



BANK FOR INTERNATIONAL SETTLEMENTS

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**

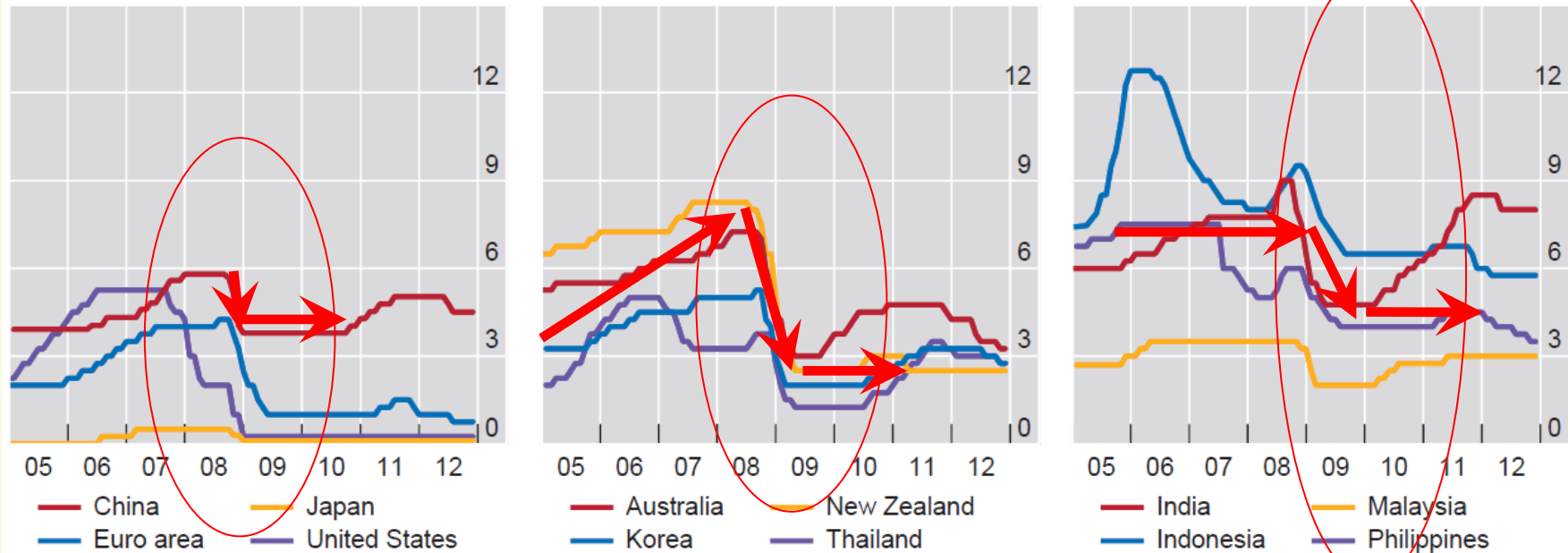
The good policy view



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.



EM Asia Response To QE

Interpreting QE Impact on Asian Financial Markets

	Announce- ment period	Total amounts (billions)	Gov't 2-year yields (bps) ↓	Gov't 10-year yields (bps) ↓	Corp bond yields ² (bps) ↓	Sov'gn CDS premia ³ (bps) ↓	Equity prices (%) ↑	FX against USD ⁴ (%) ↑
US QE1	Nov 08 to Nov 09	\$1,400	-45.37	-79.70	-52.90	-46.92	10.75	4.49
QE2	Aug 10 to Nov 10	\$600	-9.06	-9.16	-14.84	-4.80	1.53	-0.36

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**

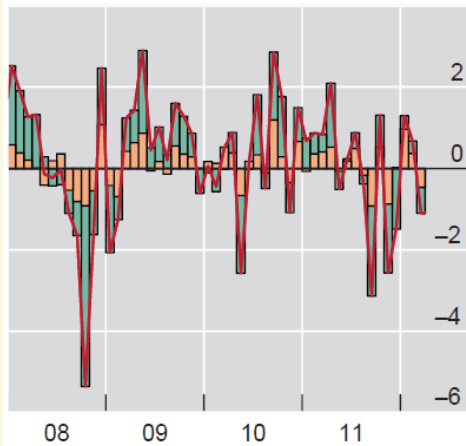
The good policy view



Resisting FX Appreciation

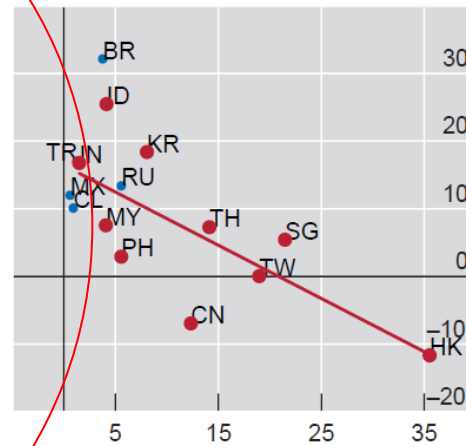
Reserves and exchange rates

FX market pressure on EM Asia¹

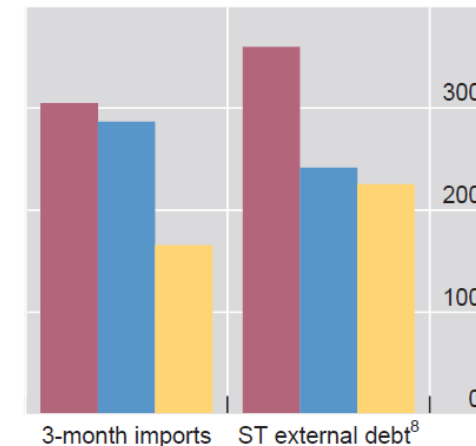


Contribution from:
 — Reserves
 — FX
 — Market pressure index²

Change in reserves and REER³



Foreign reserve adequacy, 2011⁴



— Asia-Pacific⁵
 — Latin-America⁶
 — Central Europe⁷

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.



Other Measures To Manage The Flows

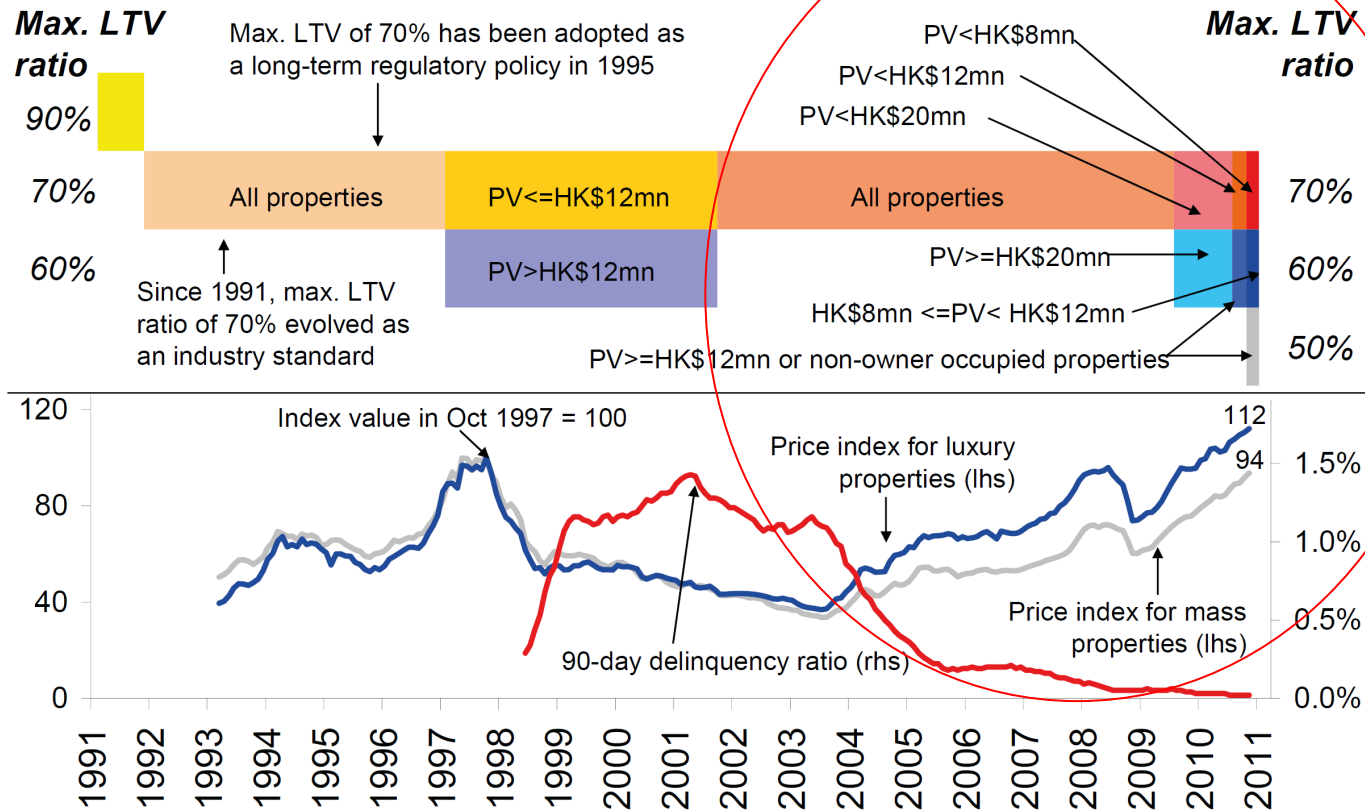
- Monetary policy...accommodative and pre-emptive to possible spillovers
- Resist FX appreciation through FX reserve accumulation
- **Developed a multilateral backstop – Chiang Mai initiative**
- **Intensified surveillance and monitoring of capital flows**
- **Renaissance in use macroprudential/capital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

The good policy view



Example: Hong Kong

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





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...**

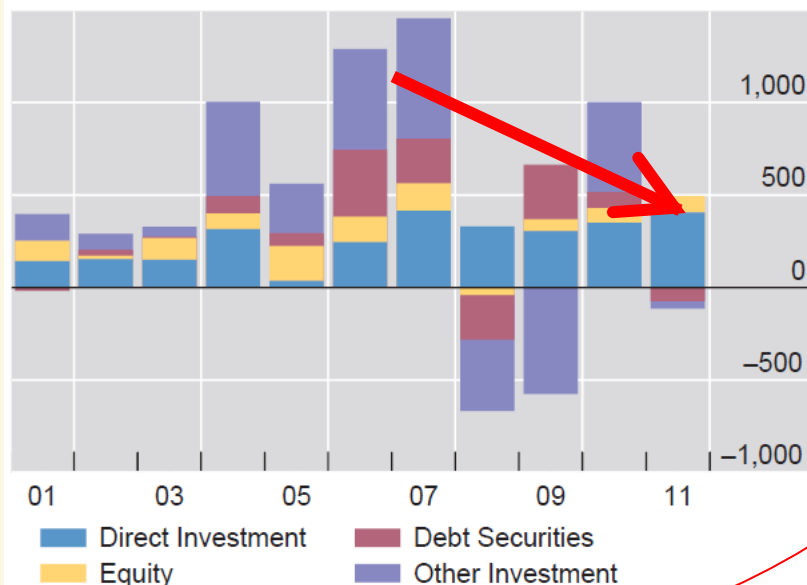


US Hot Money Flows – Not As Bad As We Thought?

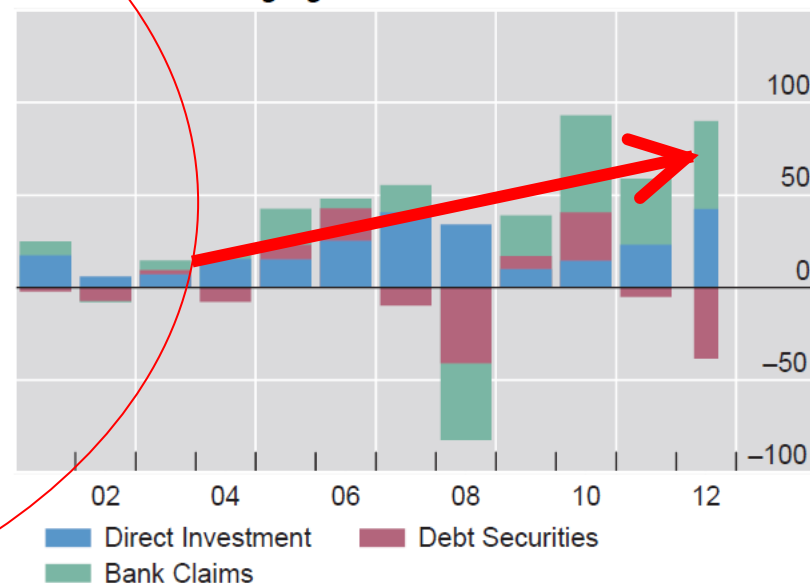
US capital outflows

In billions of USD

Total outflows



Outflows to emerging Asia¹



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

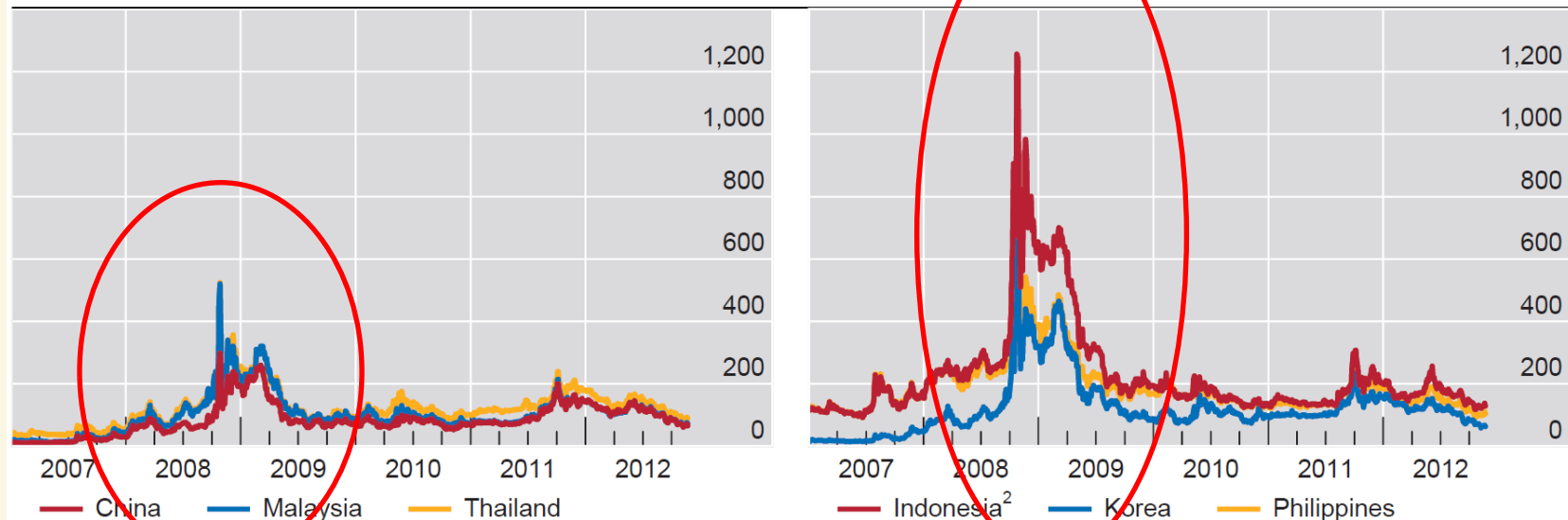
Sources: IMF *IFS*; US Bureau of Economic Analysis.



Why? International Financial Crisis And Risk Aversion

Sovereign debt CDS premia¹

In basis points



¹ CMA 5-Year Credit Default Swap premia ² Indonesia's premia exceeded 1000 on October 22, 2008, reaching a peak of 1256.7 on October 23, 2008.

Research shows most of this driven by shifts in risk aversion, not the probability of default

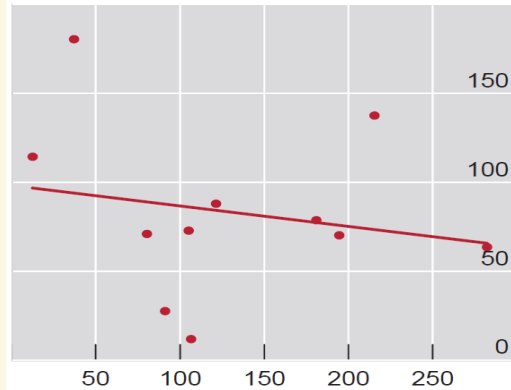


CDS Spreads And Net Capital Flows In EM Asia

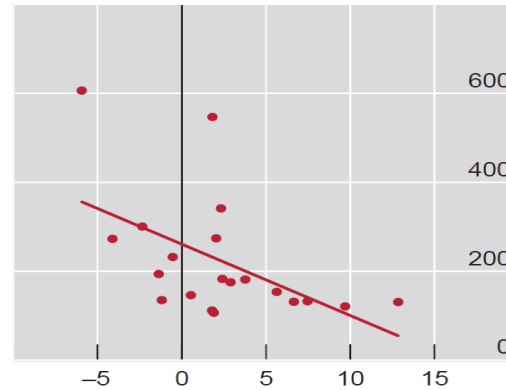
CDS spreads and net capital flows in Asia

Q1 2007 - latest

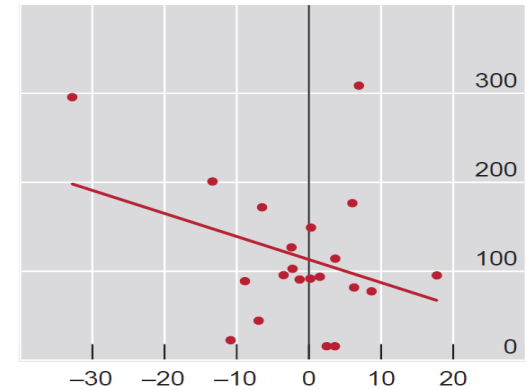
China



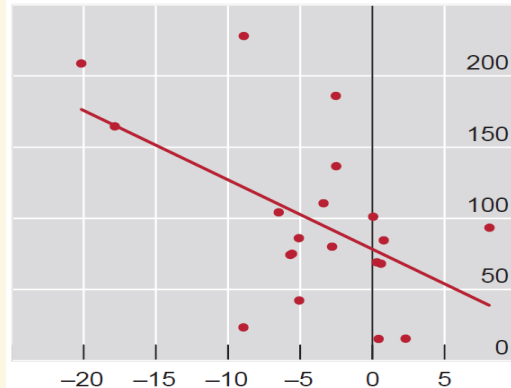
Indonesia



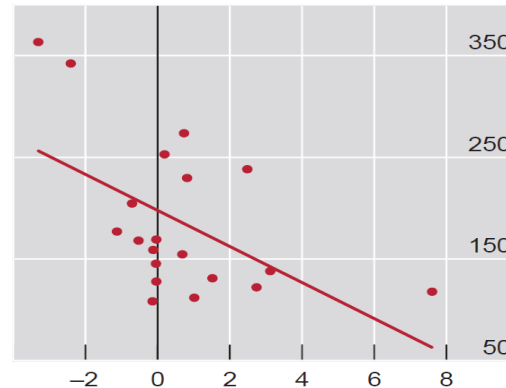
Korea



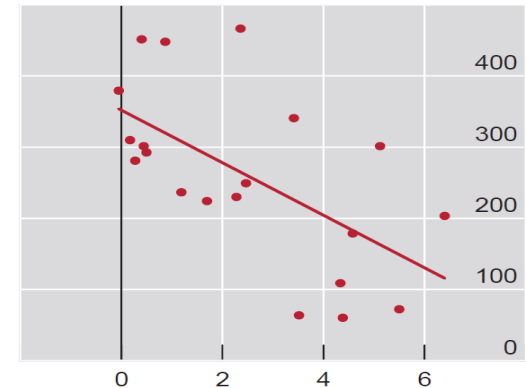
Malaysia



Philippines



Vietnam



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

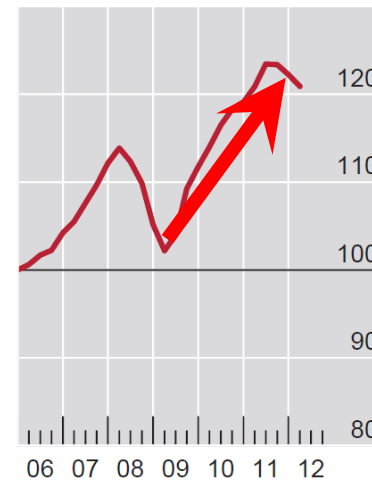
Real policy rate¹



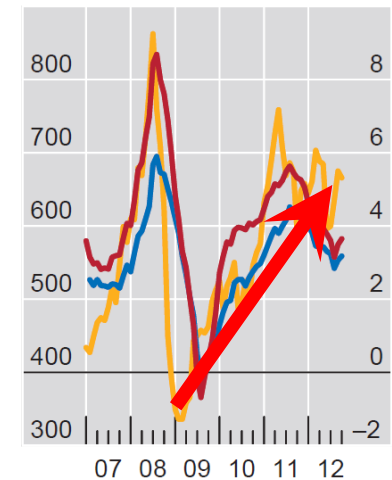
Growth of private credit²



Real housing price³



Commodity price and inflation²



Inflation:
— Headline (rhs)
— Core (rhs)
— S&P GSCI index(lhs)

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

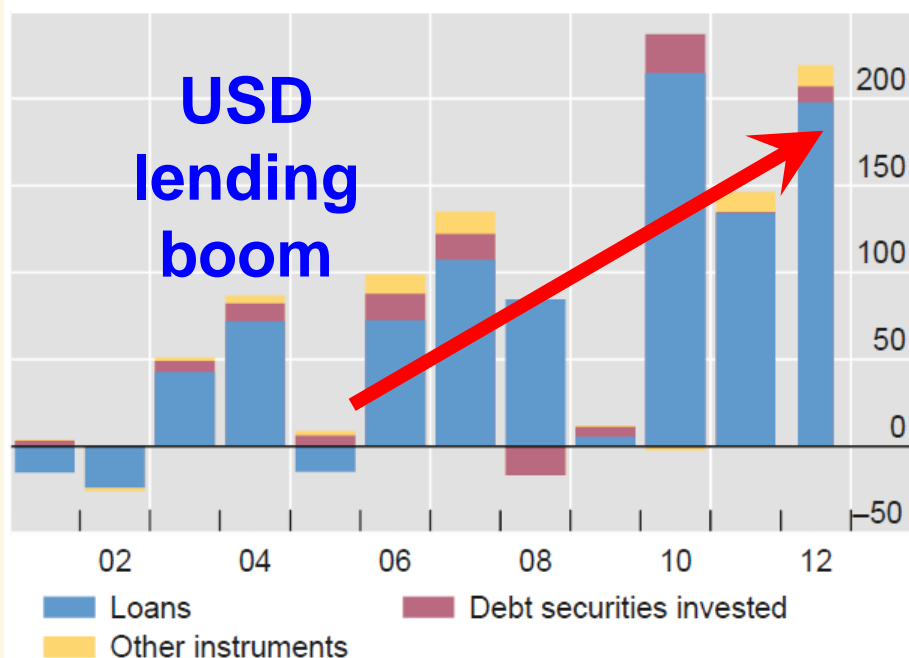


Offshore USD Lending Boom – A New Credit Channel?

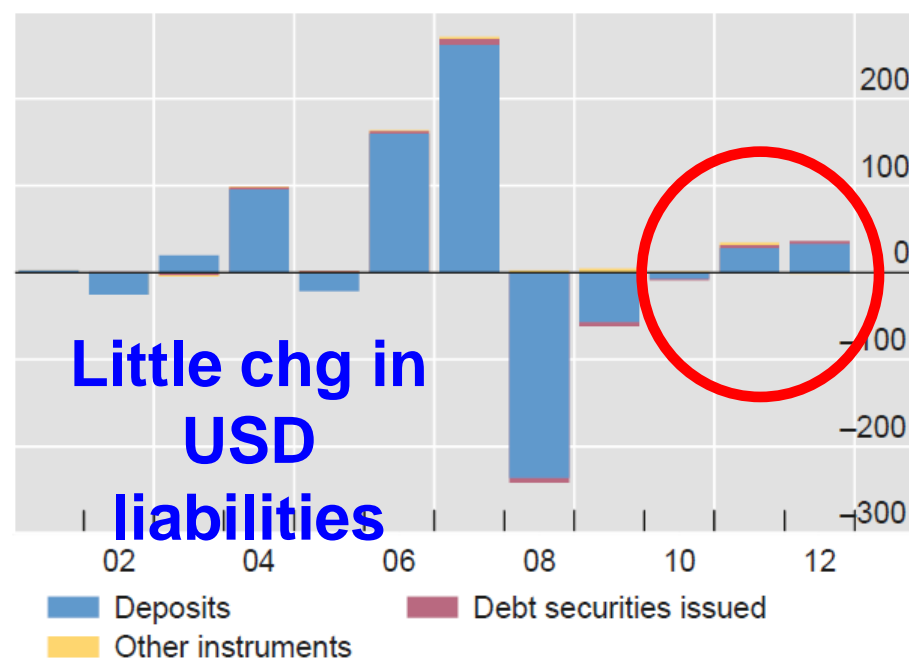
Offshore USD flows to Asia^{1, 2}

In billions of USD

Assets of non-US banks³ vis-à-vis Asian residents



Liabilities of non-US banks³ vis-à-vis Asian residents

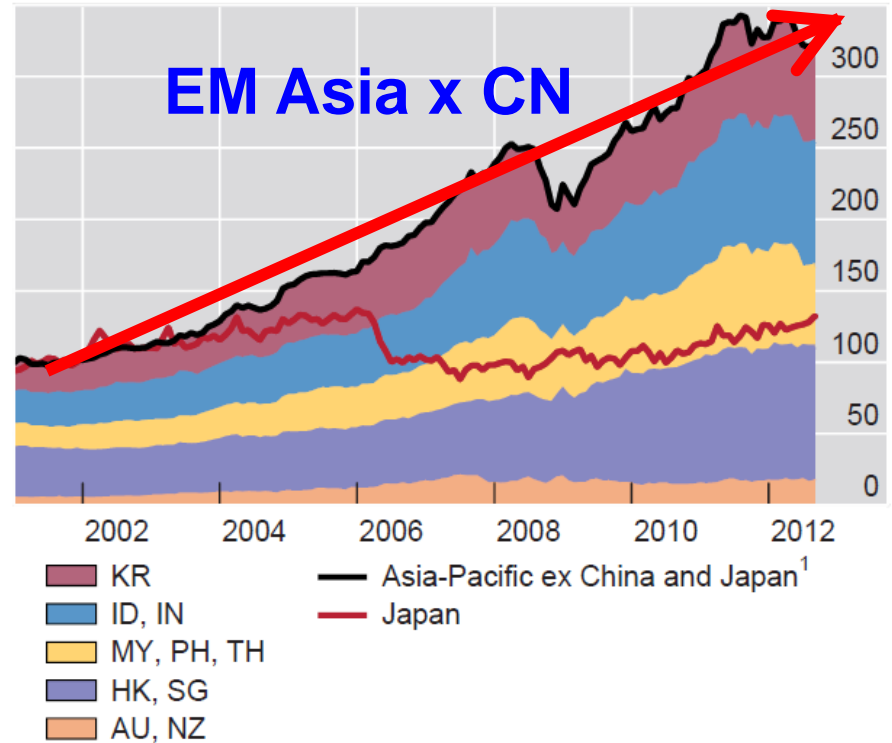
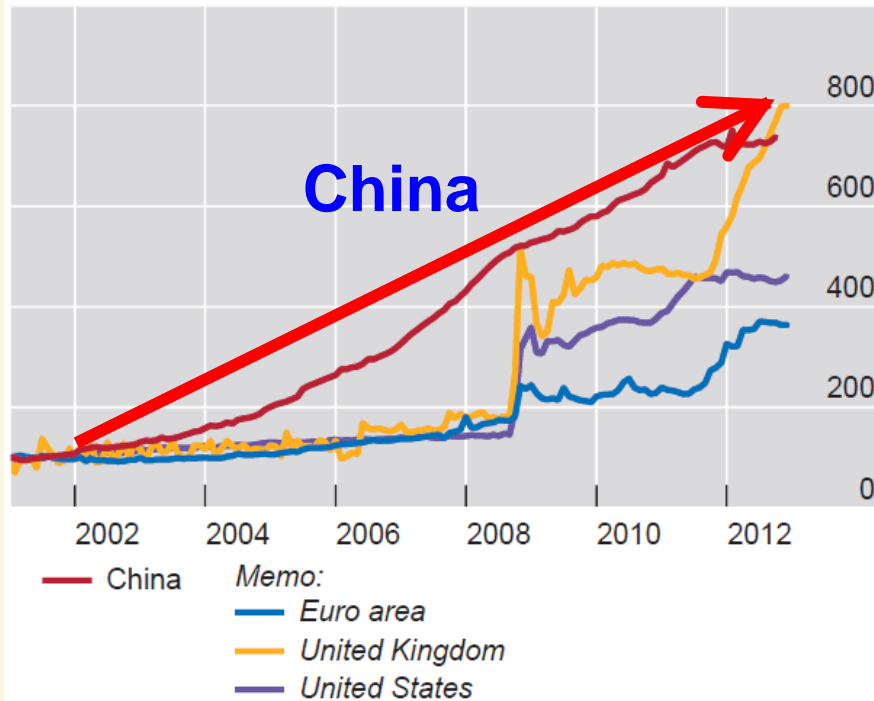


¹ 2012 figure based on annualised Q1 data. ² Estimated exchange rate adjusted changes of total positions of BIS reporting banks vis-à-vis all sectors in emerging Asia-Pacific. ³ The term "non-US banks" indicates banks outside the US



Limits From Soaring Central Bank Balance Sheets

Central bank total assets (2001=100)



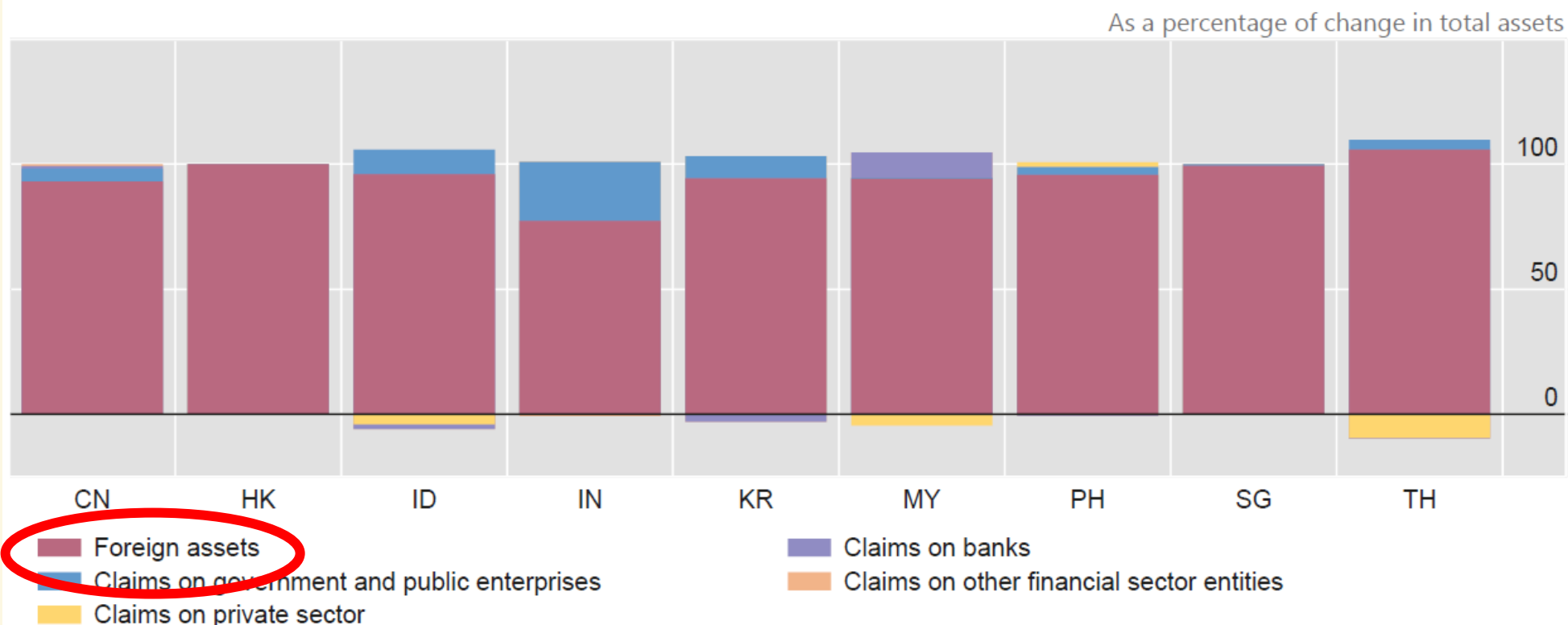
AU = Australia; HK = Hong Kong SAR; ID = Indonesia; IN = India; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand.

¹ Sum of listed economies.



Asset Side: Foreign Reserve Accumulation

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



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?

CB FX assets ↑



FX pressure ↓

CB liabilities
sterilise ↑



Lazy B assets ↑

Filardo/Grenville (2012): FX regimes with symmetric FX asset accumulation, ii) eventual reduction of CBBS called for; Filardo/Yetman (2012) on financial stability risks.



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!



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Thank you



Selective References

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