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How to Manage Foreign Capital Inflows? A Brief Technical Note

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Abstract

This note acknowledges the current policy concerns of emerging market economies (EMEs) relating to their foreign capital influxes. Although, capital mobility brings many benefits to a country's economy, it also creates instability and worsens crises. Managing this issue is not an easy task. Some measures should be put in place to curb the sudden capital influxes that are being experienced by some EMEs around the globe. This note suggests possible policy options for managing the capital inflows.

Keywords

Capital inflows; Asia; EMEs; Credit crunch



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This note acknowledges the current policy concerns of emerging market economies (EMEs) relating to their foreign capital influxes. Although, capital mobility brings many benefits to a country's economy, it also creates instability and worsens crises. Managing this issue is not an easy task. Some measures should be put in place to curb the sudden capital influxes that are being experienced by some EMEs around the globe. This note suggests possible policy options for managing the capital inflows.

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JEL Classification: F21, F32, E58, G01, G28

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Introduction

The management of the capital inflows along with exchange rate and at the same time to have counter-cyclical monetary policy is thought to be the impossible mission often called the *impossible trinity* or *trilemma* (Eun & Resnick 2009, Aizenman 2010, Agrawal 2010, Verma 2010). Prevailing theories of international economics and finance suggest that a country can achieve only two of the three objectives: price stability, floating exchange rate and capital mobility. In other words, no country can have flexible exchange rates and at the same time implement sound monetary policy to maintain low to moderate inflation, and reduce exchange rate volatility preferably within the range of undervalued exchange rates to benefit its exports. Accordingly, at any particular time, it can choose only a combination of two options out of the available three choices: capital mobility, exchange rate management, and price stability/curbing asset bubble.

Schools of Thought

The debate on capital flows is not new (Gavin et.al 1997, Rana 1998, Mundell 1999). It gets priority when we are facing global recession and/or financial crises (El-Erian 2010, Horrocks 2010, Oxford Analytica - OA 2010, International Monetary Fund - IMF 2011, Institute of International Finance - IIF 2011). This time, the most alarming issues have been the liquidity problems/credit crunch and now the capital influx to some developing nations around the globe. In this context, to handle the issue of capital inflows, there are at least three schools of thought:

- **Traditional school:** who believe that capital inflows are very important for the growth and development of an EME. There should not be any restrictions and capital should be allowed to flow freely across the border.
- **Sceptics/Critics school:** this school is sceptical over the role of capital inflows and they believe that free capital flows lead to crises in the absence of proper economic framework and policy response to curb it.
- **Fresh/New school:** who intend to find a fresh solution through evaluating and rethinking about the role of capital inflows to specific nations. This school often thinks that capital inflows neither come at the right time nor in exact quantity when required. Thus, the task here is to assess and improve the absorbing capacity and quality of investments using such capital.

Policy Options

On the issue of capital inflows, the policy response of a country usually depends on the school of thought to which its policymakers adhere. If the nation admires the traditional school, there is no policy action required on the issue of managing capital inflows; and the policy makers should *do nothing* but address other issues like exchange rate and price stability. If the nation believes in the second and/or third school, some actions are to be taken at an appropriate time to manage the influx of unanticipated capital inflows.

However, it is evident that capital inflows in some EMEs have continued to rise in recent times; which, if not managed properly, could become a threat to both economic and financial wellbeing of those nations. Accordingly, this note focuses on ten possible options of managing foreign capital flows for nations facing a surge in capital inflows. Those *policy options* are:

1. **Sterilisation:** Sterilisation is most commonly used as a first line of defence if there is no exchange rate target other than preventing excessive volatility. If there is excessive volatility and disruptions to the macroeconomic situation, central banks can intervene to prevent appreciation of local currency by buying foreign currency and supplying local currency in the market. However, this measure will have two consequences: First, as a result of sterilisation there will be an increase in foreign reserves. These reserves have to be invested properly as they are temporary and would be needed if foreign capital moves out of the economy. Most central banks invest reserves in safe and highly liquid assets, which do not pay high interest. Additionally, there is an opportunity cost of not using the reserves for productive investment. Second, as central banks buy foreign currency with local currency, money supply increases, which could lead to higher inflation. However, the government and central bank can work out a solution to prevent the rise in money supply. For example, the government can issue special bonds to soak up the excessive money supply that increased due to intervention in the foreign exchange market. However, sterilisation is not the perfect solution, as government bonds involve interest cost and is borne by the taxpayers. Furthermore, complete sterilisation is impossible due to practical difficulties. Thus, when using this measure, some amount of excess money supply is likely to remain in the financial system.
2. **Lower interest rates:** It is generally obvious that lower domestic interest rates will reduce interest rate differential leading to lower capital inflows. However, this option is not often available to central banks if they want to target very low inflation rate. This justifies having a moderate rate of inflation.
3. **Financial sector prudence:** This is an indirect measure to prevent asset bubbles in financial markets. It imposes restrictions on bank loans, asking banks to maintain higher provisions on loans to certain sectors like real estate or equity market to avoid bubbles in that asset class. This option is often favoured by those who argue against restrictions on capital flows. The Reserve Bank of India (RBI) was one of the first central banks to use this measure before the crisis. It increased provision on loans to real estate sector. When the crisis hit, banks had lesser exposure to real estate companies. Again, in the October 2009 monetary policy review, RBI increased provisions for loans to the commercial real estate sector. Recently, China, Hong Kong and Singapore have taken steps to curb the rise in the housing bubble. South Korea started an audit of lenders handling foreign-currency derivatives from 19 October, 2010 to curb volatility caused by capital inflows (Choong-Soo 2010). India is assessing its absorbing capacity of capital and thinks that it can absorb up to \$70 billion (Rangaranjan 2010). However, RBI is keeping a close eye on the capital flows. As a small and highly open economy, Taiwan now recognises that unfettered financial liberalisation and unbridled international capital flows can put financial stability at risk. On the other hand, Taiwan's Central Bank Act (Articles 19 to 31 and 33 to 35) are related to a variety of policy instruments like setting reserve requirements, managing foreign exchange, involvement in open market operations, etc. The main purpose of the Taiwanese Central Bank Act is to achieve financial and exchange rate stability, including targeted prudential regulations.
4. **Capital controls:** These are the measures that aim to control both foreign capital inflows and outflows. Capital controls also help governments raise revenues that can be earmarked to mitigate future crises or meet certain exigencies. Imposing capital controls is often a complex issue as some sector-specific restrictions have to be applied here like

loans to asset class, etc. In October 2009, Brazil imposed a 2% tax on foreign investments flowing into its equity and bond markets. A year later, Brazil raised financial operations tax, known as IFO entry tax on capital inflows into fixed-income financial instruments from 2% to 6% within a two week period to curb investment inflows. At the same time, the government also hiked the tax on margin deposits for derivatives market transactions from 0.38% to 6%. In addition to these measures, the central bank and Treasury make regular dollar purchases in the local currency market. Indonesia, South Korea and Thailand also introduced some form of measures to manage foreign capital inflows as they are also sensing the risk of instability owing to massive capital inflows. On June 16, 2010 Indonesia announced a series of measures to stabilise its financial markets, including abolishing the rule limiting banks' on-balance-sheet net open positions to a maximum of 20% of their capital, while maintaining overall net open positions at 20% of capital, widening the overnight inter-bank rate corridor and imposing a minimum one-month holding period for Bank Indonesia Certificates.

5. **Outright ban:** Policymakers can impose a ban on certain kinds of financial activity for a temporary period as deemed appropriate. For example, Taiwan imposed capital controls on November 09, 2010 through banning foreign funds from investing in time deposits in a move that appeared to be aimed at deterring bets on currency appreciation. This is because the Taiwanese Central Bank noticed that foreigners had parked about T\$500 billion (US\$15.5 billion) in Taiwan dollar accounts by October 2010 and it wants the money to be invested in stocks instead. Securities and Exchange board of India (SEBI) proposed banning of participatory notes (P-notes) issuances on October 16, 2007.
6. **Mandatory reserve requirement:** Investors may be asked to keep a certain part of the inflow amount with the central bank, government and/or regulator. Chile was one of the first emerging market economies which used this strategy. Chile's measures took the form of reserve requirements, a stamp tax on foreign credit and a minimum-stay requirement for foreign direct investment. Starting in June 1991, the Chilean government required a set portion of foreign capital inflows be put into a one-year, non-interest paying deposit with the central bank. In May 1992, the reserve requirement on external credits was raised to 30% from 20%. Later, the reserve requirements were extended to time deposits in foreign currency. In October, the central bank of Chile increased the period for which the deposit had to be maintained to one year regardless of the maturity of the loan. At the same time, the spread charged over LIBOR (London Interbank Offer Rate) in the option of paying the financial cost of the reserve requirement was raised from 2.5% to 4%. In the middle of 1995, there were further pressures towards currency appreciation. To stem it, in July 1995, the central bank extended the 30% reserve requirement to foreign financial investments, particularly on the purchases of Chilean stocks by foreigners through American Depository Receipts (ADRs) (which represent the acquisitions of shares of domestic companies by foreigners). Thus, by the second half of 1995, there was in place a 30% reserve requirement on almost all forms of foreign capital inflows (including external loans and bonds issued abroad, external credit lines used to finance trade operations, foreign-currency deposits and portfolio investment) with the exception of FDI, which was only subjected to a one-year stay requirement. On top of these, certain portfolio capital inflows such as bonds and ADRs are limited by their minimum-amount and risk-rating conditions. These instruments can only be issued if the raised amount is at least US\$25 million. Furthermore, the minimum acceptable long-term

debt risk classification demanded the issuers risk-rating of BBB or better for non-financial companies, and BBB+ or better for banking institutions. In the first half of 1998, the situation regarding capital flows changed. Accordingly, in June 1998, Chilean authorities reduced the reserve requirement for capital inflows from 30% to 10%.

7. **Tax on exit before desired period:** The duration of holding an asset could be defined when using foreign funds for purchasing such assets. An investor wishing to sell assets and/or withdraw money before the stipulated period must attract a tax. This will ensure that the foreign fund remains in the country for a reasonably longer period than otherwise expected. Thailand's cabinet in October 2010 agreed to impose a 15% withholding tax on capital gains and interest income from foreign investment in government debt in a bid to break the baht, which had climbed to its highest level since the 1997 Asian financial crisis. The announcement in Thailand came a week after Brazil doubled its tax on foreign portfolio inflows into bonds and some other financial instruments to 4% in its first round on 18 October 2010 to reduce upward pressure on its currency. Because, by October 2010, the Thai baht had gained the most among currencies in the region except Japan, increasing 10.5% compared to 10% gains for the Singapore dollar and Malaysian ringgit, 6% for the Philippine peso, 4% for the Taiwanese dollar, 2% for China's yuan and 0.4% gains of the South Korean won. Also, the inflows to the Thai stock market sent the index soaring by 30% to almost 1,000 points in four months.
8. **Restrictions on short-term asset purchase:** The restriction can be imposed on purchasing short maturity asset class like bonds, T-bills, derivatives, certificate of deposits CD, and alike by using foreign funds to make sure that the investment works for the country to help increase its absorbing capacity. Besides, short-selling in the securities market should be regulated or banned. Taiwan in 2009 banned foreigners from investing in its time deposits.
9. **Ceiling/capping on inflows:** This is a direct measure that restricts inflow to a certain amount. For example, India only allows foreign investment to a certain cumulative limit in both corporate and government bonds. until August 2010, the restriction for Foreign Institutional Investment (FII) in corporate bonds was \$15 billion and in government bonds was \$5 billion. On 23 September 2010, this limit was raised to \$20 billion for corporate bonds and \$10 billion for government bonds. The Indian government also imposes restrictions on external commercial borrowings, which are reviewed from time to time depending on the economic situation. These restrictions were applied a number of times during the periods of increase in External Commercial Borrowings (ECB) inflows. These restrictions were eased when capital flows dried up early in the current crisis. The restrictions helped mitigate the impact of the crisis and timely lifting of the restrictions helped some companies borrow from foreign sources. With the easing of the crisis, restrictions on ECBs were again imposed from January 1, 2010. On October 26, 2010, the Finance Minister of India indicated in a conference that he is not thinking of putting any cap on FIIs, as he knows that if India has \$45.5 billion inflow from FIIs it will act as insurance towards the nation's current account deficit. On June 13, 2010, South Korea unveiled measures including setting ceilings on the foreign exchange derivatives positions of domestic banks and foreign bank branches at 50% and 250% of their capital, respectively to mitigate the volatility of capital flows and exchange rates.

10. **Tobin tax:** As suggested by Nobel Laureate James Tobin, this is a tax on all cross border currency trade. The imposition of tax on financial transactions should prevent speculation in the international financial markets. The Brazilian and Taiwanese measures, as mentioned above, are some kind of Tobin tax. In 2004, India imposed a type of Tobin tax the securities transaction tax (STT) on its equity market transactions. There have been a lot of international discussions on implementation of Tobin tax. However, a universal consensus is still lacking. Those who oppose this type of measure think that free capital flows are beneficial for all nations. Besides, they argue that there is no international agency to collect these taxes; so imposition of such a tax would not be cost effective. Yet, the idea of the Tobin tax has been revisited in each financial crisis, including the current one. The discussion on Tobin tax this time was initiated by the former British Chancellor of the Exchequer Alistair Darling.

Conclusion

Based on individual circumstances, a nation can either consider one or a combination of policy measure(s) from the above noted pool of policy responses. There is no universally fit solution for tackling the problems arising from unanticipated foreign capital inflows; it varies from one country to another, depending on its stage of development, extent and nature of capital flows. This teaching note is designed as a teaching aid to illustrate this point.

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