Prasarn Trairatvorakul: Living with capital flows – an emerging market perspective

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the School of International and Public Affairs, Columbia University and School of Management, Yale University, New Haven, USA, 13–14 April 2015.

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Ladies and gentlemen,

Being amongst and having the opportunity to interact with young scholars such as you is refreshing. These days I spend much of my time in meetings with senior policymakers discussing problems and challenges facing Thailand and the world economy. **Many of these challenges are structural, having been accumulated over a long time.** They are legacies of past steps and missteps of the generation before us.

So it is fitting to be able to speak to you today, as **some of you will certainly inherit and have to deal with problems that are being created now**, largely inadvertently. I am reminded here of a marketing line by the Swiss watchmaker, Patek Phillipe, which goes something like "You never really own a Patek Philippe. You merely look after it for the next generation."

Let me then take this opportunity on behalf of policymakers the world over to tell you that we mean well and sorry for any troubles that we may pass onto you. **The fact is that real-time policymaking is hard.** Apart from serious data limitations, the world keeps changing rapidly and our knowledge often does not keep up. Today I will talk about an area where these challenges apply forcefully. That is **the impact of financial integration and how to deal with cross-border capital flows.**

Over the past two decades, **the level of financial integration across countries has increased rapidly.** If we take the total stock of external assets and liabilities relative to world GDP as a gauge of financial integration, in 1980 this stood at around a quarter, roughly equal to the ratio of global trade to world output. By 2010, global finance was nine times global trade. For emerging and developing countries, gross international assets and liabilities have increased by more than fivefold in the past ten years alone. For advanced economies, the expansion has been even more rapid.

Accompanying the trend increase in financial integration has been **a large expansion in gross capital flows as well as an increase in the volatility of those flows.** Periods of **synchronized asset price volatility** across countries and regions have become more prevalent. There is increasing talk of a **global financial cycle** driven, in part, by US monetary policy. This has led to an active debate about the impact of financial integration on individual countries' ability to manage domestic financial conditions. Does increased financial integration limit the effectiveness of monetary control? How should countries respond to increased capital flows? Is there room for policy coordination?

Let me say at the outset that there are no clear cut solutions. There is a large academic literature that discusses the pros and cons of various instruments, such as capital controls and macroprudential measures. I will not discuss these at length. Rather, I will draw from our collective experience of dealing with capital flows and offer **some guiding principles from an emerging market point of view.**

Let's begin with a broad perspective of the impact of financial integration.

Some of you may have seen the film Red Cliff directed by John Woo based on a historical battle in China around the early third century. On one side was the northern warlord Cao Cao (โจโฉ) with numerically superior forces who commanded thousands of ships to attack the southern warlord Sun Quan. In what is known as the Battle of Red Cliffs, Cao Cao had

chained his battleships together to make them more stable and prevent his men from getting seasick. Observing this, Sun Quan's generals sent unmanned fire ships towards Cao Cao's fleet and set it ablaze. Unable to separate from each other, the flames quickly swept across the entire fleet and Cao Cao was defeated.

This story reflects well the **double-edged sword of financial integration.** On the one hand, **connectivity acts as a shock-absorber.** They help to distribute and diversify risk, raising economic efficiency and contributing to system stability. Cao Cao's men did not get seasick. But when a sufficiently large shock hits, **connectivity may instead act as a shock transmitter.** Risk-sharing becomes risk-amplifying. The system transforms into a network incendiary device. A globalized financial system has a split personality. It is at once calm and turbulent, stable yet unpredictable, robust yet fragile. **Lately, the "dark side" of financial integration has increasingly come into focus.**

The global financial crisis was a vivid demonstration of what happens when the system flips over from stable to instability. And the prescribed treatment has created increasingly serious side-effects ever since. With monetary policy in advanced economies having been kept at ultra loose levels for over 5 years and still further unconventional monetary stimulus being embarked upon in some cases, **the repercussions on the rest of the world are testing the limits of macroeconomic management,** especially for emerging market countries.

Large capital inflows have **lowered long-term yields and compressed risk spreads** across a wide range of asset classes, contributing to increased risk-taking. The **marked rise in the co-movement of asset prices across countries**, particularly in bond yields, is making it harder for policies to achieve desired financial conditions domestically. At the same time, **upward pressure on exchange rates** risks undermining export competitiveness, complicating the trade-offs between macroeconomic stabilization and financial stability. And should inflows reverse abruptly, the resulting asset price and exchange rate swings could induce broad contagion effects that prove disruptive to economic activity.

In all this, the underlying concern is that **integration has amplified the vulnerability of domestic financial conditions to external shocks, while limiting the effectiveness of the tools that policymakers have for addressing those shocks.** This is not solely an emerging market problem. Indeed, the degree of co-movement in bond yields appears to be even stronger for advanced economies. Nevertheless, there are important reasons why capital flow volatility and exchange rate fluctuations may **present more challenges for emerging market countries.**

For one, **less developed and relatively shallow financial markets** means that asset prices will move more in response to capital flow volatility. Secondly, **greater reliance on exports as an engine of growth** implies more susceptibility to currency movements. Thirdly, many emerging market countries have had a long history with fixed exchange rates, which translates both into **less familiarity with hedging instruments as well as greater political pressure** in the face of exchange rate fluctuations. Finally, **weaker governance and institutions** means that inflows may be more likely to cause imbalances during booms. These very same weaknesses also tend to make investors more fickle to exit when things turn sour.

Of course none of this is entirely new. Dealing with capital flow waves or "bonanzas" have been a perennial challenge for emerging market countries. It is old wine in a new bottle. What is new this time around is that **the degree of financial integration across countries is unprecedented, as is the global monetary policy context characterized by advanced economies simultaneously pushing the accelerator to the floor** and keeping it there. There are legitimate concerns whether the bottle will break this time around.

Which brings me to the question of **how to deal with these challenges.**

If you were an alien observing all this from Mars, it might seem obvious that there are important **coordination failures at the global level.** With each central bank focusing on their own domestic mandates, financial conditions collectively for the world as a whole can be suboptimal. **Global credit and monetary expansion seems to be precariously unanchored.** Given the complexity of cross border interactions, the expansion of central bank balance sheets the world over has implications for the system as a whole that are by no means clear. This is especially worrying given that **existing facilities for international liquidity support is inadequate** for absorbing a large international crisis should one occur.

In a highly integrated global economy, **the need for collective action is inescapable.** But progress in achieving this with respect to the international monetary and financial system so far is very limited. As with all common goods, achieving political will to further the collective interest is extremely difficult. Thus while we can hope for greater international coordination, we can certainly not plan on one. Instead, **countries are left to fend for themselves.** Here, the experience of Asia offers some guiding principles.

In many ways, **Asian countries have been pioneers in terms of policy responses to dealing with capital flows.** This often entailed going against prevailing wisdom and convention. In 1998, facing intense speculative flows from hedge funds, the Hong Kong Monetary Authority purchased stocks to counter the steep fall in equity prices. In the same year, Malaysia introduced capital controls amidst the Asian financial crisis to stem the decline of its currency. In both cases, there were harsh criticisms by the international community, which deemed the measures as undermining the benefits of free markets.

Fast forward to 2008, a generalized downward spiral in asset prices and abrupt market seizures were contained by extraordinary interventions of major central banks, particularly the Federal Reserve. The interventions were far reaching, ranging from loans to banks and non-banks to direct support of private securities, such as commercial paper and mortgage-backed securities. In effect, **central banks became market makers in some segments of the market.** These interventions were widely applauded.

What a difference a decade makes! In the wake of the global financial crisis, **an emerging consensus is that market interventions in certain circumstances are justified.** No more is this evident than with respect to the use of capital flow measures, or CFMs. It is now generally accepted that **CFMs targeted at tilting the composition of inflows away from debt, especially short-term ones, can be beneficial.** More generally, macroprudential measures have become an important part of policymakers toolkit, with increasing theoretical support for their use in a counter-cyclical manner.

A similar reassessment has occurred with respect to **foreign currency intervention**, which is increasingly being recognized as a useful and justifiable complementary tool. Also, the large **accumulation of foreign reserves** that was once criticized is now credited with helping to mitigate the impact of the global financial crisis on emerging market countries.

Thus much of what Asia was doing before on the fringe, so to speak, have now become mainstream. Beyond the starkly different receptions, however, all these interventions share a commonality: they were unconventional and innovative initiatives geared to the specific context at hand. **They highlight the virtues of being practical and pragmatic, of the willingness to question conventional wisdom, and of tailoring solutions to the local context.** Countries will do well in heeding these principles when dealing with the challenges arising from financial integration.

From a longer-term perspective, however, the focus needs to move beyond the judicious use of well-timed policy interventions. This requires a particular mindset.

When people think of the Netherlands, the image of windmills comes to mind. Apart from being picturesque, they are actually a reflection of the extraordinary way in which the Dutch people have adopted to their geography for over thousands of years. **Despite being a coastal nation, the Netherlands has created new land from the North Sea through the use of dykes and other ocean barriers.** Windmills have been pumping water out off reclaimed land since the fourteenth century. Today, nearly one-third of the Netherlands lies below sea level. "Floating homes" can now be found in Amsterdam and elsewhere. Some would be on dry land and float up when flooded; others are built over water but could cope with its changing levels.

The important lesson from the Dutch solution to floods is clear: live with the water, don't fight it. The need and benefits of living on reclaimed land have been accepted and the focus is on strengthening the infrastructure to sustain this. Similarly, financial integration is a choice. Countries decide to become financially integrated because the perceived benefits of doing so outweigh the costs. **Moving forward sustainably requires going beyond *coping* with capital flows to *living* with them.**

This involves developing and leveraging on **fundamental economic strengths to enhance countries' resilience to external shocks. A diversified export base** focused on high value-added products and services translates into higher margins and pricing power, and hence less sensitivity to swings in the exchange rate. At the same time, developing **a firm domestic consumer base** will solidify economies' internal strength and lessen the dependence on external demand.

Much can also be done on the financial side. **Deep and liquid markets** would help to absorb swings in capital flows without overly large price movements. The **availability and widespread usage of risk management instruments,** particularly foreign currency hedging, would mitigate the negative repercussions from asset price volatility. **Outward capital flows** by domestic investors can enhance stability as international asset holdings can provide an important buffer during periods of volatility. Last, but not least, **limiting leverage in the banking system** can go a long way in cushioning the economy from external shocks.

In most cases, **exchange rate flexibility will be an indispensible part of living with capital flows.** While there are certainly grounds for limiting exchange rate fluctuations to prevent temporary misalignments, targeting exchange rates is likely to be counterproductive in the long-run. Doing so requires policymakers to choose a level of the exchange rate to stabilize around. This can be very difficult to implement in practice, not least because the target would change over time as fundamentals evolve. Importantly, **there is little that monetary policy can do to influence real exchange rates in the long run.** Past attempts to give the exchange rate more weight in monetary policy decisions tended to generate more interest rate volatility, with little lasting effect on the real exchange rate.

Here, I should note that **emerging markets are generally better placed than in past cycles to withstand capital flow volatility.** Key areas where progress has been made include: more flexible exchange rates, clearer monetary policy frameworks, larger foreign reserve cushions, generally moderate external debt levels, improved fiscal discipline, and better capitalized banking systems, supported by stronger supervisory and regulatory frameworks. Moreover, the general shift away from debt-based finance towards equity and foreign direct investment, which together now account for two-thirds of emerging market financing, is significant from a stability perspective.

Nevertheless, I want to stress that **there is an enormous amount of heterogeneity among emerging market economies.** The underlying strengths and weaknesses in terms of institutions and economic capabilities of Thailand and Brazil, for example, are very different. **The destinies of emerging markets are not tightly bounded to each other like General Cao Cao's battleships.** The more the international investment community succeeds in differentiating each country's prospects, the better the outcome will be, both for investors' returns as well as the countries involved.

Ladies and gentlemen,

I have spent much of my remarks talking about the challenges of financial integration. It is important, however, not to lose sight of the bigger picture. **The benefits of being part of an open and integrated global economic and financial system are immense and should be embraced.** The question is not whether to be integrated, but how to best do it in a way that **avoids a drift towards financial protectionism.** Success on this front ensures that the legacy we leave for the generations behind us is one of opportunities rather than problems.

In choosing the appropriate strategies, a balance has to be struck between **boldness and humility.** We should be bold in our **willingness to question conventional wisdom** and try new initiatives. But in a constantly evolving global economy, we must remain humble about our understanding of how things work and be acutely aware of the **limits of our knowledge.** As Albert Einstein once said **"The difference between genius and stupidity is that genius has its limits."** At an institution for learning such as this, I think it is fitting to end with that quote.

Thank you for your attention.