Policy panel: Regional challenges ahead – dealing with capital flows, prolonged exchange rate intervention and their consequences in Asia and the Pacific

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Capital flows are an old and recurrent problem exacerbated by the global crisis.

- Inflows posed challenges to Asia during the run-up to the 1997 Asian crisis. For much of the last decade, in the middle of the Great Moderation – or the Great Bubble, depending on your point of view – inflows were also strong. And after the global financial crisis, extraordinarily accommodative monetary policy in advanced economies and strong fundamentals in Asia set the stage for inflows to return in force.
- Why do inflows pose a problem for Thailand, and for many emerging market economies? The primary reason is that for small open economies with developing capital markets, ***large sustained capital inflows can significantly affect domestic monetary and financial conditions***. Most directly, capital inflows can have outsized effects on the ***exchange rate***. Rapid currency appreciation threatens export competitiveness and overall growth. To the extent that capital inflows fuel a rise in asset prices and lower long-term interest rates, they can also exacerbate ***financial imbalances***. Large inflows also increase the ***risk of abrupt reversal*** and associated economic disruptions.
- Adjusting monetary policy in response to the impact of capital inflows is challenging. For example, ***reducing policy rates to offset rapid exchange rate appreciation could lead to higher domestic inflation, and may worsen growing financial imbalances***. On the other hand, raising interest rates to stem the impact of capital inflows on asset prices and domestic credit conditions ***may invite more inflows***. And a ***policy of benign neglect*** is unlikely to be practical, because exchange rate appreciation ***may reinforce market expectations of further appreciations, and attract more inflows***. An appreciation large enough to mitigate such dynamics could be too much for the private sector to bear in the short term.
- Indeed, it is worth noting that there are perceptions ***even in advanced economies*** with large capital markets that ***capital flows can compromise domestic monetary conditions***. A prime example of this is debates in the US about the 'yield conundrum' and 'global savings glut'.

Thailand's strategy for dealing with capital inflows

- Before I turn to the use of ***exchange rate intervention***, which is the focus of this session, I would like to stress that this ***is only one element of our overall approach to dealing with capital inflows***. Our integrated policy responses can be described as a combination of the following: (i) exchange rate adjustment as a first buffer; (ii) exchange rate intervention to deal with excessive movements; (iii) liberalisation of outward investments by residents to help balance out the inflows; (iv) the use of macroprudential tools to mitigate financial stability concerns; and (v) development of deeper capital markets to enhance absorptive capacity.

- Against this backdrop, let me turn to the issue of exchange rate intervention.
- ***In Thailand, our managed float system is based primarily on curbing undue volatility in the short run.*** Volatility management is designed to help cushion the private sector in the short run from potential under-/overshooting of the exchange rate in the context of incomplete hedging instruments. We do not have level targets and are fully committed to allowing the exchange rate to reflect economic fundamentals in the long run.
- Clearly, then, we do not aim to limit volatility over the long term. At the same time, very high frequency fluctuations in the exchange rate, daily or weekly, typically reflect a high degree of noise that is unlikely to materially hamper economic activity. ***We are more concerned about unwarranted volatility that may cause distortions to economic activity and/or about overly sensitive inflation developments.*** While it is clearly difficult to pin down exactly the frequency over which such risks are greatest, movements over months and quarters serve as a good starting point for making such assessments.

Intervention is a second-best solution in a second-best world, and is not without costs.

- The accumulation of reserves that results from intervention exposes central banks to the ***risk of significant losses***. Foreign reserves typically constitute by far the riskiest asset on central banks' books, given that the exchange rate risk cannot be hedged without undermining the original purpose of the intervention. If losses do occur, they can hurt the credibility of the central bank and expose it to considerable political pressure.
- A large war chest of reserves may ultimately backfire. Large reserves may constitute a temptation for ***government appropriation of reserves*** to set up a sovereign wealth fund or to fund other initiatives. The temptation is especially acute if fiscal room is dwindling. This is a real issue for emerging markets, as demonstrated by the recent experience in Argentina, and it is also a challenge that the Bank of Thailand is grappling with today. Our experience has been that ***it's exceeding difficult to counter popular belief that foreign reserves constitute unencumbered national wealth as opposed to what they really are – borrowed funds***.
- ***Sustained reserve accumulation and sterilisation can also become operationally complex*** as the amount of central bank debt rollover becomes large, potentially creating a 'gorilla' in the markets that may create distortions. For example, outstanding Bank of Thailand bonds issued to sterilise foreign currency purchases accounted for over a third of total outstanding bonds in Thailand at the end of 2010. To be frank**, *we do not fully comprehend the impact of such an abnormally large central bank balance sheet – particularly on the liability side – on market function and the banking sector***. This is an issue that our colleagues in the US, Japan, and UK are currently grappling with as well.

The problem of capital inflows is not new. In the aftermath of the global crisis, now is the time to rethink and to propose bold solutions to old problems.

- The rise of global banking has arguably reinforced the transmission of global liquidity conditions across borders, thus intensifying the trade-offs facing monetary policy from global liquidity.
- We have reached an undesirable equilibrium. The maintenance of ultra-loose monetary policy in advanced economies, combined with sustained intervention by emerging economies, is a bad equilibrium. Strong sustained inflows and a desire to avoid being ahead of the pack in terms of currency appreciation compel emerging markets to intervene. These interventions collectively reduce the effectiveness of the exchange rate channel in helping advanced economies to rebound, reinforcing the need for monetary authorities there to supplement exceptionally low interest rates with extensive quantitative easing.
- There are two ways to break the bad equilibrium
  - First, unilaterally. For example, emerging economies can cease intervention. Of course, this route would be more effective if large economies were to take action first. First movers would bear the cost of adjustment disproportionately, but in the long run all would gain if subsequent regional appreciation lessened the need for large-scale intervention, and allowed for a lower degree of monetary accommodation in advanced economies.
  - Second, multilaterally. The major economic blocs of the world, advanced and emerging, could form an international forum which would serve as a platform to internalise the externalities associated with monetary policy spillovers across currency areas. The G-20 Mutual Assessment Process (MAP) offers a good starting point, as it provides a representative forum designed precisely to improve the mutual compatibility of national policies, and could be further institutionalised. Likewise, the initiation of the IMF's reports on outward spillovers is a step in the right direction.
- To really make headway on the multilateral front, though, we need to revisit the conceptual underpinnings of how policy is conducted in the context of a highly interconnected global financial system. In such a world, purely country-centric approaches to understanding the workings of the economy and formulating policies are bound to be inadequate. A more globe-centric approach is called for. A more top-down approach in which the role of common factors and inter-linkages are emphasized will minimise the risk of actions that may appear reasonable from an individual country's perspective but result in undesirable outcomes (eg a fallacy of composition). This applies especially to considerations regarding cross-border financial flows, exchange rate policies, and financial stability.
- These issues have become more pressing in the current global context. A fundamental side-product of rapidly worsening fiscal problems in the advanced economies is that the universe of safe assets has shrunk significantly. As doubts emerge over previously perceived safe sovereign debt, investors have become more fickle in their portfolio allocations. The end result is more capital-flow volatility and more intense appreciation pressure on currencies that are still perceived as safe, notably the Japanese yen and Swiss franc. The fact that both countries have been pushed to intervene despite long-standing traditions of abstaining from such actions is a testament to the economic and political pressure that safe-haven flows can generate. Emerging markets as an asset class, while largely being innocent bystanders, have nonetheless felt the full force of these intense swings in global asset allocations. This constitutes additional examples of unsustainable forces at play in the global monetary system that need to be tackled at the global level.