Managing Capital Flows: Some Considerations Based on the Fund's Institutional View

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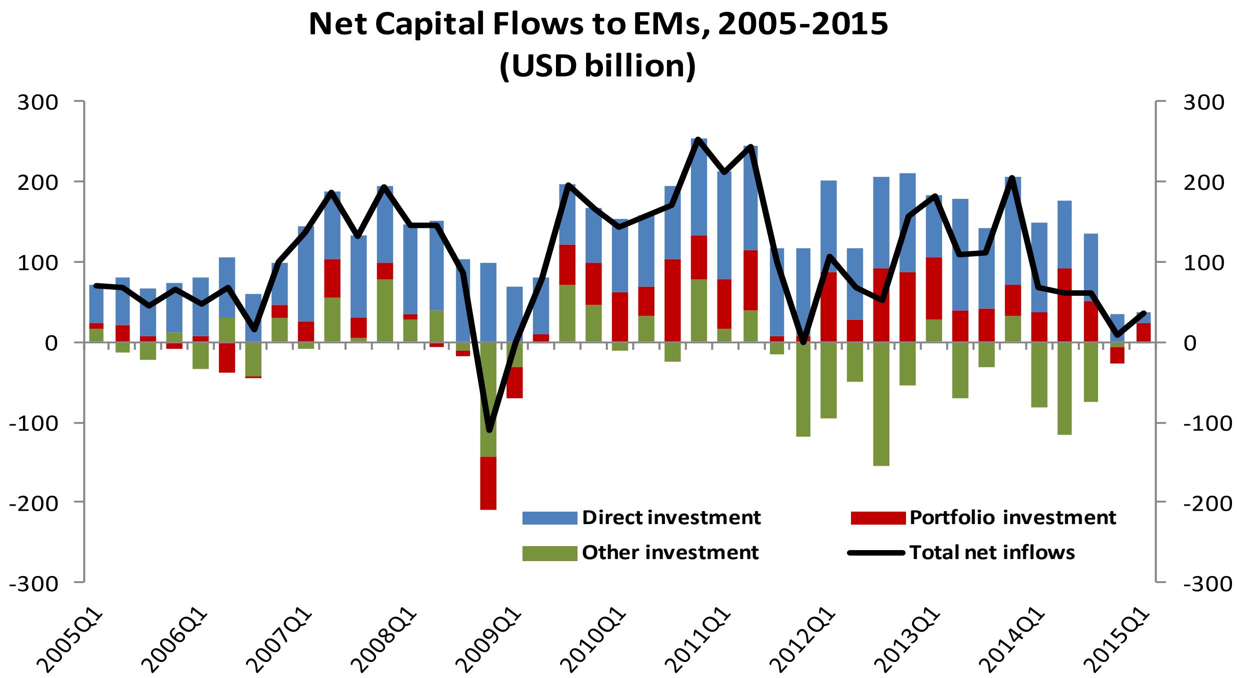
Overview

- Recent capital flow developments
- Recap of IMF's Institutional View
- Policy responses to capital flows
- Use of capital flow management measures (CFMs) and macroprudential measures (MPMs)
- Further considerations

Capital Flows: Recent Developments

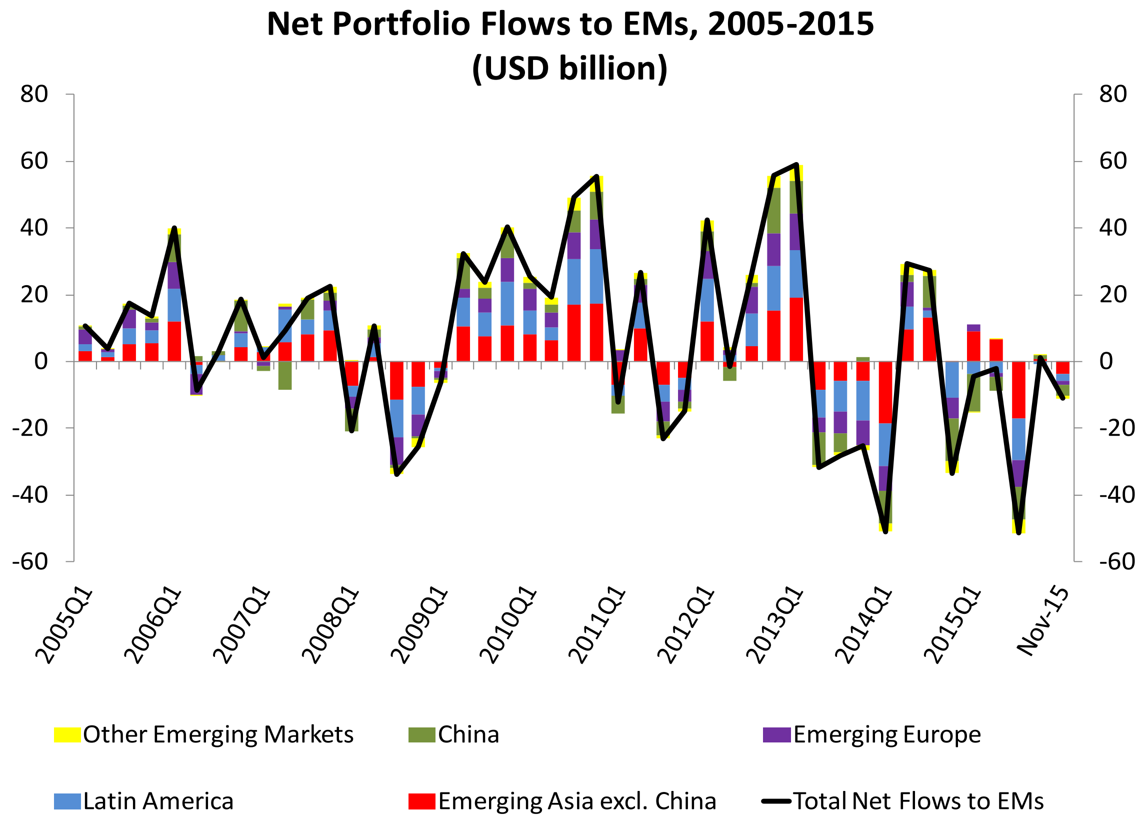
Capital flows to EMs have been volatile over the past decade, in particular portfolio and other (mainly bank-related) investment



Sources: IMF BOPS and Fund staff calculations.

Capital Flows: Recent Developments

Portfolio flows to EMs surged partly driven by loose AM monetary policy in response to the GFC, but have weakened across all regions in recent years

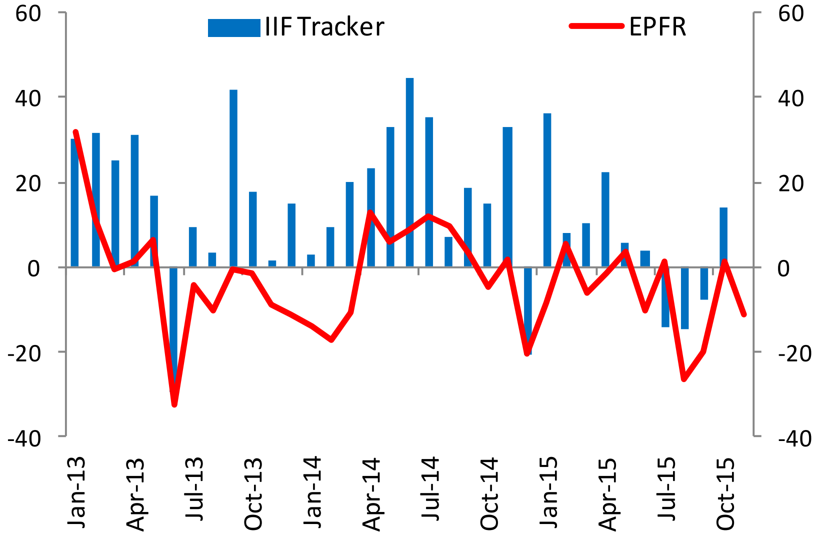


Source: EPFR.

Capital Flows: Recent Developments

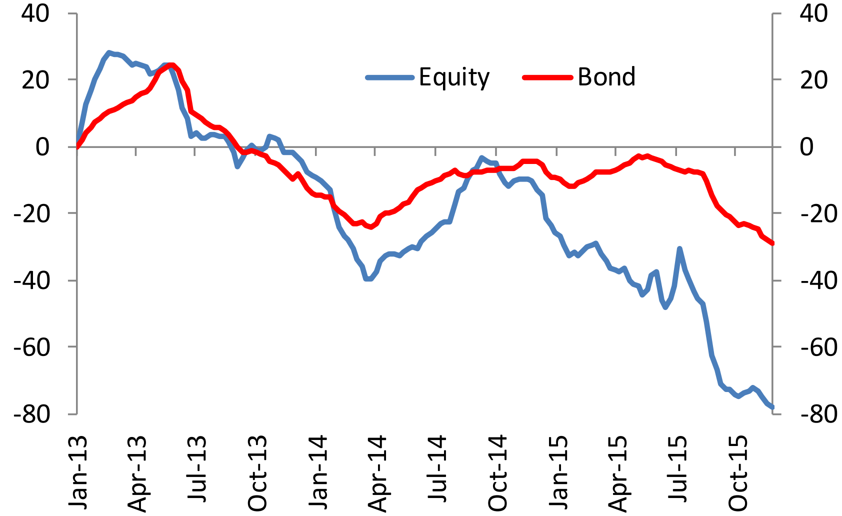
EMs faced sharp flow reversals during the Taper Tantrum and mid-2015, with risk of further weakening ahead of monetary tightening in some AMs

Net Portfolio Flows to EMs, 2013-2015 (USD billion)



Sources: IIF and EPFR.

Cumulative Flows to EMs, 2013-2015 (USD billion)



Source: EPFR.

Fund's Institutional View: Managing Capital Flows[1]

- Capital flows can have substantial **benefits**, but also carry **risks**
- Large and volatile capital flows can pose risks to macroeconomic and financial stability and create **policy challenges**
- These risks can be magnified by insufficient levels of **financial and institutional development**, and inadequate regulation
- **Macroeconomic policies** (monetary/fiscal/exchange rate) play a key role to address such risks, as well as sound **financial supervision and regulation** and strong **institutions**
- In certain circumstances, **capital flow management measures** (CFMs) can be useful to support, but not substitute for, warranted macroeconomic adjustment
- Appropriate policy responses involve **both recipient and source countries**

1/ IMF (2012, 2013a).

Fund's Institutional View: Managing Capital Flows[1]

CFMs can have a role in supporting macro policy adjustment and safeguarding financial system stability in **certain circumstances**:

- When the room for adjusting macro policies is limited
- When the needed policy steps require time, or when policy adjustments require time to take effect
- When an inflow surge raises risks of financial system instability
- When there is heightened uncertainty about the underlying economic stance due to the surge

…with a need to evaluate on an ongoing basis the **economic usefulness** of maintaining CFMs over longer term for managing systemic financial risks against their **costs**

1/ IMF (2012, 2013a).

Capital Inflows: Policy Responses[1]

Monetary/fiscal	• Lower interest rates in absence of overheating, or tighten fiscal policy
Exchange rate	• Allow currency to strengthen if it is not overvalued • Intervene to accumulate reserves if reserves are not more than adequate
CFMs	• CFMs can be used in certain circumstances

1/ IMF (2012, 2013a).

Policy Responses During 2009-10 Inflow Surge[1]

Monetary/fiscal	• Some lowered interest rates, while others tightened amid inflation pressures fueled by credit growth and asset prices • Limited fiscal response in most countries
Exchange rate	• Currencies allowed to appreciate in most cases • Extent of intervention varied across countries
CFMs	• CFMs generally accompanied some degree of macro adjustment

1/ Based on a review of policy responses in selected EMs (IMF, 2011) and IMF country staff reports.

Capital Outflows: Policy Responses[1]

Monetary/fiscal	• Adjust stance as necessary based on macro conditions, policy space/credibility, and nature of shocks
Exchange rate	• Allow exchange rate to be a shock absorber • Intervene to counter disorderly market conditions, provided reserves are adequate
CFMs	• Relax existing inflow CFMs may be useful in some circumstances • Use outflow CFMs only in crisis or near crisis

1/ IMF (2012, 2013a).

Policy Responses During GFC and Taper Tantrum (TT)[1]

Monetary/fiscal	• Countercyclical monetary and fiscal policies (GFC) • Monetary policy response more differentiated (TT) • Unchanged fiscal policy (TT)
Exchange rate	• Exchange rate used as a shock absorber • Intervention part of policy response (wider and larger during GFC than TT), using reserve buffers
CFMs	• Inflow CFMs eased or rolled back in a few cases • Outflow CFMs used only in crisis-type situations

1/ Based on a review of policy responses in selected EMs (IMF, 2014) and IMF country staff reports.

Policy Responses in 2015[1]

Monetary/fiscal	• Monetary and fiscal policies have generally eased • Some hiked rates to combat inflation pressures • Policy space now more limited
Exchange rate	• Exchange rate used as a shock absorber • Relatively limited intervention • Vulnerabilities from higher corporate leverage and FX exposures
CFMs	• Outflow CFMs used mainly in crisis or near crisis situations

1/ Based on a review of policy responses in selected EMs.

CFMs and Macroprudential Measures (MPMs)[1]

IMF's **definition** of CFMs and MPMs:

- CFMs are designed to limit capital flows
- MPMs are designed to limit systemic financial risks, including risks associated with capital flows

Measures that are **both CFMs and MPMs**:

- To the extent that capital flows are the source of systemic financial sector risks, tools used to address those risks can be seen as both CFMs and MPMs
- For this type of measures the IMF's frameworks for capital flow management (IV) and macroprudential policies overlap and are consistent, based on a set of common principles

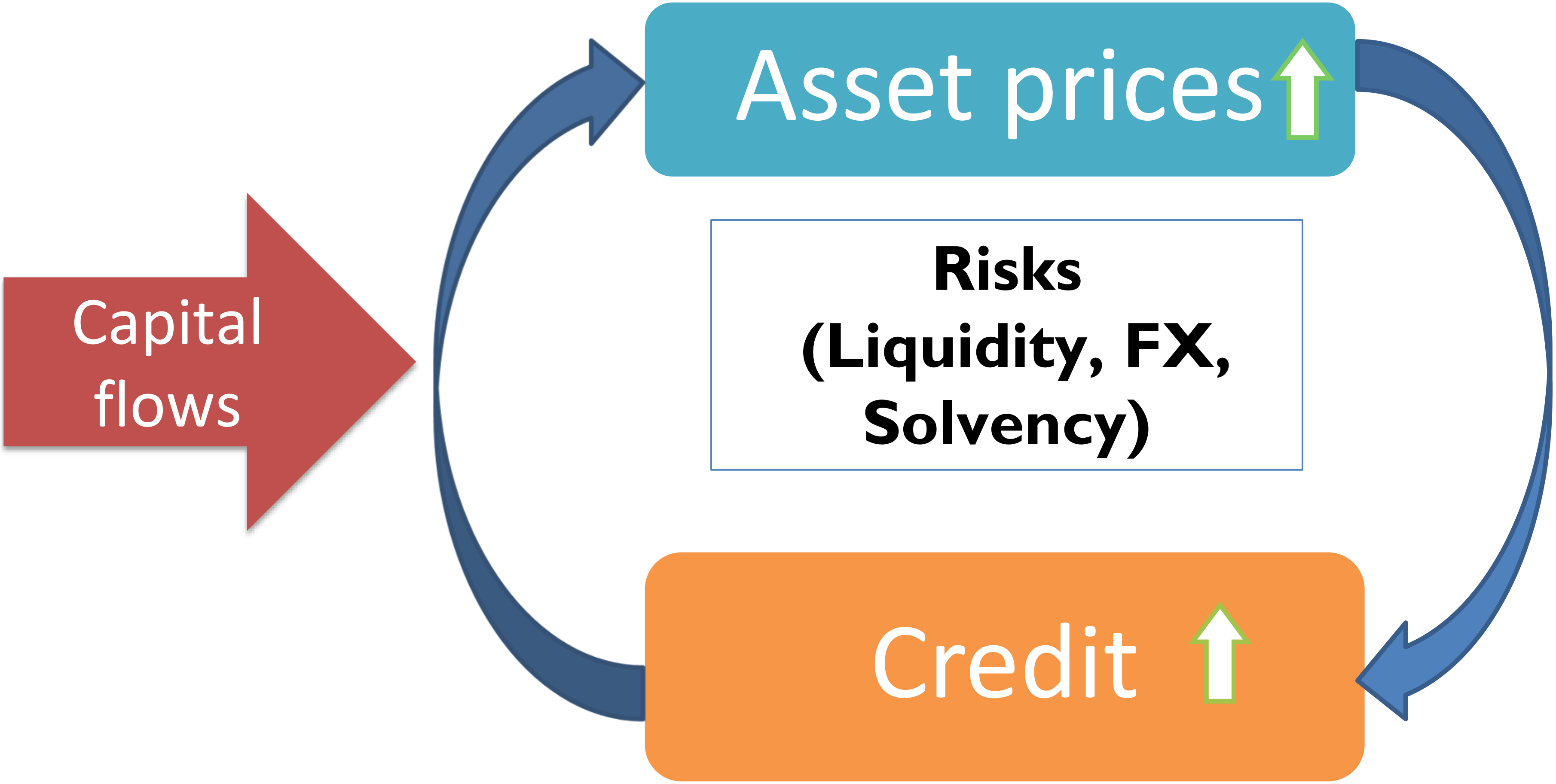
1/ IMF (2012, 2013b).

Inflow CFMs: Some Recent Examples[1]

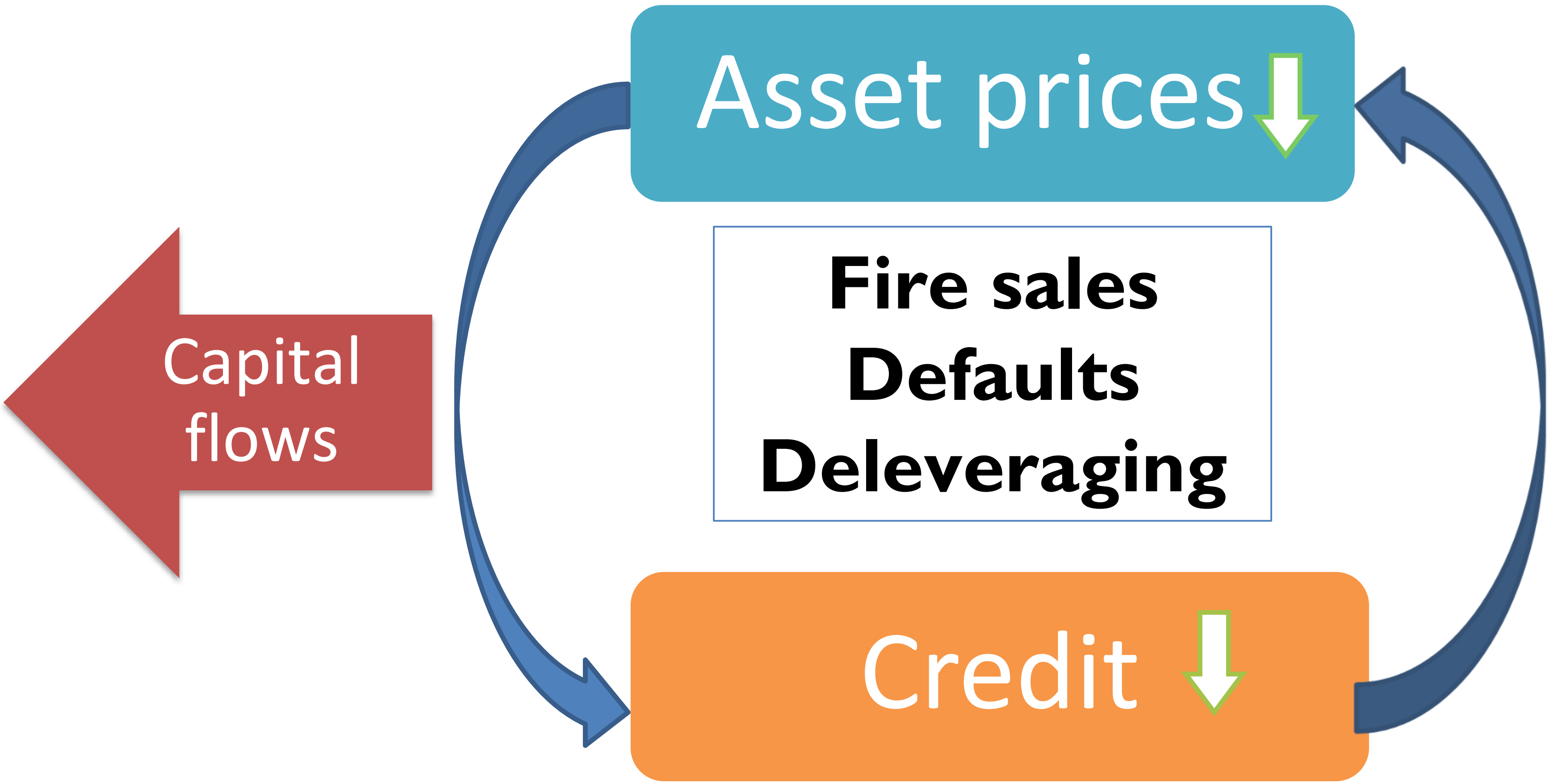
Limit / Holding period	• Limit on banks' short-term external borrowing • Minimum holding period on central bank bonds
Tax	• Tax on portfolio inflows or derivative transactions • Withholding tax on gains from public bonds • Fee on purchases of central bank paper
Reserve requirement (RR)	• RR on deposits or loans in foreign currency • RR on long-term credit lines • RR on purchases of central bank paper

1/ IMF (2012, 2013a). Some of these CFMs could also be MPMs depending on their design and purpose.

Capital Inflows and Systemic Risk: Channels



Capital Outflows and Systemic Risk: Channels



CFM/MPMs: Purpose[1]

- Limiting **capital flows** and containing **systemic risk**
- Different **types of measures** to address systemic risk:
  - Contain systemic liquidity risks associated with banks' reliance on **short-term external funding** and indirectly dampen excessive credit growth funded by capital inflows (e.g., by increasing cost of bank funding)
  - Mitigate systemic liquidity risks related to **currency and maturity mismatches** on banks' balance sheets driven by capital inflows (e.g., by increasing cost of FX forward transactions)
  - Limit build-up of systemic risks stemming from capital flows to overheating domestic **property market** (e.g., by increasing cost of property purchases)

1/ IMF (2015).

CFM/MPMs: Some Illustrative Examples[1]

Limit	• Limit on banks' short-term external liabilities • Limit on banks' FX derivative positions
Tax	• Additional stamp duty on property purchases • Levy on banks' non-deposit FX liabilities
Reserve requirement (RR)	• RR on banks' external obligations • RR on banks' FX derivative transactions

1/ IMF (2015).

Further Considerations

- Coping with **lower capital inflows** or **flow reversals**
- **Stock-taking** of recent country experiences with capital flow policies in the context of Fund's Institutional View
- **Appropriate use** of CFM/MPMs
  - Objective and design of measure
  - Also depends on country-specific circumstances, including context in which measure is implemented
- **Effectiveness** of CFM/MPMs
  - Difficult to assess as they are usually part of a larger set of measures and broader macro policy response
  - Also depends on country-specific factors (such as policy frameworks and institutional settings)

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