Introduction

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In 1997–98, emerging Asian economies were subjected to a crisis, with Thailand, Republic of Korea (hereafter Korea), Indonesia, and Malaysia being the most affected economies. The crisis was preceded by surges in private capital inflows of a largely short-term nature, creating double mismatches of currencies and maturities, and inflating asset prices, followed by a sudden stop and massive reversals of capital flows. With central banks of crisis-affected countries not being able to hold the line, currencies depreciated sharply, exposing the weaknesses of the banking system.

Although the crisis devastated several emerging Asian economies, the recovery of crisis-hit countries proved to be remarkable, facilitated by comprehensive government reforms and a favorable external environment. Since the recovery from the Asian financial crisis, most emerging Asian economies have enjoyed current account surpluses, attracting more foreign capital, and accumulating international reserves that have reached new heights. Yet, these very same developments pose major policy challenges to policymakers in the region.

Massive capital inflows put pressure on the currency to appreciate; this has prompted monetary authorities in the region to intervene in the foreign exchange markets. However, the tendencies of emerging Asia's currencies to appreciate against the US dollar continue, threatening their competitiveness. Policymakers in the region are faced with questions on best policy responses and regional cooperation initiatives to utilize capital inflows while maintaining macroeconomic stability.

Against this background, the Asian Development Bank Institute (ADBI) organized a series of conferences to provide a forum for policymakers, academics, and private sector participants to identify, study, and debate issues on capital flows and alternative measures for managing such flows. As these papers have been largely prepared as a basis for policy dialogue among national and regional policymakers, we hope that they would help shape the development of a framework for managing capital flows in the region.

The sixteen chapters in this volume are the fruit of the collaborative efforts of the participants in this project. The chapters are grouped into three parts: (i) Managing Capital Flows in Emerging Asia and Review of the Literature (Chapters 1 and 2); (ii) Perspective Papers (Chapters 3 to 7); and (iii) Country Studies (Chapters 8 to16).

The first chapter, by Masahiro Kawai and Mario B. Lamberte, which partly draws from the analyses made by various chapters of this book, provides a comprehensive discussion of the experiences of Asia's emerging economies with surges in capital inflows and in managing such inflows. They argue that following the restoration of the US and European financial stability and the easing of the ongoing global credit crunch precipitated by the US subprime crisis, capital inflows to emerging Asian economies (EAEs) will likely resume in a big way and pose serious policy challenges to EAEs for macroeconomic management, exchange rate policy, and financial sector supervision. In the final section of the chapter, the authors suggest possible policy measures to manage capital flows that are consistent with macroeconomic and financial sector stability. They include, among others, improving prudential regulations, using capital controls at the time of inflow surges rather than as a permanent measure in a country where the regulatory authorities have the administrative capacity to enforce them, making the fiscal stance countercyclical to surges in capital inflows, rebalancing growth, and exploring regional collective action such as exchange rate coordination and strengthening of regional financial market surveillance and integration.

Chapter 2 by Masahiro Kawai and Shinji Takagi presents a succinct literature survey focusing on developing and emerging market economies. More specifically, they review empirical work on the benefits of free capital mobility and discuss the evolution of thinking on capital account liberalization, the use of capital controls as an instrument of managing capital inflows, and the effectiveness and limitations of conventional macroeconomic and structural instruments. The authors point out that the literature provides little practical guidance on capital account liberalization, except to advocate the need for pursuing sound macroeconomic policies and establishing an effective framework of prudential regulation. They stress the need for additional work to develop tools to identify and quantify the various risks of capital inflows.

Chapter 3 by Stephen Grenville discusses key operational questions confronting policymakers, particularly those directed to central bankers. Grenville addresses the question of why capital flows cause problems to economies, particularly emerging market economies, and discusses policy responses that might be grouped into two categories: those preventative measures put in place *before* the crisis, and those used to try to ameliorate the unfolding crisis. He suggests a practical research agenda that would encompass the design parameters of a managed float, reserve holdings, and intervention policies, including the possibility of using state-contingent assets and government foreign/domestic debt management, as well as conventional reserves.

Chapter 4 by Susan Schadler reviews episodes of large capital inflows of economies in several regions since the early 1990s and investigates the macroeconomic characteristics of successful episodes. Schadler finds that only a modest portion of the capital inflow episodes have ended in crisis, and overheating pressures have not in general been severe. While all regions experienced some crises, proportionately more emerging Asia episodes had hard landings. She points out that much attention has been given to the issue of whether sterilized intervention or capital controls are effective in managing capital flows, but insufficient attention has been accorded to fiscal policy which she argues is most likely to have a strong and constructive effect.

Chapter 5 by Robert N. McCauley surveys the nature of hot money inflows into Asia since the peak of the US dollar in the first quarter of 2002 and the policy responses to them. McCauley points out that the most important qualitative change since 2002 involved foreign bank flows, which have returned to net inflows after five years of pay-down after the 1997–98 financial crisis. Carry trades, although difficult to measure, appear to have become important. He observes that capital inflows have become more volatile in recent episodes and that the authorities in the region have adopted measures both to encourage outflows and to discourage inflows to deal with such volatility. McCauley concludes that progress in Asia toward fuller capital account convertibility has the character of two steps forward, one step back, rather than a monotonic process.

Chapter 6 by Eduardo Levy-Yeyati, Sergio L. Schmukler, and Neeltje van Horen analyzes the effects of capital controls and crises on the integration of emerging economies with the international financial system. The authors characterize the behavior of the cross-market premium around crises and changes in different types of capital controls by computing summary statistics and by using an event-study methodology. They find that controls on cross-country capital movement appear to work as intended and segment markets effectively. They also find that when crises erupt, the cross-market premium becomes volatile, reflecting the shocks that markets receive and the difficulties in performing instantaneous arbitrage. The authors conclude that cross-market premium could be used as a tool to measure capital market integration, particularly during periods of capital controls and crises.

Chapter 7 by Jürgen von Hagen and Iulia Siedschlag discusses the experience of Central and Eastern European countries which recently joined the European Union with capital account liberalization and discusses some lessons and implications for EAEs. The authors find that since 2000, the group of fast liberalizers has experienced larger net capital flows than the gradual liberalizers. They argue that fiscal policy is the more appropriate policy instrument for dealing with large capital inflows and add that more effective spending controls and improved budgeting procedures rather than higher taxes will best promote macroeconomic stability.

The next nine chapters detail the experiences of emerging Asian economies in managing capital flows. They analyze the types and magnitude of capital flows, their impacts on the domestic economy, and effectiveness of national authorities' responses, and discuss policy implications.

In Chapter 8, Yongding Yu provides a comprehensive account of the evolution of the People's Republic of China's (PRC) management of capital flows. The PRC's successful management has been crucial in achieving high growth rates and macroeconomic stability, and should be treated as part of a long-term economic reform and liberalization program, not merely a way to reduce the pressure on the Chinese yuan to appreciate. With the lowering of the interest rate in the US, Yu argues that the objective of tightening monetary conditions has become increasingly difficult to achieve. Thus, he recommends that the PRC maintain capital controls whenever possible so that the People's Bank of China can implement an independent monetary policy to sustain the economy's growth in the next decade.

In Chapter 9, Ajay Shah and Ila Patnaik point out that there is a substantial mismatch between the needs of India, a fast-growing and fast-globalizing trillion dollar economy, and the present policy framework of capital controls and monetary policy. The authors argue that at this point in India's progression towards integration into the world economy, the rapid dismantling of capital controls appears to be the best strategy. However, this opening up needs to be accompanied by a monetary policy reform, a shift towards greater exchange rate flexibility, and the creation of currency derivatives markets. They point out that the lack of defined goals of the central bank is the most important weakness of the Indian policy environment.

In Chapter 10, Ira S. Titiheruw and Raymond Atje examine capital flows in Indonesia's post-Asian financial crisis period and the country's economic performance. They observe that the government shifted its development financing away from reliance on foreign currency to local currency bonds, which have attracted foreign capital inflows. Foreign capital inflows have remained volatile, as was apparent during the mini crisis in 2005. Currently, the government and the monetary authority direct their attention towards achieving sounder economic fundamentals such as maintaining fiscal restraint and controlling inflation. The monetary authority has undertaken some measures to monitor capital flows in both directions which can help improve its capability to respond in a timely manner against any eventuality.

In Chapter 11, Soyoung Kim and Doo Yong Yang document the recent trend in capital inflows and asset prices in Korea, and review how a surge in capital inflows can increase asset prices. They find that capital inflows shocks increased the stock prices but not land prices. The effects of capital inflows on the nominal and real exchange rates are limited, and this is related to the accumulation of foreign exchange reserves. Aside from encouraging capital outflows and exploring the use of fiscal policy to counter the effects of massive capital inflows, the authors suggest that Korea expand its risk management policies on credit expansion into the equity and real estate market.

In Chapter 12, Kee Kuan Foong discusses issues pertaining to capital flows in Malaysia under two regimes: fixed exchange rate and managed float exchange rate. In recent years, massive net inflow of portfolio funds generated a rise in liquidity in the financial system. To overcome inflationary pressure and to stabilize interest rates, the monetary authority conducted sterilization operations combined with prudential lending procedures, which effectively lowered credit growth. The author also explores other policy measures to overcome the negative effects of capital flows. He points to fiscal policy which Malaysia is trying to use in conjunction with sterilization to handle surges in foreign capital.

In Chapter 13, Josef T. Yap examines the impacts of foreign currency inflows on the Philippines' domestic economy and evaluates policy responses of the country's monetary authority. He finds that capital inflows could lead to an increase in reserves, a real appreciation of the peso against the basket of major trading partners' currencies, domestic liquidity, and inflation; but they appear to have no significant impact on domestic interest rate, consumption, investment, and government expenditures. Results of his analysis lead him to conclude that the reserve accumulation and subsequent sterilization has not undermined the policy of inflation targeting. To revive domestic private investment, Yap recommends efficient utilization of overseas remittances, which are quite substantial in the Philippines.

In Chapter 14, Hwee Kwan Chow finds that Singapore's experience with capital flows after the Asian crisis appears to have been somewhat benign. She argues that it is the overall package of policies – including strong economic fundamentals and a robust financial system, prudent policy management on both the fiscal and monetary side, and credible exchange rate policy aligned with underlying fundamentals – and having the latitude to react promptly and on a sufficiently large scale to economic and financial developments that serve to increase Singapore's resilience towards disruptive swings in capital flows.

In Chapter 15, Kanit Sangsubhan points out that since the beginning of 2005, capital inflows in Thailand have increased substantially, leading to a gradual appreciation of the baht. It is estimated that a 12 per cent appreciation of the baht reduces the profits of the real sector by 6.4 per cent. Foreign exchange rate intervention made by the Bank of Thailand caused a build-up of foreign exchange reserves within a short time. In view of the negative impact of capital controls imposed on equity, bond, and currency transactions, Sangsubhan suggests that it is better to explore other strategies to reduce pressure on the baht, such as exploring several channels of capital outflows as tools for capital outflow management. He argues that monetary policy should be conducted to stabilize long-term inflation through intermediate instruments such as exchange rate.

In Chapter 16, Tri Thanh Vo and Chi Quang Pham note that the recent surges in capital inflows have led to a financial boom in Viet Nam with commensurate increase in risks, especially in the context of macroeconomic policy inconsistencies and weaknesses in financial sector supervision. In their assessment, they find that the macroeconomic policy responses so far (up to February 2008) seem to be less effective in stabilizing the economy and in reducing policy inconsistencies as well as financial risks. The authors recommend a broad reform package including tackling the bottlenecks in the economy (the weaknesses of economic institutions, infrastructure, and human resources), modernizing the State Bank of Vietnam, and strengthening risk management in the banking sector and financial supervision system. They argue for a firm commitment to combating high inflation and combining tight monetary policy with a more flexible exchange rate and tight fiscal policy.

Finally, we would like to take this opportunity to thank our paper writers, who painstakingly prepared the papers and ably addressed the reviewers' comments and suggestions, participants of the conferences for their insightful comments and guidance on the draft papers presented during the conferences, and all those who have been involved in preparing this book, particularly Elsbeth E. Gregorio for editorial assistance, Hiroyuki Kiyota and Elvira Kurmanalieva for research assistance, and Kayo Tsuchiya for administrative assistance.