

International Capital Flows and Domestic Financial Conditions

BOT-IMF Conference

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Introduction

- Long-term trend: financial globalisation
- But global cycle in international capital flows
- External influences on domestic financial conditions
- Domestic and international policy challenges

Outline

- Review international capital flow patterns for Emerging Asia
- Analyse interconnections between capital flows and domestic financial conditions
- Examine optimal design of macro-financial policy framework
- Conclusions

IFI

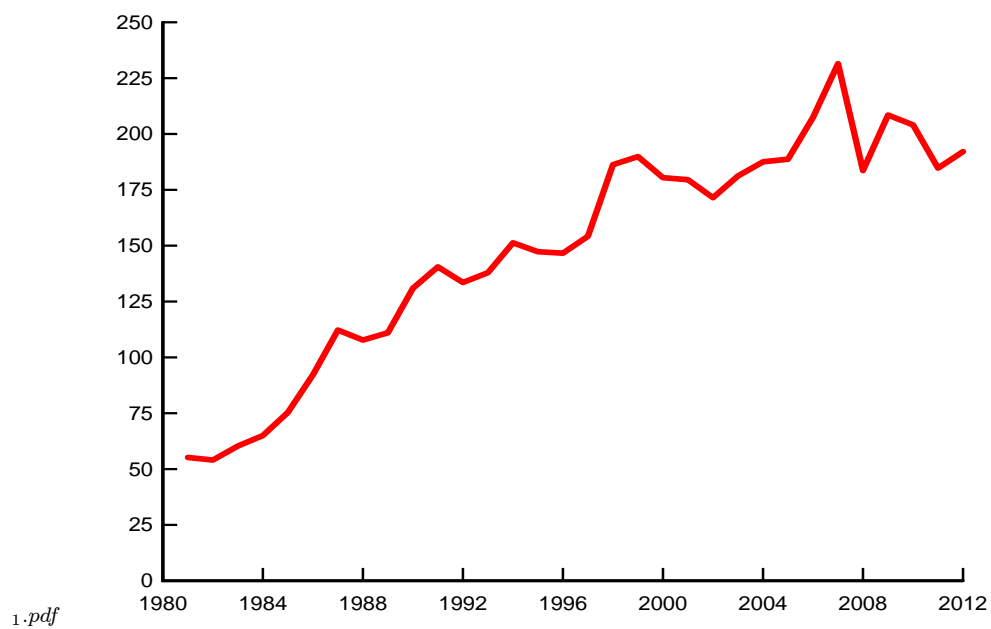


Figure 1: Emerging Asia: International Financial Integration Ratio, 1981-2012. Note: IFI ratio is sum of foreign assets and foreign liabilities divided by GDP. Source: Based on update of Lane and Milesi-Ferretti (2007).

KFLOWS

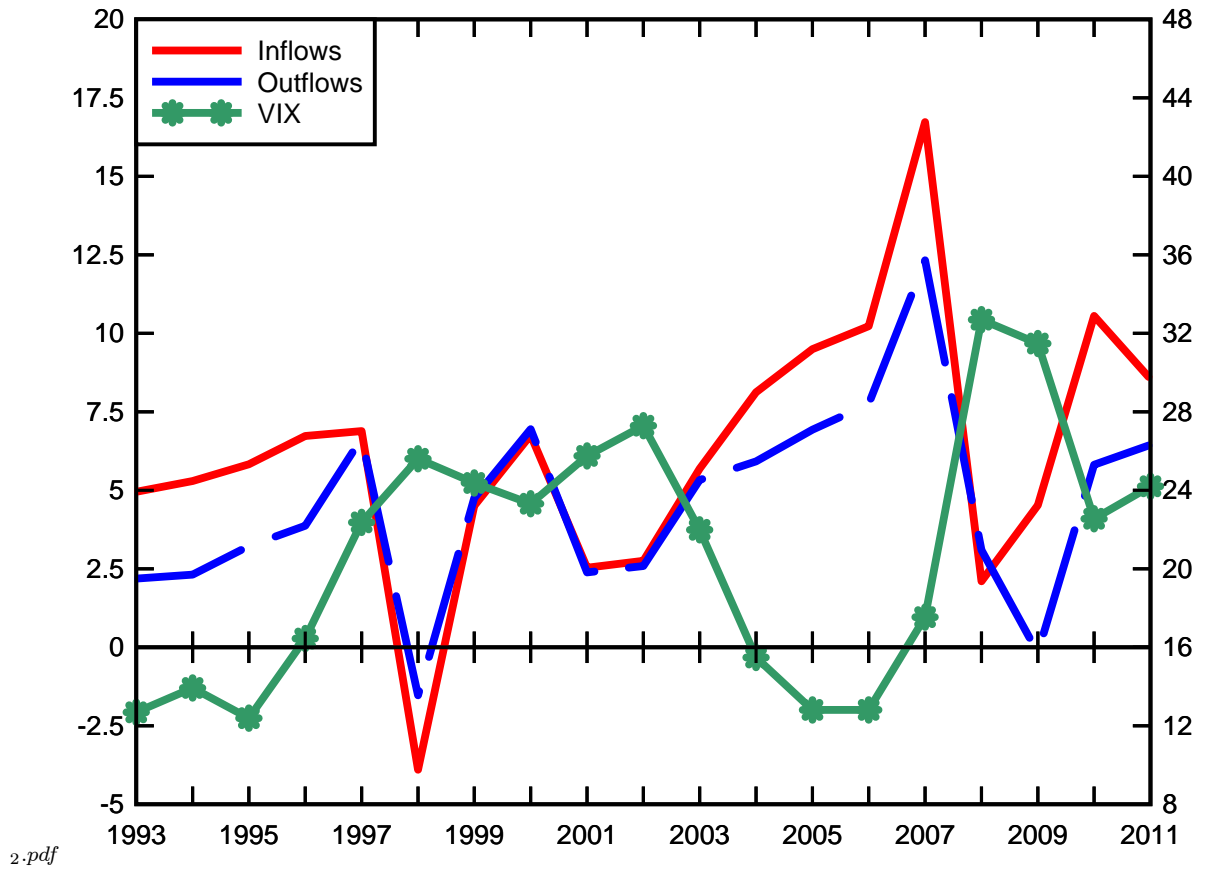
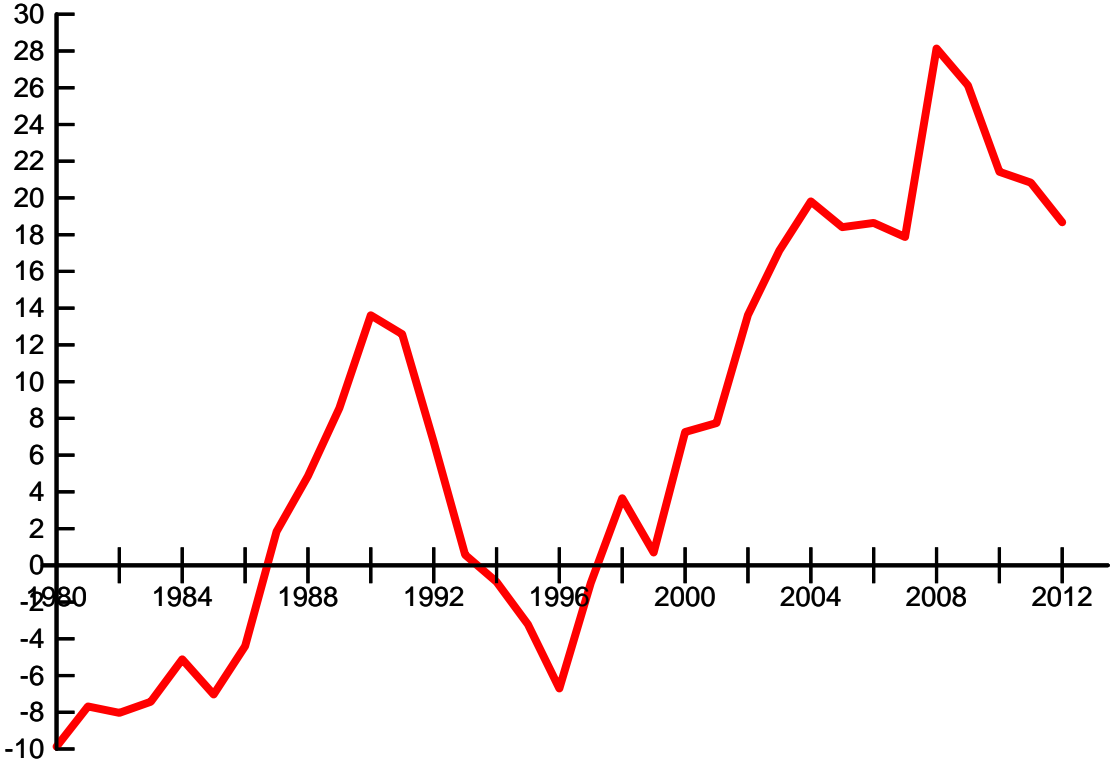


Figure 2: Emerging Asia: Capital Flows and the VIX. Note: Capital inflows and outflows (ratios to GDP) for aggregate emerging Asia group on left scale; VIX index on right scale.

Source: IMF BOP dataset and Chicago Board of Trade.

ASIA



3.pdf

Figure 3: Emerging Asia: Net International Investment Position. Note: Ratio to GDP for aggregate emerging Asia group. Calculated from updated version of Lane and Milesi-Ferretti (2007).

ASIA

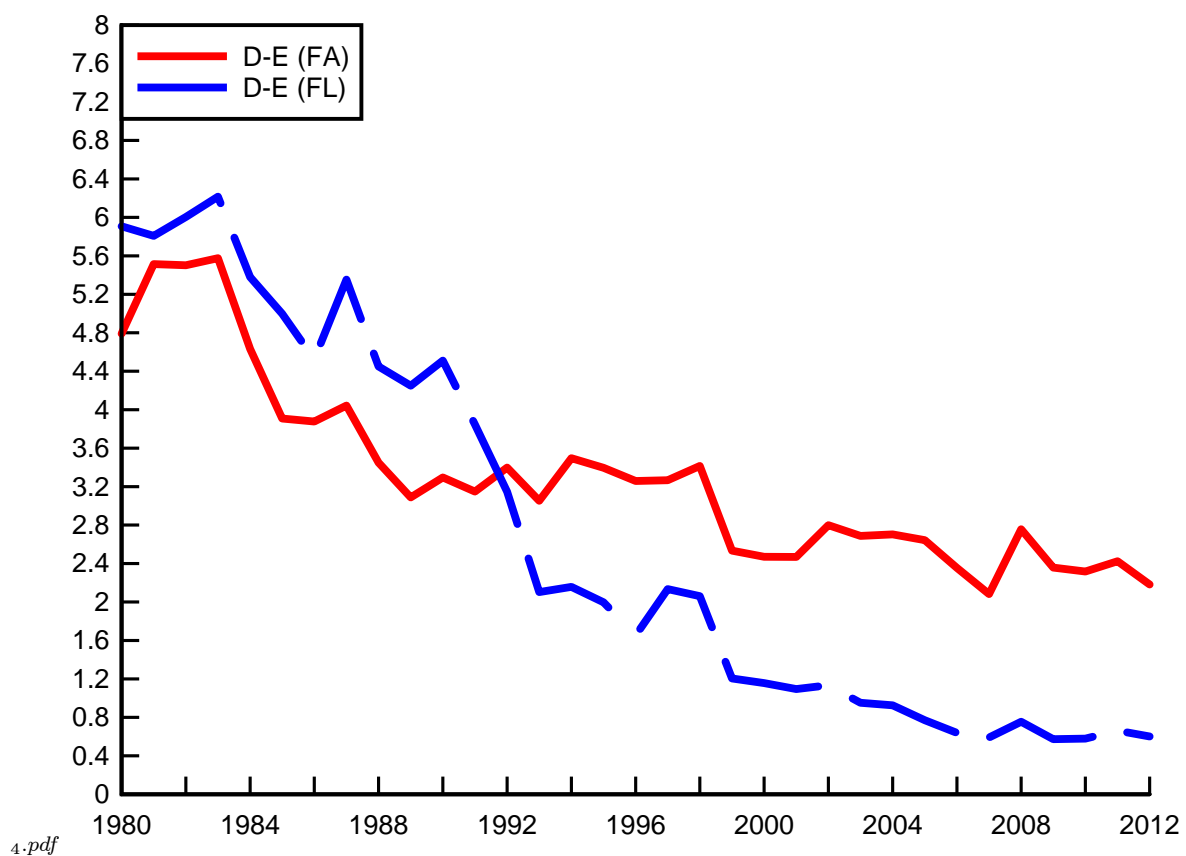


Figure 4: Emerging Asia: International Debt-Equity Ratios. Note: Debt-equity ratios in foreign assets and foreign liabilities for aggregate emerging Asia group. Calculated from updated version of Lane and Milesi-Ferretti (2007).

FXRES

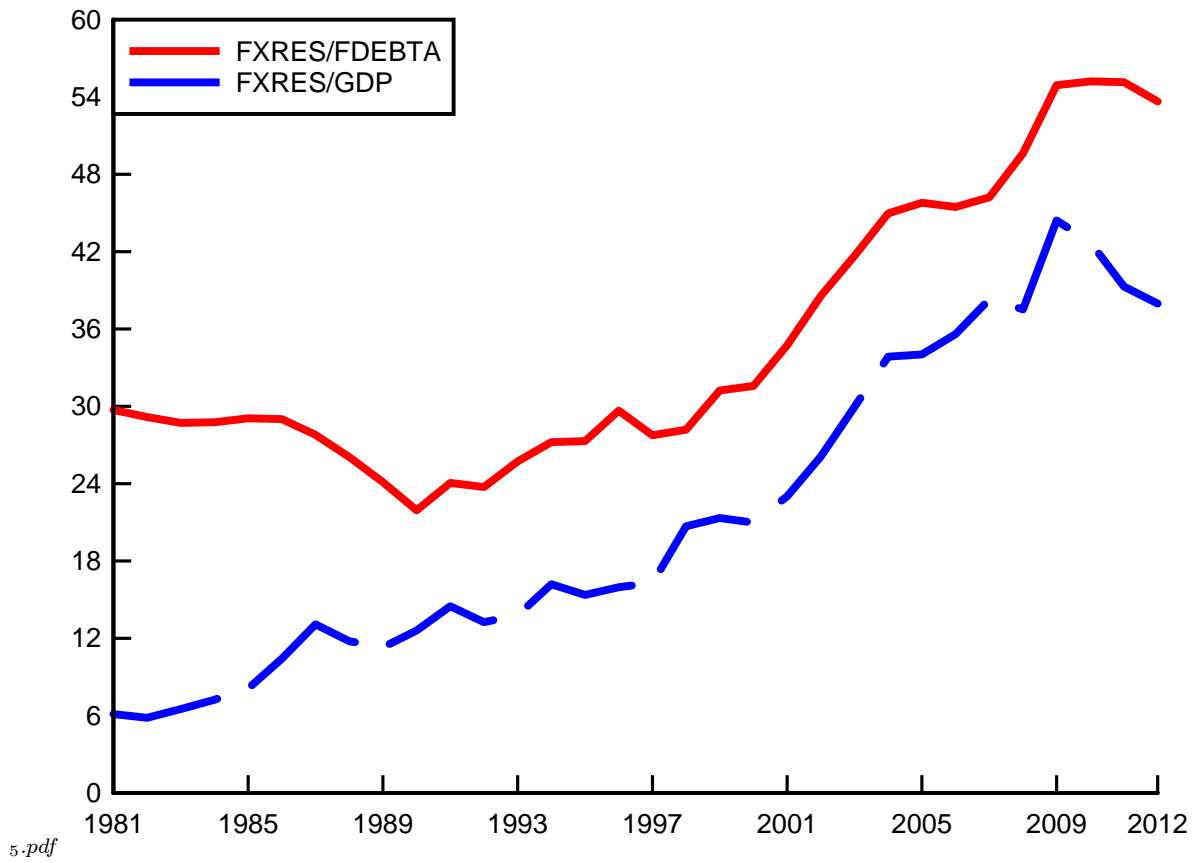


Figure 5: Foreign Reserves, 1981-2012. Note: Foreign reserves expressed as a ratio to total foreign debt assets and as a ratio to GDP. Source: Based on update to Lane and Milesi-Ferretti (2007).

LIABS

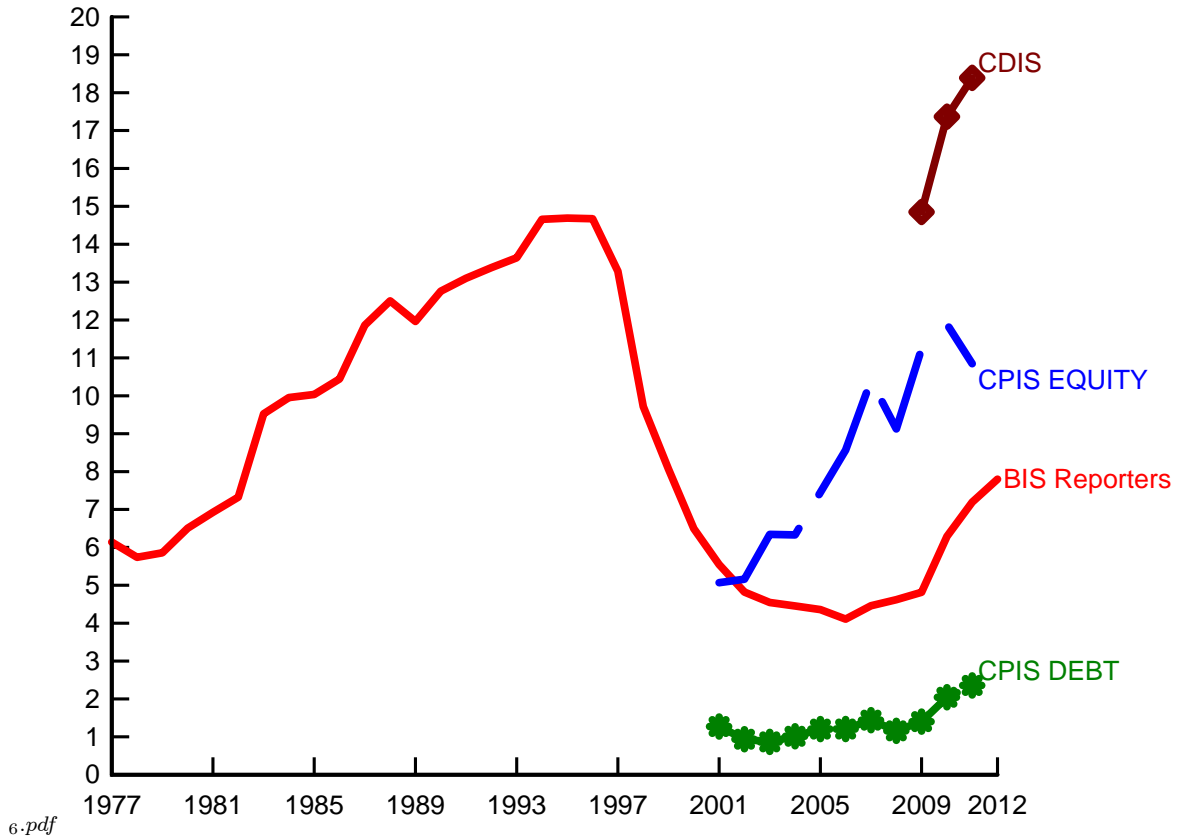


Figure 6: Emerging Asia: Share in Global Cross-Border Liabilities. Note: BIS Reporters: cross-border locational bank data; CPIS Equity: portfolio equity data from IMF CPIS dataset; CPIS Debt: portfolio debt from IMF CPIS dataset; CDIS: FDI from IMF CDIS dataset.

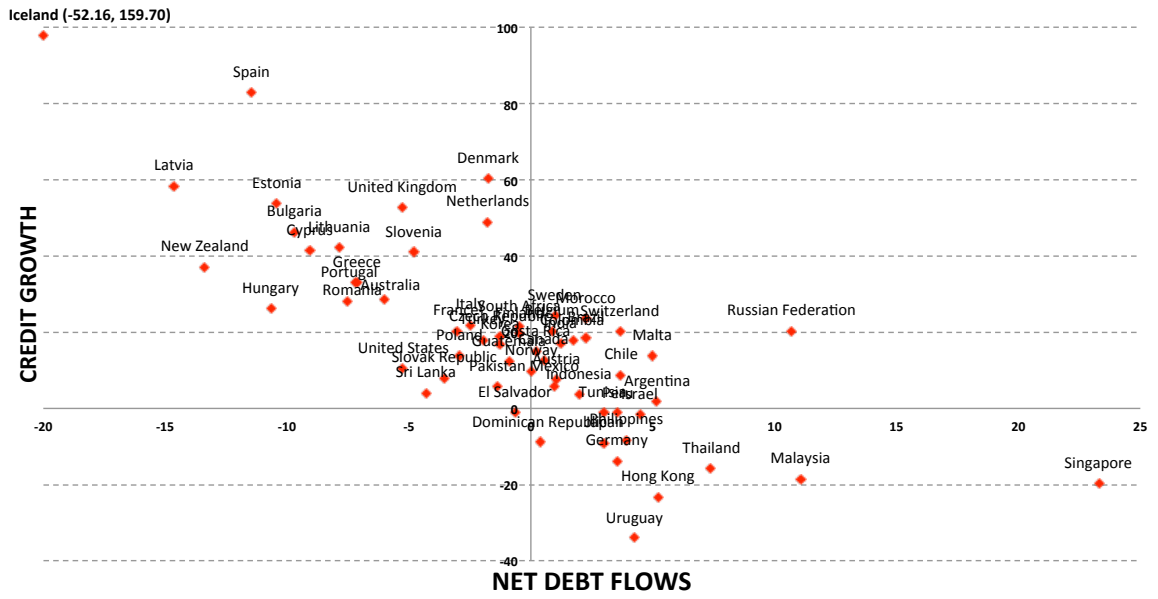


Figure 7: Domestic Credit Growth and International Debt Flows, 2003-2008. Source: Based on Lane and McQuade (2013).

Future Evolution of Asian Capital Flows?

- Rising incomes, domestic financial deepening, gradual relaxation of capital controls
 - Increase in private-sector foreign assets; foreign debt liabilities
 - Regional focus
 - International role of the RMB

International Capital Flows and Domestic Financial Conditions: Linkages

- External Imbalances
- Risk exposures embedded in international balance sheet
- Cross-Border Banking
- International transmission of advanced-economy monetary policies

External Imbalances

- Sectoral shifts in activity (traded/nontraded)
- Shifts in expenditure levels relative to output levels
 - Challenges for domestic financial system (and labour market) in resource reallocation
- Risks of sudden stops
 - Impact on output, asset prices, default rates
 - Deficit countries; surplus countries

International Risk Exposures

- Impact on balance sheets of shifts in the value of foreign assets and foreign liabilities
- Also funding risk (rollover risk)
- Risk analysis: equity/debt mix; currency composition; geographical composition; maturity structure; sectoral distribution; identity of foreign counterparties

Cross-Border Banking

- Cross-border funding and domestic credit growth
 - International inter-bank market
- Internationalisation and total size of banking sector
- Feedback effects from losses on foreign assets
- Interaction between exchange rate movements and international leverage

International Transmission of Monetary Policies

- Bruno and Shin (2013); Rey (2013)
- Cut in US policy rate
 - Decline in market risk indicators (e.g. VIX)
 - Increased leverage of globally-active wholesale banks
 - On-lending to foreign banking systems
 - Reinforced by appreciation of foreign currencies against dollar

Macro-Financial Policy Frameworks

- Preventive framework
- Crisis resilience
- Crisis management
- International financial system

Preventive Framework

- Interest rate policy
- Macro-prudential instruments
- Capital controls
- Fiscal policy

Interest Rate Policy

- Policy Trilemma or Dilemma?
- Evidence: flexible exchange rate regimes enable activist interest rate policies
- Evidence: EM with strong fundamentals willing to cut interest rates during crisis conditions
 - Balance sheet impact of currency depreciation positive for economies with positive net foreign currency positions
- Problem: during boom periods, hiking the interest rate may be ineffective and/or destabilising

Macro-Prudential Instruments

- Important extra set of policy tools
- “Structural” instruments
 - Capital-asset ratio; LTV ratio; DTI ratio; stable funding ratio
- “Counter-cyclical” instruments
 - State-contingent, time-varying
 - Implementation issues
- Capital Controls

- Financial cycle versus output cycle
- “Leaning against the wind”
- Time-varying tax rates (especially for peggers)
- Backstop function for government balance sheet (Obstfeld 2013)
 - Safe level of public debt; liquid rainy-day fund
- Formal fiscal frameworks (fiscal rules; independent fiscal councils)

International Policy Coordination

- Regulation of international banking (home-host issues; Basel III; international resolution frameworks)
- CIEPR (2011): International Monetary Policy Committee (IMPC)
- International financial system reform
 - Expansion in global and regional safety nets (alternative to excessive self-insurance)
 - Internationalisation of RMB

Conclusions

- International capital flows: international transmission mechanism for external and domestic financial shocks
- Common/global drivers of capital flows : challenges for domestic policy frameworks
- Dual strategy: activist “leaning against the wind” preventive policies; crisis resilience policies
- Close monitoring required (better data also)