Session 1 Discussion

Evidence on Capital Flows and Exchange Rates

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Inseok Shin

Member of Monetary Policy Board

Bank of Korea

□ Background

◆ **Mundell's monetary trilemma/impossible trinity:**

– Policy trade-offs among monetary autonomy, exchange rate stability, and free capital mobility

◆ **Traditional prescription:**

– Should pursue free capital mobility while preserving monetary autonomy. Hence, should accept free floating of exchange rate, sacrificing exchange rate stability.

□ Background

◆ Two questions on the prescription

(1) The transition problem

During the transition state when an EM country is in the process of financial opening, flexibility of exchange rate may not be sufficient for maintaining monetary autonomy and/or, more importantly, financial stability of the country.

Is there a 'crisis-proof' transition path?

⇒ Agenda of MIAO's paper

☐ Background

(2) The global financial Cycle problem

If the global financial cycle exists, even with a free floating regime, a small open economy may not be able to keep monetary autonomy/financial stability.

The challenge of a small economy may be the dilemma between financial opening and monetary autonomy instead of the trilemma.

How sensitive capital flows to small open economies are to global factors; is the problem really the dilemma rather than the trilemma?

⇒ Agenda of Goldberg and Krogstrup's paper

□ Miao's prescription for a safe transition

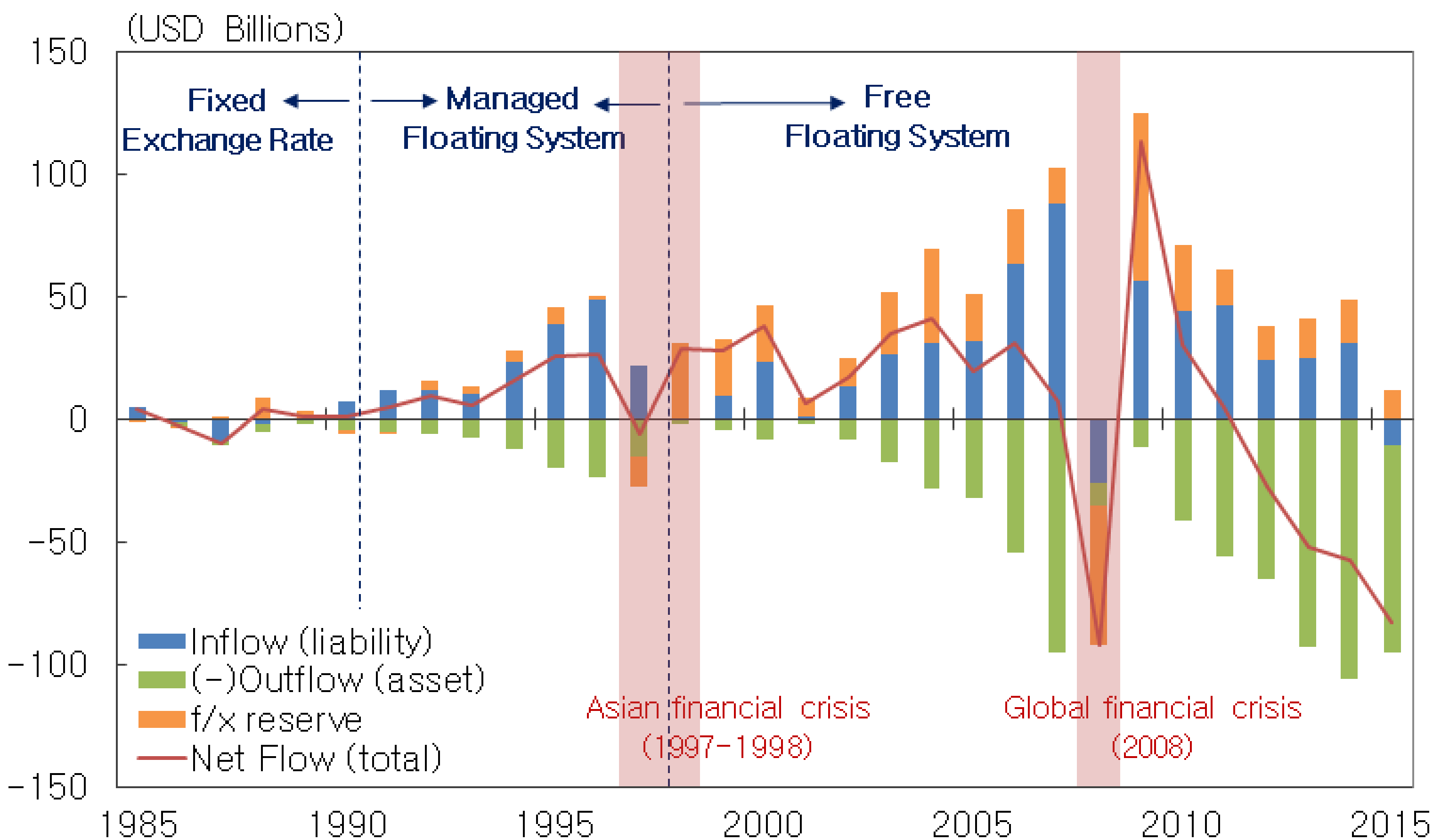
- **Other policy tools are necessary to preserve financial stability in addition to enhancing exchange rate flexibility.**

  – Avoid excessive f/x debt and currency mismatch

  – Build a large war chest of f/x reserve

☐ Korea's experience

Exchange rate regimes and capital flow



Source: The Bank of Korea

□ Korea's experience

- Observations

- It was foreign creditor's "run" on Korean banks' short-term f/x debt that triggered the crisis of 1997. Currency and maturity mismatch mattered, as Miao argues.

- Given the turmoil of 2008, it remains an open question if sizable f/x reserve guarantees financial stability.

- Is Miao's list complete? He could include discussions on …

- Regional policy cooperation
  In the aftermath of the Asian crisis, ASEAN+3 agreed on the two regional initiatives (the Chiang Mai initiative and the ABMI) to address the "double mismatch" problem

- Capital flow management

Goldberg and Krogstrup

They propose

- **a new measure of capital flow pressure:**

  a modified exchange market pressure (EMP) index
  a la Girton and Roper (1977), …

- **a new measure of sensitivity of capital flow to the global risk:**

  correlation coefficient between the modified EMP index and the VIX

☐ Do we need new measures of capital flow pressure?

◆ Why not just use private inflow as in e.g. Rey(2015)?

Correlation of Private Capital Inflow to Korea with the VIX

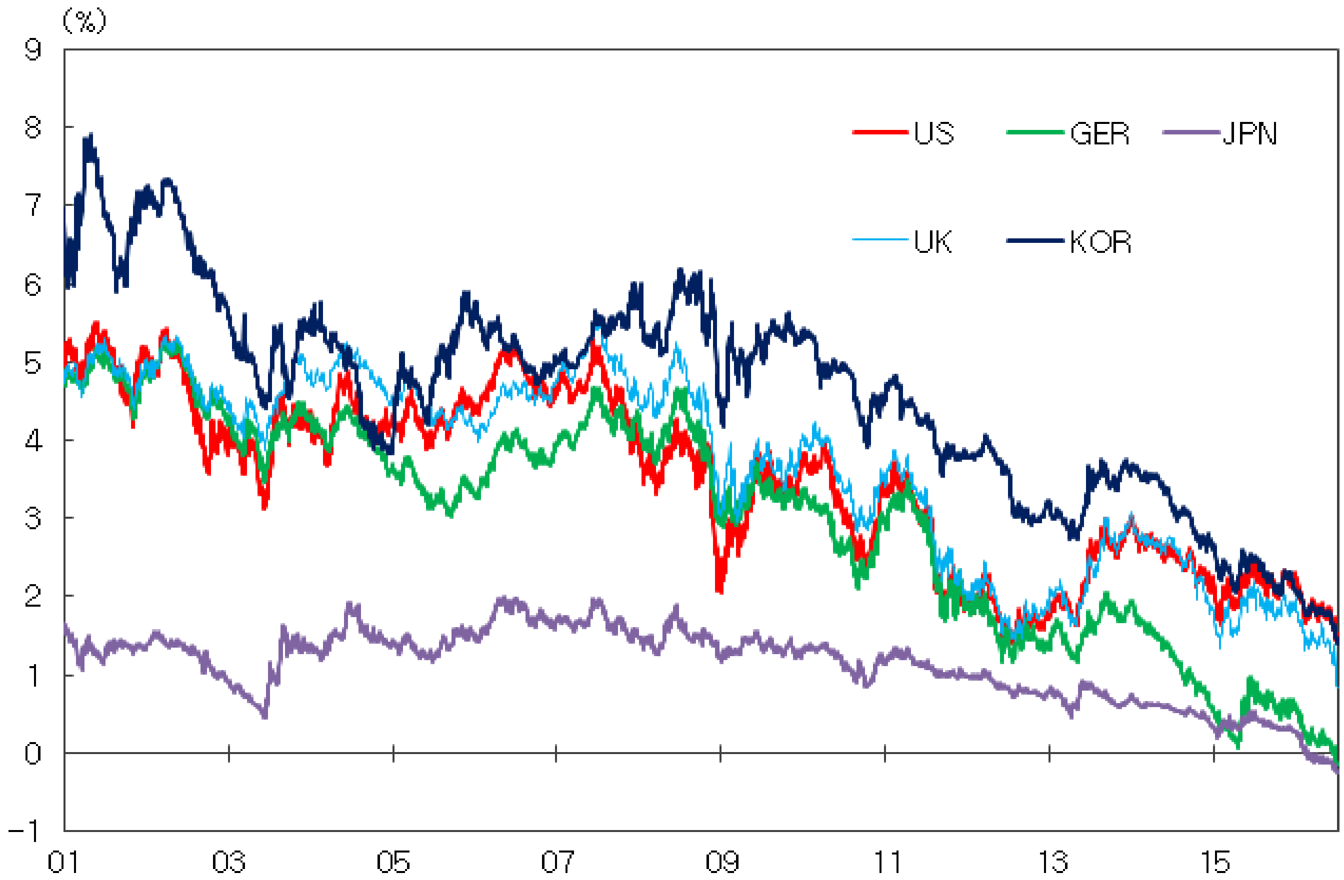
Period	FDI	Equity	Debt	Credit
2000~2015	-0.1	-0.1	-0.2	-0.5
2009~2015	0.0	0.0	0.3	-0.1

◆ Two possibilities

– The global risk factors matter only during extreme-volatility periods.

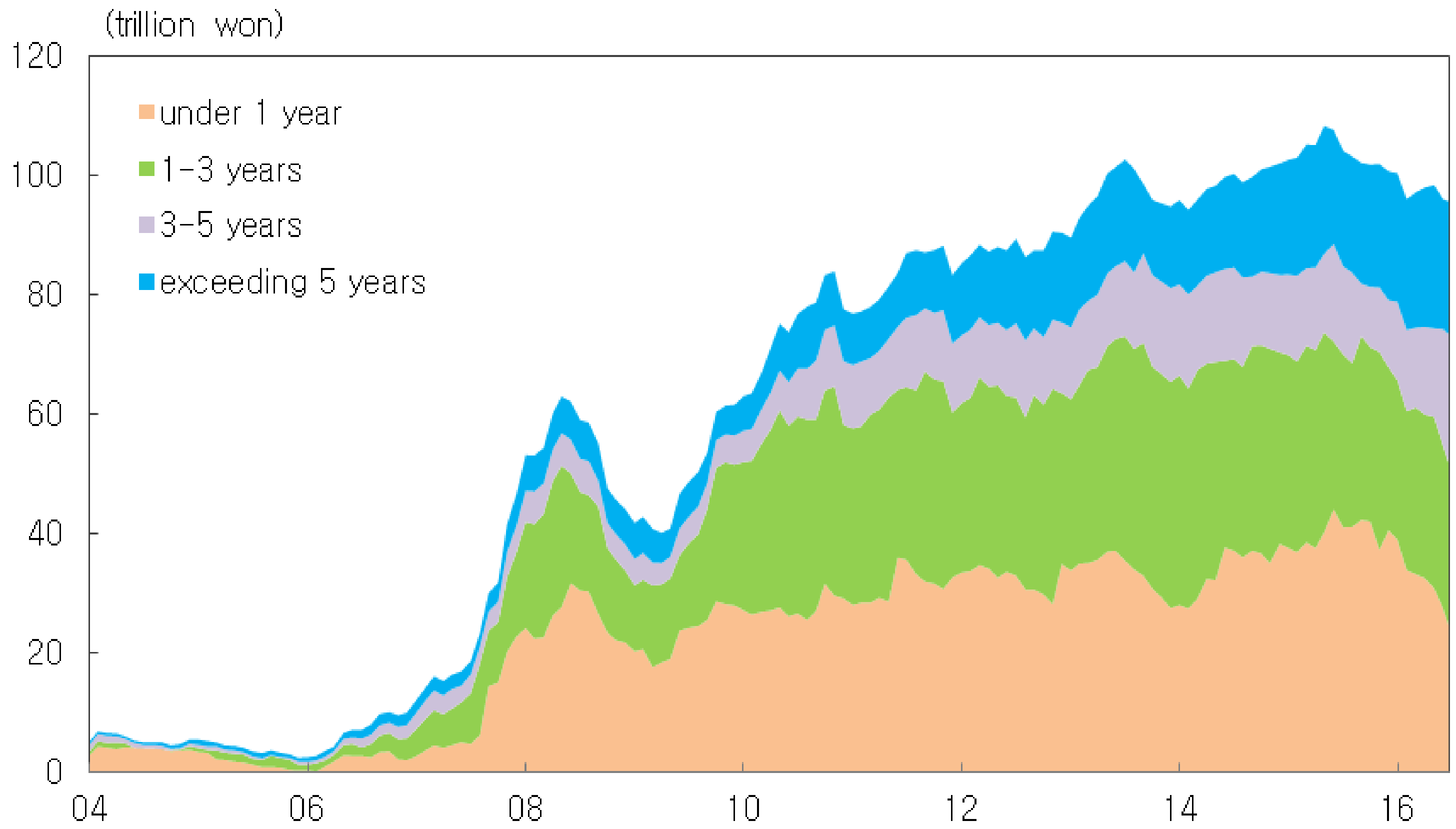
– Capital flow is not a good measure of the external flow shock.

10-year Government Bond Yield



Source: Bloomberg

Foreign holdings of Korean Bonds



Source: Yonhap Infomax

□ To wrap up,

- **Agree with Miao**

More than exchange rate flexibility is needed to preserve financial stability while pursuing financial openness.

Would like to know if the list is complete

- **Agree with Goldberg and Krogstrup**

More measures of capital flow pressure or capital flow shocks are necessary.

Would like to know more about the performance of their measures