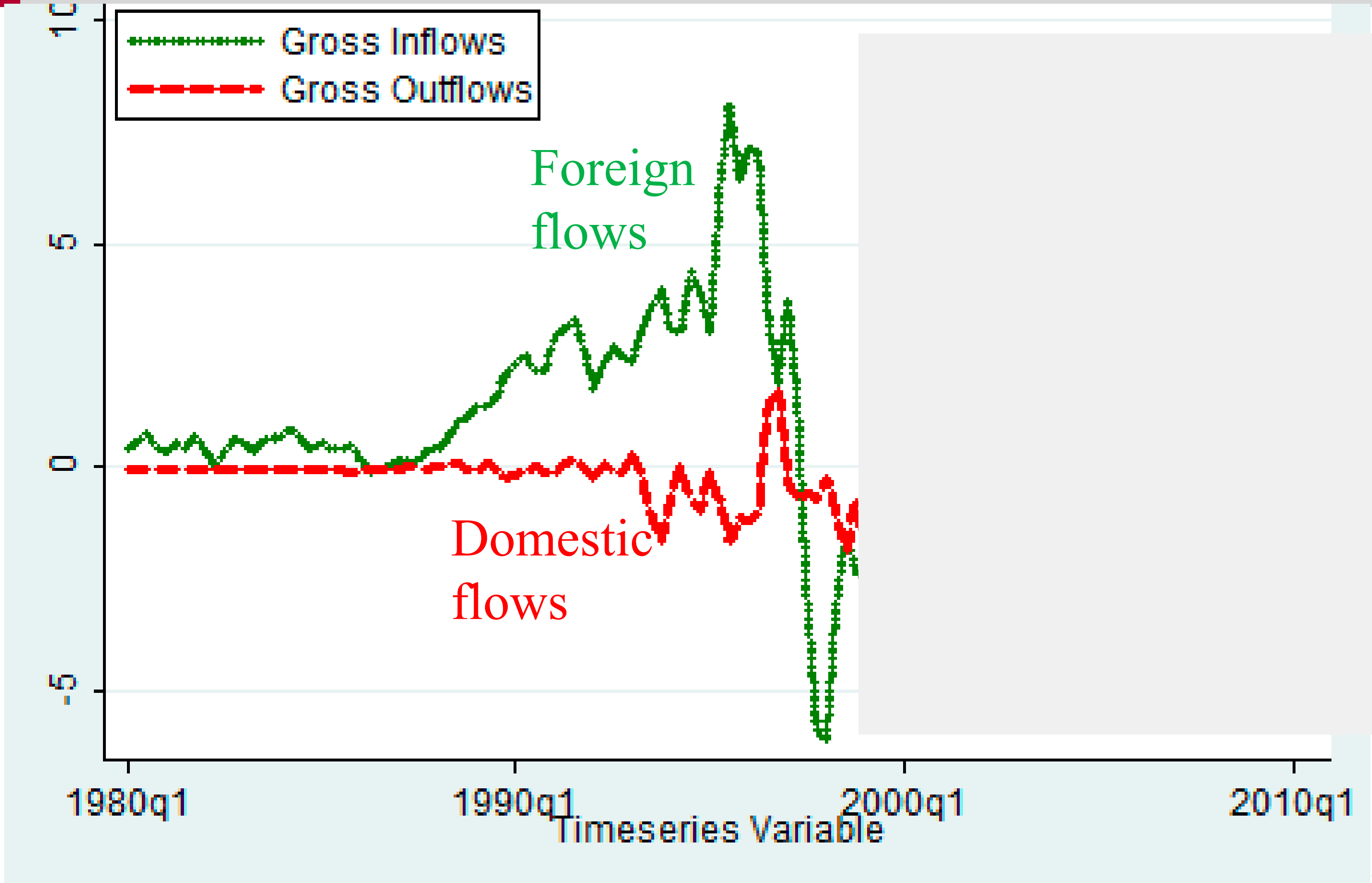
Recent Surge of Capital (bn$)



Source: IMF, Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework, Feb, 2011

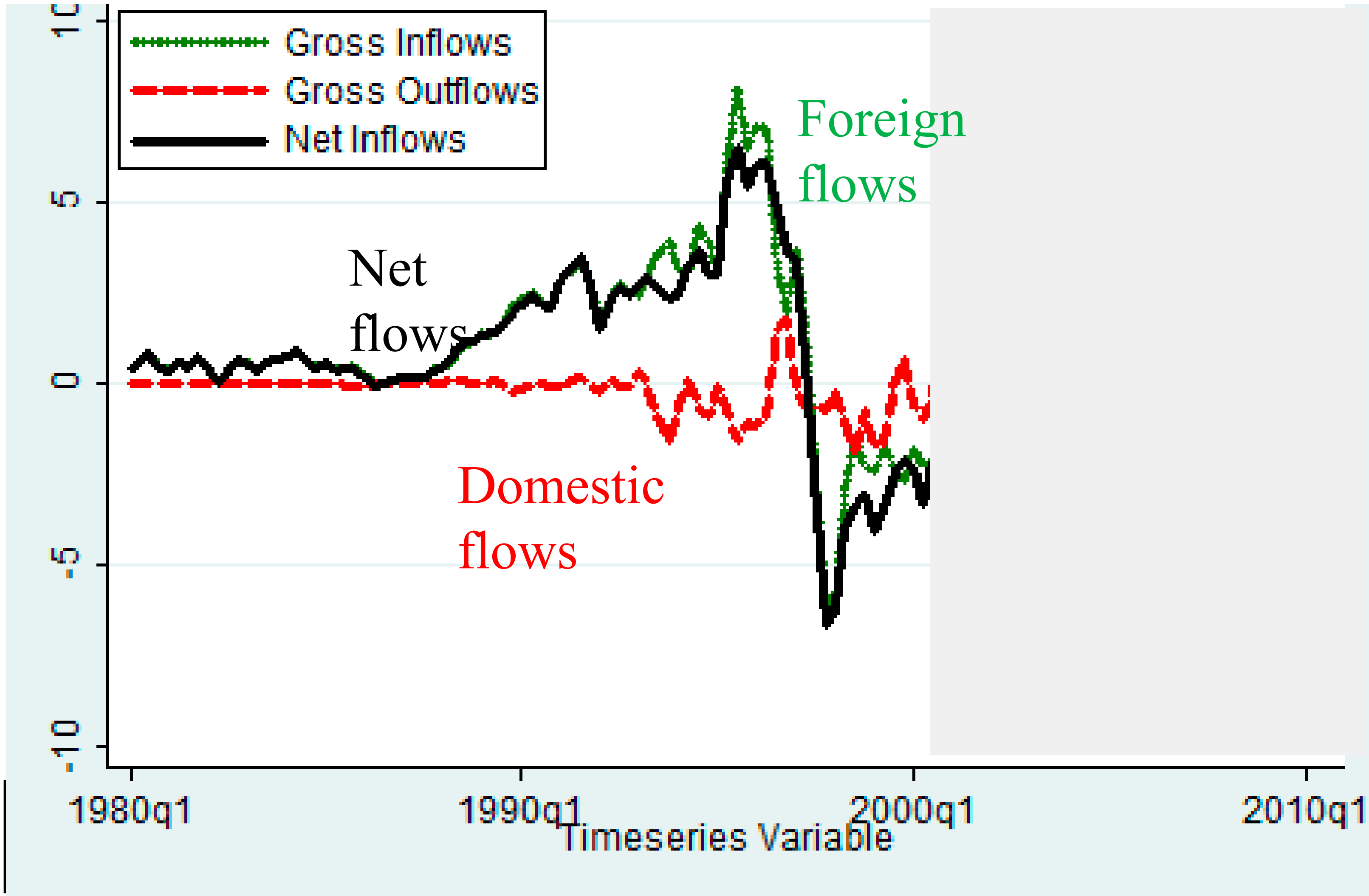
Thailand: Gross Inflows & Outflows

(2q averages)



Thailand: Net and Gross Flows

(2q averages)



Thailand: Gross Inflows & Outflows

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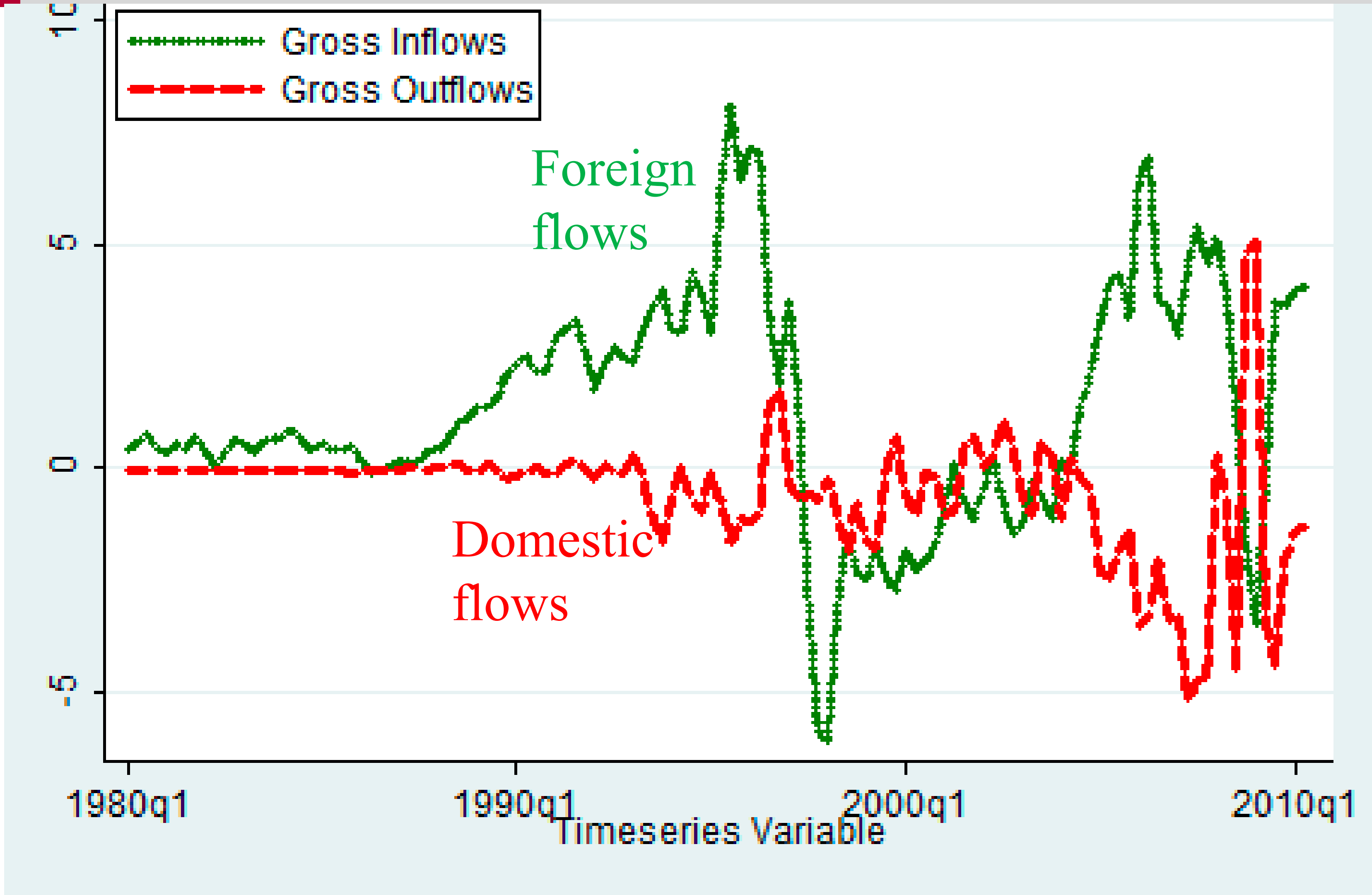

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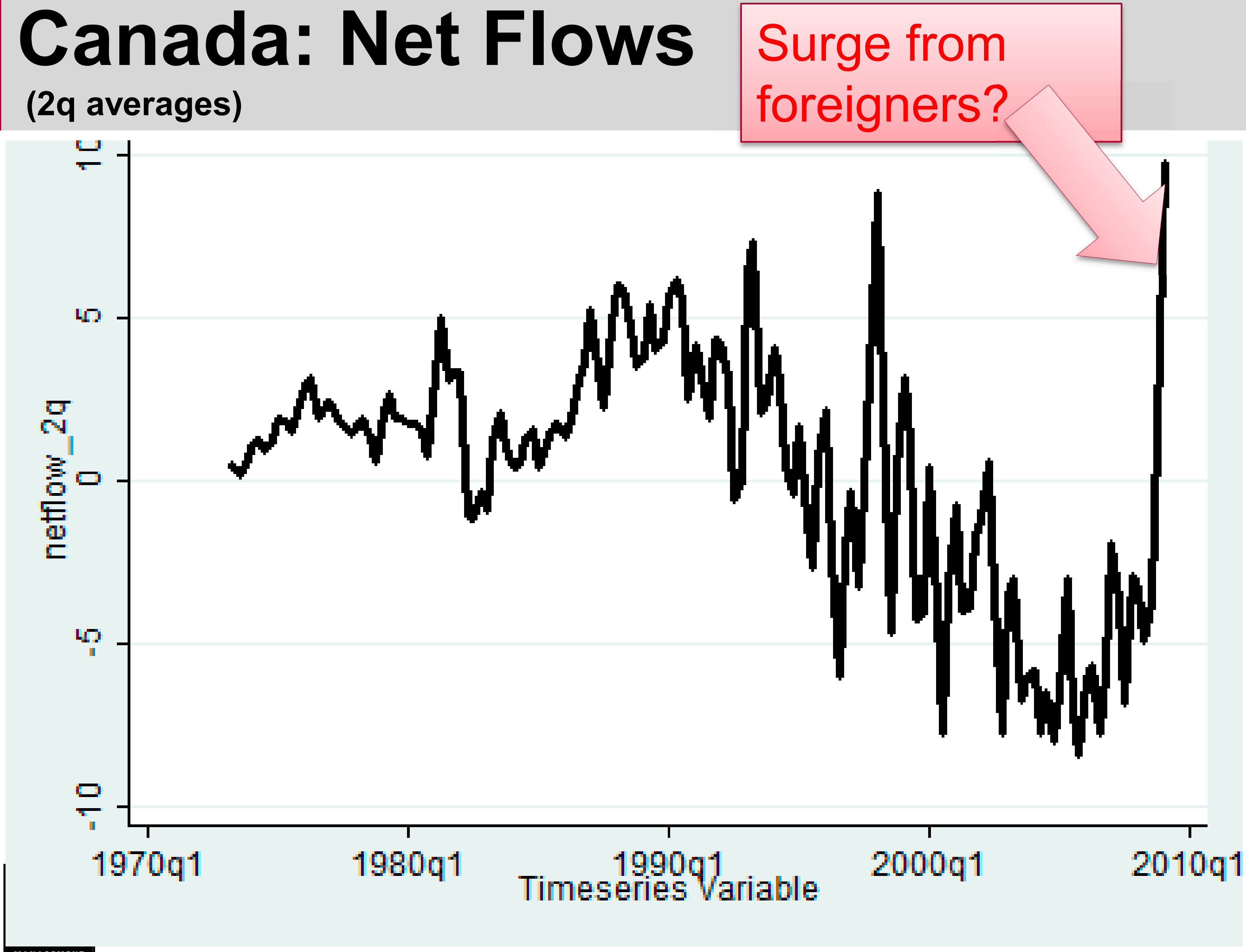
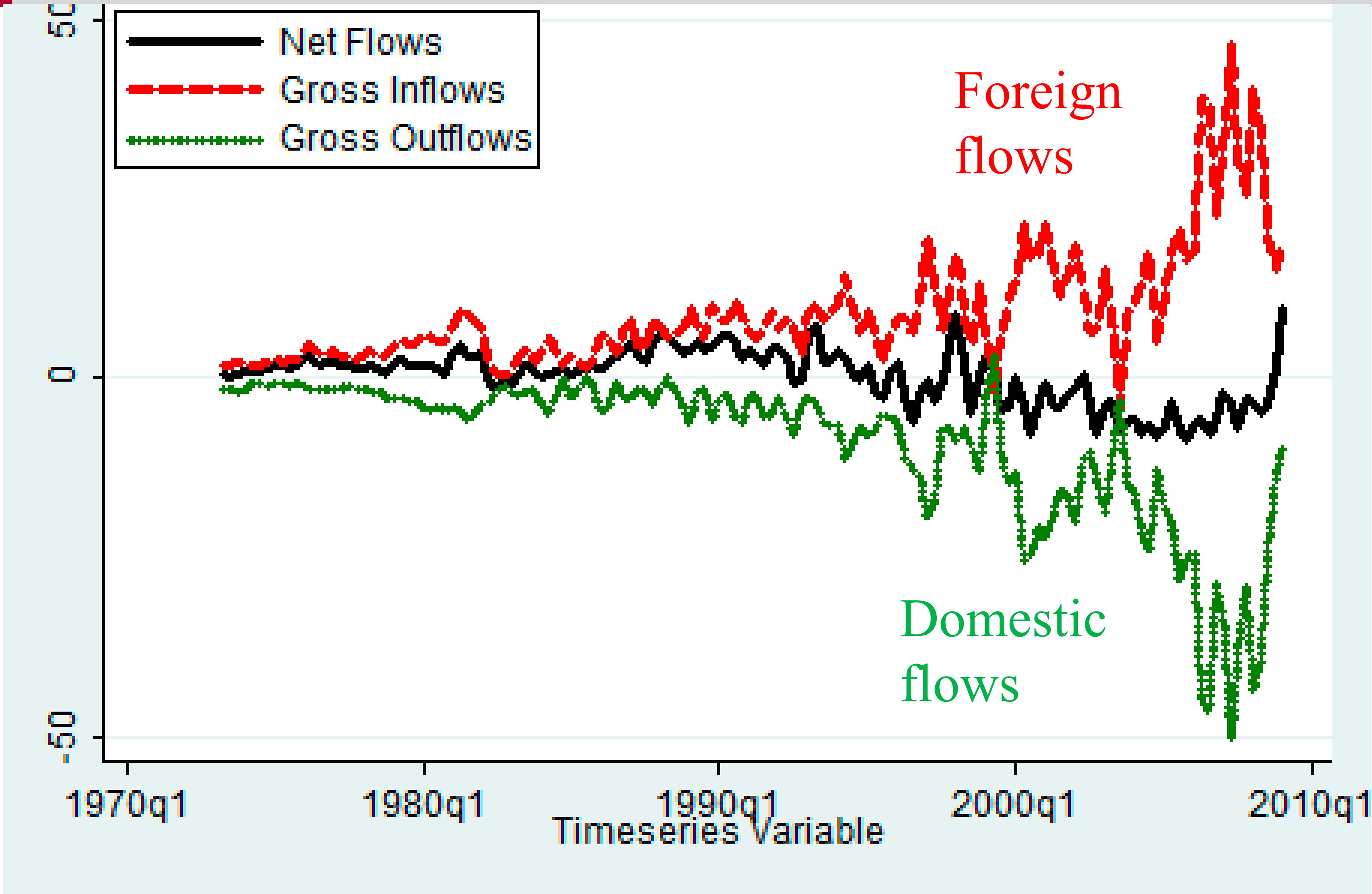
Canada: Net Flows

(2q averages)



Canada: Net and Gross Flows

(2q averages)



Are Controls Effective?

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Are Controls Effective?

- Forbes and Warnock (2011) explains “waves” of capital flows
  - Including “surges” or “stops” in inflows driven by foreigners relative to trend
- Test for role of:
  - **Global factors**: global risk, global liquidity, global interest rates, global growth
  - **Contagion**: through financial links, trade, and geographic location
  - **Domestic factors**: financial system, fiscal situation, domestic growth, financial integration/capital controls, income

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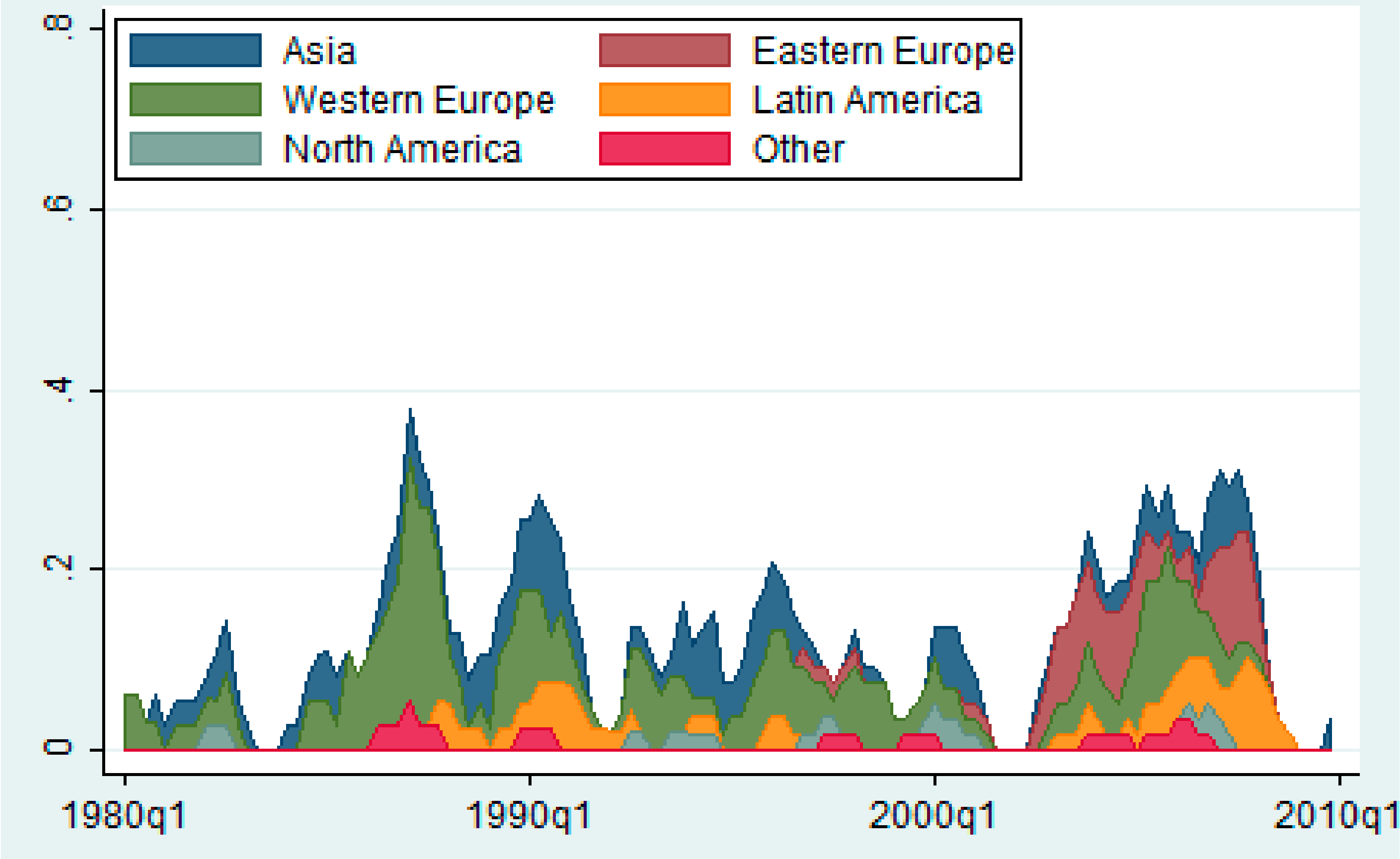
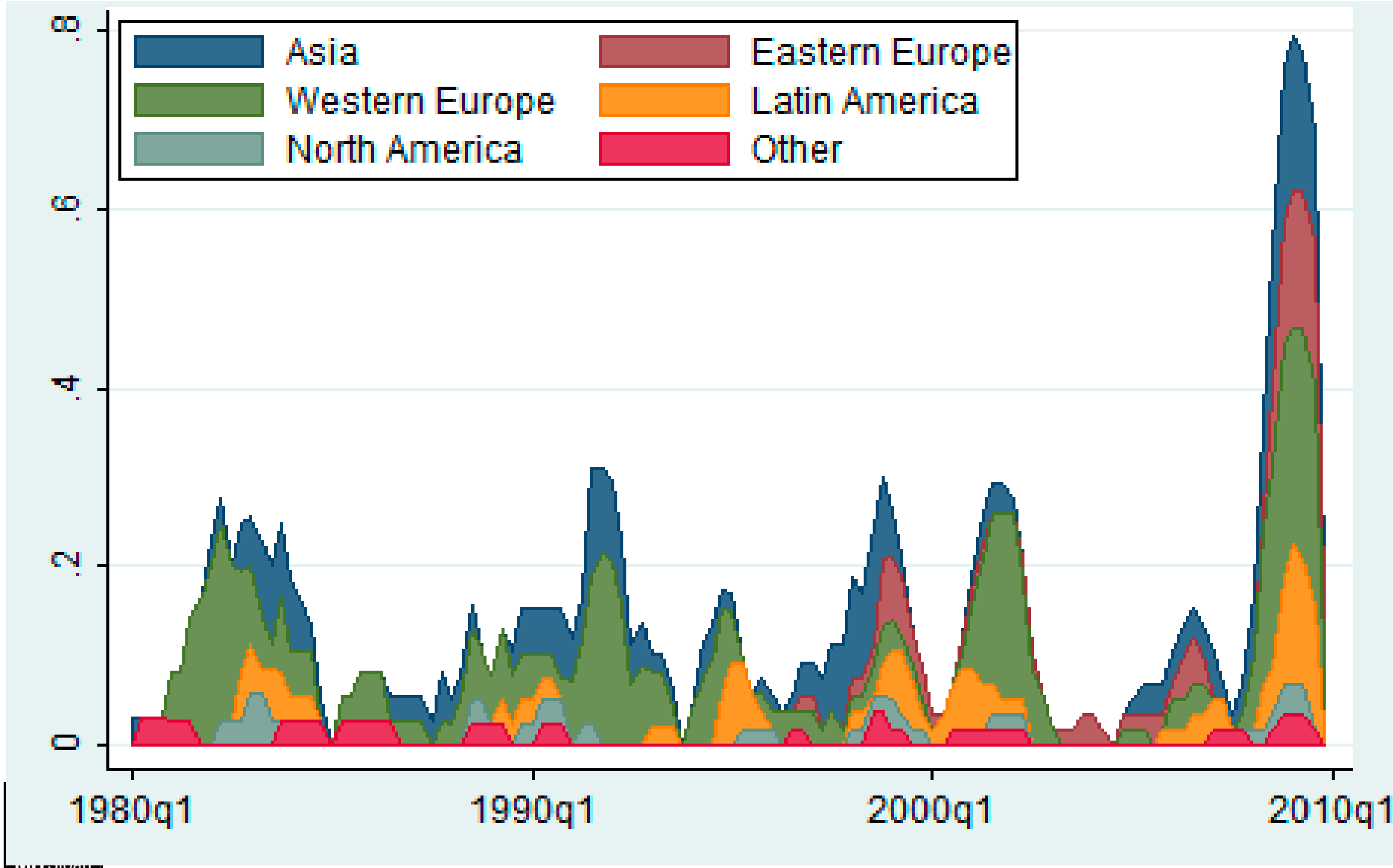
Share of Countries with a "Surge" of Capital Inflows from Abroad



Share of Countries with a "Stop" of Capital Inflows from Abroad



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Results & Implications

- Key Results
  - Global factors (risk, global growth) most important factors driving “surges” and “stops” of inflows from abroad
  - Contagion important in driving slowdowns in capital flows
  - Domestic factors play minimal role – only domestic growth
  - No significant effect of capital controls on the probability of having a “surge” of net inflows or gross inflows from abroad

- Implications
  - Countries have limited ability to stop the “waves” of capital flows
  - Countries should focus on strengthening ability to adjust to changes in inflows and outflows
  - Important role for multilateral institutions and cross-border cooperation

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Was the IOF Effective?: Results from Investor Surveys

- Range of views
- Equity investors
  - Minimal effect
  - Expect high returns and size of taxes is too small
- Bond investors—mixed reactions
  - Can make country more attractive
  - Increases country risk so shift to shorter-term
  - Harder to make a profit, will invest less in future
- Numerous ways to minimize tax
  - Shift to FDI vehicles, ADRs, derivatives
  - Bonds—harder—but different structures of investment to minimize tax that cost something and add risk

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Key Issue:
The New World Order

Not a **temporary** phenomenon

Source, *Economist* cover, 09/11/10

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Do the Benefits Outweigh the Costs?

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Costs of Controls

- Academic literature has identified numerous microeconomic costs
  - Increase financial constraints for small firms, important engine of jobs and growth
  - Less efficient pricing in financial markets
  - Less efficient allocation of resources as reduce market discipline
  - Numerous distortions to firm & individual behavior as use resources to avoid controls
- Multilateral effects?
  - Preliminary results: Forbes, Fratzscher, Straub & Widelz (2011)
  - Some, but weak and limited to limited investors & countries

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Costs vs. Benefits

- Do the benefits of controls outweigh these costs?
  - Cross-country literature: unclear
  - Cline (2010) argues no
  - Ostry et al (2011) and Jeanne argue yes
- My sense
  - Answer will depend on country situation
  - Costs grow over time as evasion increases
- Must consider both costs and benefits
- Can you achieve the same benefits through prudential regulations without the costs of controls?

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Final Thoughts

- No magic bullet for a country with an overvalued ER, inflation, and financial system concerns
  - Should start with standard macroeconomic responses & macroprudential regulations
  - IMF has laid out situations when capital controls can be included as part of this “toolkit”
- But, key questions must be answered before using capital controls more widely
  - What is the role of domestic investors? Is targeting inflows from abroad the appropriate goal?
  - Do capital controls work?
  - Do the benefits outweigh the costs?
    - Can you achieve the same benefits more efficiently through prudential regulations (without additional costs)

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