

## Peter Pang: Managing capital flows – the search for a framework

Welcoming address by Mr Peter Pang, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Asian Development Bank Institute and Bank for International Settlements Joint Seminar for the book launch on “Managing Capital Flows: the Search for a Framework”, Hong Kong, 21 April 2011.

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Good morning, Ladies and Gentlemen.

1. Let me thank Mr Kawai for inviting me to this event. It’s my honour to welcome you to this joint seminar by the Asian Development Bank Institute (ADBI) and the Bank for International Settlements (BIS) to mark the launch of the new book, “*Managing Capital Flows: the Search for a Framework*”. This is a topical issue right at the centre of attention of policymakers in this region. And as the title suggests, it is also a subject that we are still in search for an answer.

2. There is an old Chinese proverb saying that “water can keep a boat afloat but it can also capsize the vessel”. This suitably characterises the nature of international capital flows – it brings both benefits and risks to the development process in Asia. Capital inflows have been playing a key role in the economic development of the region – funding investments and bringing along technology and skill transfers. These were conducive to the emergence of the “four Asian Tigers” in the 1980s, and the rapid modernisation process of China, India and other Asian economies. On the other hand, the pro-cyclicality and highly volatile nature of capital flows poses significant macroeconomic management challenges to policymakers. If not properly managed, the build-up of excesses amid strong capital inflows and the subsequent bursting of the bubbles could be detrimental to financial stability, wreaking havoc on economic growth.

3. Managing capital flows has been a dynamic learning process for policymakers in developing economies. Prior to the Asian financial crisis, Asian economies embraced capital flows with little wariness of the downside risks. The dominant flow pattern at that time was for Asian governments to invest their savings in high-grade government papers of the advanced economies. The funds were then recycled back to Asia in the form of highly volatile short-term capital flows. These resulted in serious imbalances in the balance of payments accounts, and mismatches in currency and maturity in the balance sheets of banks. The subsequent shifts in market sentiment and expectations led to abrupt reversals of capital flows out of Asia. Currency crashes amplified the adverse effects as capital fled the region in a drove. The Asian Miracle went bust. The capital flows that had once fertilised the impressive growth eventually caused a capsize when the Asian financial crisis hit us in 1997 – a lesson that we all still vividly remember.

4. The Asian financial crisis gave us a much-needed wakeup call at a dear price. Yet, looking back, the crisis also has its silver linings: the painful adjustments that followed prompted governments to strengthen economic fundamentals, enhance banking systems, deepen local bond markets, and build up foreign reserves to cope with potential external shocks. Because of these developments, the region has been able to emerge from the recent global financial crisis relatively unscathed and is now one of the key driving forces supporting the global economic recovery.

5. But we cannot afford to be complacent, as we are now confronted with a new round of challenges in uncharted waters. The unprecedented monetary easing in the advanced economies has led to global excess liquidity. And with the robust recovery of the emerging

markets, there are powerful push and pull factors driving investors to search for yields in developing economies including Asia. From Q3 2009 to Q4 2010, the net capital inflows to emerging Asia<sup>1</sup> amounted to US\$541 bn, the largest inflows in recent years.

6. The strong capital inflows and resultant abundant liquidity have led to exchange rate appreciation, fuelled credit growth and driven up asset prices in the region. With output gaps closing, inflationary pressures are accelerating in a number of Asian economies. Capital flows also complicate the macroeconomic policy responses. While exchange rate appreciation and monetary tightening could theoretically cool down the economy, in practice, they may attract even more speculative inflows to profit from interest rate arbitrage and currency appreciation.

7. So how should we cope with these challenges presented by the unprecedented scale of global excess liquidity? Given the global nature of fund flows and the increasing interconnectedness of the global financial system, it is obvious that national policies alone are insufficient to tackle the challenges. We need greater international and regional cooperation to manage risks posed by volatile capital flows to global financial stability. I believe there are three main areas for cooperation.

8. First is enhancing the resilience of the global and regional financial systems through financial regulatory reforms. A large amount of work in this area is under way at the G20, the Financial Stability Board (FSB) and various standard setting bodies – including but not limited to strengthening banks' capital and liquidity requirements, reducing moral hazard posed by systemically important financial institutions, and reforming the OTC derivatives markets. Recently, the FSB decided to set up regional consultative groups, including one for Asia, to bring together central banks, finance ministries and regulators in different regions. These groups are expected to serve as a platform for us to discuss and cooperate on issues of interest to regional financial stability, and to reflect the region's collective views to the FSB in the international standard setting process.

9. The second area is enhancing the global and regional financial safety nets. We welcome the recent significant augmentation of IMF's resources and lending facilities. These enhancements will allow the IMF to respond more effectively and speedily to member countries in need. Regionally, the establishment of the Chiang Mai Initiative Multilateralisation (CMIM) further enhances the regional capacity to cope with capital flows and safeguard financial stability of the region. The HKMA fully supports this important regional initiative, and indeed we have played an active role in its development and participated directly in the arrangement.

10. The third area is enhancing the capacity of regional capital markets to absorb capital inflows and channel them to productive uses. In this regard, the HKMA took the lead in developing the Asian Bond Funds (ABF) under the aegis of the Executives' Meeting of East Asia Pacific Central Banks (EMEAP). The ABF, as a pioneer product, aimed to provide a convenient low-cost local-currency instrument for investment, and at the same time help identify and remove the impediments to bond market development. In parallel, with the strong support from the ADB, ASEAN+3 members have undertaken a range of projects under the Asian Bond Markets Initiative to promote the development of the local currency bond markets. Notwithstanding these regional efforts, we still have a long way to go in developing a regional bond market that is broad and deep enough to channel the region's abundant savings to meet its huge investment needs. Continued national and regional efforts in this regard are much needed.

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<sup>1</sup> Emerging Asia includes China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.

11. At the domestic level, there has been growing recognition that there is no one-size-fits-all approach to capital flows management. While conventional macroeconomic policies are useful in containing overheating in the overall economy, their deployment is often constrained by their broad-brush nature and the concern about attracting even more speculative inflows. Therefore, many developing economies have also adopted other prudential and capital account measures to manage capital inflows and to contain the build-up of excesses in specific sectors of the economy and the banking system. For example, some regional economies have recently tightened the mortgage underwriting standards of their banks, and limited banks' foreign currency borrowing and derivatives positions.

12. To effectively manage capital flows, policymakers would need to improvise with the apparatuses in their policy toolkit and apply a policy mix tailored to their domestic circumstances. It is like the use of "Chinese herbal medicine" – we feel the pulse, carefully calibrate a combination of remedial herbs (i.e. policies), and follow through with continuous fine-tuning in the light of market reactions. The process is pragmatic and, to a large extent, interactive.

13. Given the need for customised solution at the national level, the sharing of experience is therefore very important. We welcome the timely publication of this book, which provides a good basis for studying the different approaches to managing capital inflows by different economies. Individual countries' experiences would, collectively, help shed light on the formulation of an effective policy framework.

14. Ladies and gentlemen, let me end my remarks by quoting a line from the book: "Risk of crisis as financial integration increases will never disappear, and countries must pursue protection from risks of volatility and sudden stops"<sup>2</sup>. We should always be vigilant, even in peace time. To Mr Kawai and other authors, congratulations yet again on the launch of this new and important book.

15. Thank you.

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<sup>2</sup> Chapter 4: "Managing large capital inflows: taking stock of international experiences" (by Susan Schadler).