Battling Capital Inflows

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The capital inflows problem is back. After the failure of Lehman Brothers, many observers sounded the death knell of financial globalization. The Great Credit Crisis wrought many changes, but one thing it didn't change was the ability of investors to transfer funds across borders. And now, with near-zero interest rates in the United States and the surety that the dollar will depreciate further, emerging markets are again confronted with massive flows into their markets.

No one can foresee the consequences, but the prospects are not reassuring. Asset markets are frothy. Property prices are surging. Increasingly there are signs of bubble trouble.

There is also confusion about how to manage this embarrassment of riches. This makes it important for policy makers to understand what works and what doesn't.

The one guaranteed way of moderating inflows and dampening their impact is by tightening fiscal policy. Cutting back on public spending leans against the consumption and investment boom set on foot by capital inflows. Less government borrowing also puts downward pressure on interest rates, which reduces the incentive to engage in the carry trade (to borrow in the United States in order to invest in higher-yielding assets abroad).

Fiscal tightening in boom times is difficult; the authorities hesitate to take away the punch bowl when the party is underway. But at the moment many emerging markets have extraordinary fiscal stimulus in place—spending measures that were never intended to be permanent. Now would be a good time to begin scaling them back. By putting downward pressure on interest rates, doing so will discourage capital inflows. And, given that emerging economies are again growing robustly, high levels of public spending are no longer needed. Korea has already indicated that it intends to scale back its stimulus by half in 2010. Other emerging markets should follow.

Second on the list of policy responses are targeted prudential measures. To cool off real estate markets, regulators should require higher down payments. Hong Kong has done just this, but so far Chinese regulators have raised initial installment requirements only on second homes, which is weak soup. Where they control bank lending directly, they can lower the ceiling on the permissible level of new loans. They can also increase collateral and margin requirements on asset purchases generally. Here, unfortunately, Chinese regulators' decision to allow margin trading starting next year is the wrong move at the wrong time.

Regulators can also impose higher collateral and capital charges on banks' offshore borrowings, like those currently under consideration by Korea's Financial Services Commission. Banks are the principal channel through which foreign capital enters emerging market economies. Higher capital charges on foreign funds will therefore help to dampen their impact on local markets.

And with foreign funds sitting idly in the banking system, the incentive for capital inflows will be less.

Third on the list should be taxes applied directly to capital inflows like those imposed by Brazil. Brazil is a special case in that it has long maintained a system for monitoring every dollar that flows into its economy. Other countries lacking comparable experience may find it more difficult to limit evasion. But this is not to say that they shouldn't try.

Finally, policy makers should allow greater currency flexibility. An exchange rate that can move either way creates risk for speculators. In a world where the renminbi can either appreciate or depreciate, speculators would think twice before borrowing dollars to make leveraged bets on China, since if the renminbi unexpected depreciates they will be wiped out. This is an argument for a more flexible renminbi and for more flexible emerging-market currencies generally.

In the current environment, unfortunately, more currency flexibility, on China's part in particular, could have perverse results. More renminbi appreciation today might only set up expectations of more renminbi appreciation tomorrow. The carry trade and capital inflows would only be encouraged. Renminbi appreciation would still help to cool off financial markets and economy by making China's exports more expensive and competing imports cheaper. But to the extent that flexibility also encouraged capital inflows, it would only compound the problem.

At some point—once the renminbi rises by 30 or 40 per cent against the dollar—expectations of further currency appreciation would recede. From that point the exchange rate could move either way, and currency flexibility would become a deterrent to capital inflows. But this is a solution to tomorrow's capital-inflow problem, not to today's.

There is no reason to delay making a down-payment on that solution by moving now in the direction of greater flexibility. That said, the priority for dealing with the inflows problem should lie elsewhere, with fiscal tightening, targeted prudential measures and market-based capital controls.

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