Choongsoo Kim: Increasing volatility in global capital flows – central banks' policy response

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the 19th Central Banking Seminar, Bank of Korea, Seoul, 30 November 2011.

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Greetings

I bid a warm welcome to central bankers one and all participating in the Central Banking Seminar in 2011. I also would like to express my gratitude to Dr. Hyun Song Shin, Professor of Economics at Princeton University, who is so generously setting aside his precious time to favor us with a special lecture.

The Central Banking Seminar, which is being held for the 19th time this year, has contributed greatly as a forum for the sharing of wide-ranging experiences and know-how, and the building up of human networks linking the working-level staff of leading central banks. We look forward to a lively discussion on "Increasing Volatility in Global Capital Flows: Central Banks' Policy Responses" among the 22 experts from 19 countries gathered here for this seminar.

Concerning this topic, as you are well aware, every country is now striving to set up an effective framework of macro prudential policy and discussions are well under way on establishing the related global jurisdiction.

Since the Asian financial crisis did not spread to the core of the global financial system during the 1990s, the mooted establishment of a "New International Financial Architecture" did not bear fruit.[1] However, I believe that this global crisis will spur on a major advance for the global economy through the crafting of optimal policy options to tackle the challenge represented by financial crises.

I would like to take this opportunity to say a few words about the challenges the global economy is facing from the increasing volatility of capital flows among countries and what should be central banks' policy responses.

Challenges relating to capital flow volatility

Beset by the euro zone sovereign debt crisis and the aftershocks of the global financial crisis, the world economy is now shrouded in darkness as it traverses a long and deep trough. We have no means of seeing where it may come to an end nor yet of knowing what awaits us up ahead.

The fact that these adversities that go by the name of uncertainty are not being so easily countered tells us that the post-crisis world economy may have to attain a new economic paradigm rather than returning to the pre-crisis status quo.

Efforts to attain a new paradigm are being driven forward mainly by the governments and central banks of major countries by way of various frameworks for international cooperation such as the G20.

The first challenge ahead is from the imbalances in the real economy that we term "global imbalances". These are the outcome of the combination of macroeconomic policy failure in major advanced countries and the savings gluts of emerging market countries. Historically

[1] Robert Wade, "From Global Imbalances to Global Reorganisations", Cambridge Journal of Economics 2009, 33, 539–562

speaking, most financial crises have been largely attributable to similar imbalances in the real sector. To put it differently, we should be aware that in all financial crises, there are underlying real sector crises. Unless we understand this correctly, we may end up with unintended consequences of having killed the messenger as the first way to deal with the crisis. There is a broad consensus that, if these global imbalances persist for a long time, the situation will develop into a global crisis or at least provide fertile soil for it. Opinions, however, differ as to the train of causation.

On the one hand, long-lasting monetary policy accommodativeness and sustained exchange rate imbalances are cited as the root cause of the global imbalances. Others single out structural problems which will not be easily resolved any day soon, including the financial development gap between advanced countries and emerging market countries. Under the current international financial system, global imbalances are highly likely to persist[2] and, unless fresh and powerful proposal for their solution are soon put forward, the world economy may run the risk of lurching once again into a crisis of the global system. Therefore, it is very important to form a strong and sustainable adjustment mechanism to resolve these global imbalances.

The next challenge ahead is that, in the course of the transmission of the imbalances in the real economy to the financial sector, there is the growing likelihood of systemic risk being spread by a shock suffered by a single financial institution or market as financial interconnectedness is much greater than in the past. With the rapid deleveraging of financial institutions following the sub-prime crisis leading to fire sales of assets and the foreign exchange market turmoil, the US financial markets collapsed in a chain and innocent by-standers including Korea, despite their sound fundamentals, experienced severe hardships due to abrupt capital outflows. Consequently, an international consensus has been reached that policy responses in mitigation are needed, in the case of emerging market countries, whose capital flow volatility is greater than that of advanced countries.

For the advanced countries, net flow volatility is slight because capital outflows and inflows are mutually offsetting, despite the high volatility of certain types of capital flows. This is not the case for emerging countries for whom surges in capital flows are largely unidirectional with massive capital outflows taking place at the time of a crisis and capital inflows building up again after a crisis.[3]

Policy efforts to mitigate capital flow volatility are directed internationally toward expanding and tightening up global financial safety nets (GFSN) in forms such as currency swaps between central banks, expansion of the resources for financial support by international organizations, and the strengthening of regional financial cooperation. At an individual country level, they focus on strengthening policy responses to capital flows. A wide range of policy instruments are being tried out in many emerging market countries in the wake of the global financial crisis.

Measures in response and future tasks

As I pointed out earlier, due to the heightened volatility of emerging market country capital flows, their central banks are hard put to come up with appropriate policy responses. Since the overriding priority in policy responses should be placed upon ensuring domestic financial stability, it is absolutely vital to keep inflation expectations low and stable. To this end,

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2 Serven, Luis and Ha Nguyen (2010), "Global Imbalances before and after the Global Crisis", Policy Research Working Paper 5354, World Bank

3 IMF, World Economic Outlook CH4. (2011.4)

emerging market countries should implement sound macroeconomic policy as a matter of urgency.[4]

At the G20 Finance Ministers and Central Bank Governors' Meeting held in Paris in October, agreement was reached on coherent conclusions to guide the management of capital flows and on supporting the development and deepening of their bond markets to help emerging market countries cope effectively with capital flows.[5] Major points on which agreement has been reached include that while macro-prudential policy autonomy is widely recognized, capital controls[6] should be implemented only temporarily; that emerging market countries' capital flow management measures and key-currency countries' domestic policies (monetary policies) should be subject to the IMF's surveillance; and that it is important to call for emerging market countries to carry out gradual capital liberalization while recognizing the autonomy of their capital flow management measures.

Our historical experience tells us that there is no one-size-fits-all solution to problems associated with volatile capital flows. Country-specific circumstances and management capacities have to be taken into account to come up with a varied policy mix involving foreign exchange rate adjustment, market intervention, monetary and fiscal policies and capital flow controls.[7]

In the medium and long term, economies should consider following a three pronged approach consistent with individual local circumstances: firstly 1) capacity-building to cope with volatile capital flows, secondly 2) strengthening macro-prudential regulation, and thirdly 3) enhancing international financial cooperation.[8]

1) Individual countries' capacity building to cope with volatile capital flows

With growing economic integration, the effects of individual economies' conditions on other economies are growing, and the importance of each economy's stability has increased further as a result. With a view to stability, sound macro-economic policies are the first line of defense in reducing economies' vulnerability to external shocks. Events that might trigger a crisis should be forestalled preemptively by avoiding a build-up of short-term external debts and maintaining an appropriate level of foreign reserves. What is more, financial sector capacity building is important, by for example, expanding the basis for the foreign exchange market over the medium and long-term, so that surges in capital flows can be absorbed.

2) Strengthening macro-prudential regulation

Sharp surges in capital flows are analyzed as brining about the deepening of systemic risks in addition to the changes they cause in monetary policy transmission channels. To minimize their adverse side effects, it might be helpful to look into non-macroeconomic options for moderating capital flow volumes. The imposition of regulations by an individual economy, including a Tobin tax, needs to be undertaken with caution, as it can give rise to regulatory arbitrage and reduce international confidence. Properly-designed and well-implemented prudential policies may play an effective role in alleviating capital flow pro-cyclicality and minimizing the policy side effects.

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[4] Jaime Caruana, "Capital flows to the emerging market economies: a perspective on policy challenges", the 46th SEACEN Governors' Meeting ('11.2.24~25) Keynote Speech

[5] Press Release from Korea Ministry of Strategy and Finance, "G20 Finance Ministers' and Central Bank Governors' Meeting, October 2011, Paris"

[6] Although there is no clear definition of capital controls, the OECD's "Code of Liberalization of Capital Movements" uses discrimination between residents and non-residents in explaining capital controls.

[7] Jonathan D. Ostry et al, "Capital Inflows: The Role of Controls", 2010 IMF Staff Position Note 10/04

[8] The Bank of Korea, "Managing Capital Flows in the EMEAP Region" (2011.7)

Let me briefly introduce a new macro-prudential measure the Korean government introduced this August, a Macro-prudential Stability Levy. The main purpose of this measure is to control the high volatility in the capital market caused by increases in banks' non-core liabilities. Actually the idea of introducing such an instrument was originated by the seminar paper written by Professor Hyun Song Shin, who emphasized the importance of controlling the excessive volatility in the banking sector due to increases in non-core liabilities of the banking system. That was the way to deal with the pro-cyclical nature of the changes in the liquidity.

After Korea thought of the necessity of introducing such a macro-prudential measure the first thing we did was to send government and central bank officials to international organizations including the IMF and the OECD for consultation, to ensure that the measure is in line with global norms. Although it is still premature for us to assess its effectiveness, we believe it will contribute to stabilizing the capital market through reducing highly volatile and excessive capital movements. The levy is distinguished from the so-called capital control measures represented by the Tobin tax, in that it does not make any discrimination between residents and non-residents. The OECD has been analyzing the effects of this measure for the past several months, and I do hope they will come up with a conclusion to make it a globally accepted instrument.

3) Enhancing international financial cooperation

Given the current environment of financial globalization and strengthened financial interconnectedness, it is no longer possible for any individual country to achieve the expected policy effect on its own, and international financial cooperation is therefore indispensable. In light of international policy coordination, we need to bear in mind that, if an individual country pursues domestic economic policies without considering negative externalities, it is highly likely that the country will fall into a prisoner's dilemma trap and that the world economy will reach a sub-optimal multi-local equilibrium.

Concluding remarks

Historically, an economic crisis has generally led to a crisis in economics. Before the outbreak of the recent global financial crisis, neither economists nor economic agencies had a full understanding of housing market speculation and they were unable to arrive at a correct prediction of the outcomes resulting from banks' behavior and their competitive structure.

Although central banks are not free of such criticism, the greatest change since the recent crisis is that their role and position have been heightened as they have been actively involved as lenders of last resort in overcoming the crisis. On the other hand, however, the possibility has also increased that central banks will face a paradox of credibility due to the conflict between their policy goals of achieving both financial system stability and price stability. In this regard, central banks, as the guardians of the financial system, are called upon by society to undertake the task of analyzing and examining macro-prudential policies and regulations. In line with this trend, the Bank of Korea was given responsibility for financial stability under revised legislation this August, so that it is now better placed to exercise its financial stability function more actively.

Hopefully, this seminar will provide an opportunity for central banks from around the world in the light of their particular economic situation to come up with wide-ranging ideas on how to cope most effectively with capital flow volatility.