Asia and the Financial Crisis. Asset Price Bubbles and Capital Controls

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Capital controls are back in fashion. In June 2010, South Korea and Indonesia announced several policy measures to regulate potentially destabilising capital flows, which could pose a threat to their economies and financial systems.

South Korea it announced a series of currency controls in June to protect its economy from external shocks. Indonesia quickly followed suit when its central bank deployed measures to control short-term capital inflows. In October 2009, Brazil announced a 2 per cent tax on foreign purchases of fixed income securities and stocks. Taiwan also restricted overseas investors from buying time deposits.

The policy measures introduced by South Korea's central bank have three major components: restrictions on currency derivatives trades; enhanced restrictions on the use of bank loans in foreign currency; and, further tightening of the existing regulations on foreign currency liquidity ratio of domestic banks.

The new restrictions on currency derivatives trades include non-deliverable currency forwards, cross-currency swaps and forwards. New ceilings have been imposed on domestic banks and branches of foreign banks dealing with forex forwards and derivatives.

OBJECTIVES OF CONTROLS

The overarching aim of currency controls in South Korea is to limit the risks arising out of sharp reversals in capital flows. Despite its strong economic fundamentals, South Korea witnessed sudden and large capital outflows due to de-leveraging during the global financial crisis. It has been reported that almost $65 billion left the country in the five months after the collapse of Lehman Brothers in September 2008.

Another objective of these policy measures is to curb the country's rapidly growing short-term foreign debt. At $154 billion, its short-term external debt accounts for as much as 57 per cent of its foreign exchange reserves. A sudden shift in global market sentiment can trigger large reversals in short-term capital flows, thereby precipitating a financial crisis of one sort or another.

Bank Indonesia, the country's central bank, announced a one-month minimum holding period on Sertifikat Bank Indonesia (SBIs). During the one-month period, ownership of SBIs cannot be transferred.

Issued by the central bank, the one-month SBIs are the favourite debt instruments among foreign and local investors because of their high yield (an interest rate of 6.5 per cent in early June 2010) and greater liquidity than other debt instruments.

The central bank will also increase the maturity range of its debt instruments to encourage investors to park their money for longer periods. These new curbs are in response to growing concerns over short-term capital inflows. Indonesia's relatively better economic performance has attracted large capital inflows in the form of portfolio investments, since early 2009.

Consequently, Indonesia's stock market index was up 85 per cent in 2009, the best performer in the entire Southeast Asian region. The rupiah rose 17 per cent against the dollar last year.

ASSET PRICE BUBBLE

However, the Indonesian authorities remain concerned that its economy might be destabilised if foreign investors decide to pull their money out quickly. Analysts believe that these new measures may deter hot money inflows into the country and monetary policy may become more effective. Despite recovering faster than developed countries, many emerging markets are finding it difficult to cope with large capital inflows. Apart from currency appreciation pressures, the fears of inflation and asset bubbles are very strong in many emerging markets.

The signs of asset price bubbles are more pronounced in Asia as the region's economic growth will continue to outperform the rest of the world. As a result, the authorities are adopting a cautious approach towards hot money flows and considering a variety of policy measures (from taxing specific sectors to capital controls) to regulate such flows.

USE OF CAPITAL CONTROLS

Contrary to popular perception, capital controls have been extensively used by both the developed and developing countries in the past. Although mainstream theory suggests that controls are distortionary, rent-seeking and ineffective, several successful economies have used them in the past. China and India, two major Asian economies and "success stories" of economic globalisation, still use capital controls today.

Post-crisis, there is a renewed interest in capital controls. It is increasingly being accepted in international policy circles that due to the limited effectiveness of other measures, such as higher international reserves, capital controls could protect and insulate the domestic economy from volatile capital flows.

Even the IMF these days endorses the use of capital controls, albeit temporarily, and subject to exceptional circumstances. In the present uncertain times, imposition of capital controls becomes imperative since the regulatory mechanisms to deal with capital flows are national whereas the financial markets operate on a global scale.

Yet, it would be incorrect to view capital controls as a panacea to all the ills plaguing the present-day global financial system. The imposition of controls by South Korea and Indonesia assume greater significance because both countries are members of G-20. It remains to be seen how the G-20 responds to the use of capital controls. Will it take a collective stand on the issue?

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