How to Deal with Capital Flow Volatility

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After the global financial crisis, many emerging market countries, including Thailand, have experienced surges in capital inflows. Prominent drivers include robust domestic economic growth, a search for yields amidst the global low interest rates environment, and a shrinking universe of safe assets arising from the chronic fiscal problems in the euro area.

However, capital flows can be fickle. Sustained inflows could rapidly turn into substantial outflows as investor sentiment shifts. For example, the rapidly worsening European debt crisis has recently triggered financial market jitters and heightened capital flow volatility. It also caused foreign investors to pull out of emerging countries' assets over the past few months. As a result, fears of macroeconomic and financial instability or even the risk of sudden stop have been heightened.

In the face of such risks, policymakers may respond through a number of options. First, exchange rate flexibility constitutes the primary buffer to cushion the effects of capital flow volatility. In the case that the resulting movements in exchange rates are deemed excessive and unjustified by fundamentals, foreign exchange rate intervention can be undertaken.

Moreover, to mitigate systemic risks in both the banking system and the real economy, macro-prudential policies can be usefully employed. These include limits on banks' open FX positions and higher reserve requirements. For example, in 2010-2011, Korea reduced ceilings on banks' FX derivative positions as a proportion of their capital to limit banks' external debt positions.

At the same time, it is important to press ahead with reforms that deepen local capital markets and enhance absorptive capacity. Deeper and more liquid markets help to increase resilience to higher capital flow volatility and large shocks. Liberalization of outward investments by residents also helps to the extent that it promotes more balanced capital inflows and alleviates upward pressure on the exchange rate.

Finally, if need be, capital control measures may be considered. In doing so, thorough consideration must be given to the potential distortions that may arise.

Capital controls work by affecting cross-border movements of capital. This can be in terms of reducing the volume of capital inflows and/or outflows, or changing the composition of capital inflows. In doing so, they create room for other policy instruments, such as interest rates, to address domestic concerns.

Capital controls can be divided into two broad categories, namely administrative or direct controls and market-based or indirect controls. Administrative controls typically aim to affect the volume of capital flows mainly through outright prohibitions and/or explicit quantitative limits. On the other hand, market-based controls affect the cost of specific cross-border capital transactions. Examples include explicit taxation and unremunerated reserve requirement (URR).

On the whole, capital controls may be useful for macroeconomic and financial stability in the short run, especially to curb excessive exchange rate and capital flow volatility and to limit the buildup of financial imbalances. But they inevitably generate large costs by discouraging good capital flows, reducing foreign investors' confidence and high monitoring and management costs. As such, it is imperative to carefully study the pros and cons of each measure before deciding whether to adopt them or not.

The views expressed are the author's own.

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