

**CAPITAL FLOWS AND THEIR IMPLICATIONS
FOR CENTRAL BANK POLICIES IN
THE SEACEN COUNTRIES**

Min B. Shrestha and Choon-Seng Lim, Vincent



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FOREWORD

The SEACEN countries have benefited significantly from the large volume of capital flows in the last two decades. After experiencing a financial crisis in 1997, most of the countries in the region have become increasingly concerned about the effective management of capital flows. Despite the numerous benefits, capital flows may also pose challenges to monetary and financial stability of an economy. Massive capital inflows may complicate the transmission of monetary policy while their sudden reversal may create instability in the financial markets. In light of these issues, this study explores the implications of capital flows for central bank policies and reviews country experiences on managing capital flows in the SEACEN region.

This study finds that both domestic and external factors are responsible for the increased capital inflows in the SEACEN region and that the surge in capital inflows was one of the contributory factors for asset price bubbles and sharp increase in bank credit. Based on the analysis of the composition of capital flows in the SEACEN region, the study argues that due to the increasing share of highly volatile short-term capital inflows, the SEACEN economies are facing the risk of sudden significant capital reversal. The study also puts forth some suggestions to optimise the benefits of capital flows while minimising potential risks. We hope that the findings and suggestions of this study may be valuable reference to central bankers and other policy makers.

This collaborative research was led by Dr. Min B. Shrestha and Dr. Choon-Seng Lim, Vincent, both Senior Economists of The SEACEN Centre, and participated by 14 country researchers from 12 member central banks and monetary authorities. The SEACEN Centre wishes to express its sincere gratitude to the participating member central banks and their country researchers for actively participating in this project and preparing the country papers for their respective countries. They are namely, Ms. Nurhuaida Damit of the Ministry of Finance, Brunei Darussalam; Mr. Yayat Cadarajat of Bank Indonesia; Mr. Raja Syamsul Anwar and Ms. Tan Bee Chin of Bank Negara Malaysia; Mr. Gan-Ochir Doojav of The Bank of Mongolia; Daw Thida Myo Aung of Central Bank of Myanmar; Mr. Bibhu Aryal of Nepal Rastra Bank; Mr. Tanu Irau of Bank of Papua New Guinea; Ms. Sittie Hanisha M. Butocan of Bangko Sentral ng Pilipinas; Mr. P. Pushparajah of Central Bank of Sri Lanka; Mr. Yu Hsiao Yuan of Central Bank of the Republic of China (Taiwan); Mr. Khatharit Sitthikul and Ms. Nasha Ananchotikul of Bank of Thailand and Ms. Ngo Thi Thu Tra of State Bank of Vietnam. The SEACEN Centre also wishes to thank Dr. Ramon Moreno, Head of Emerging Market Issues, Bank for International Settlements,

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The views expressed in this study, however, are those of the authors and do not necessarily reflect those of The SEACEN Centre or the SEACEN member central banks/monetary authorities.

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June 2009

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EXECUTIVE SUMMARY

The SEACEN economies have liberalised their external accounts and domestic financial markets. The current account is fully convertible in all the countries in the SEACEN region while the capital account is by and large fully convertible in the majority of these countries. Since early 1990s, net capital flow to the SEACEN countries increased steadily until 1996 due to the massive increase in total capital inflows. However, after the financial crisis of 1997, total capital outflows have outweighed total capital inflows resulting in a negative net capital flow.

Both domestic factors such as attractive economic growth, attractive interest rates and large current account deficits and external factors such as low world interest rates are responsible for the increased capital inflows in the region. However, determinants of short-term capital inflows vary from that of the total capital inflows. Notably, short-term capital inflows are found to be inversely associated with domestic economic growth. The effects of push and pull factors on capital flows vary across the countries. Recent experiences of SEACEN countries indicate that the US sub-prime mortgage crisis has led to slower capital inflows in the region while domestic political climate, further liberalisation in overseas investment; and, encouragement to invest abroad have accelerated capital outflows.

The SEACEN region has benefited significantly from the increased capital inflows mainly in terms of increased investment, higher economic growth, favourable external accounts and developed financial markets. However, capital flows have also led to challenges for monetary and financial stability. The recent experience of SEACEN countries shows that capital flows can create asset price bubbles and induce sharp increases in bank credit while outflow of capital results in lower equity prices and depreciation of exchange rates.

Short-term capital inflows are highly volatile and prone to sudden reversals. After 2003, the share of short-term inflow started to become increasingly dominant in the total inflow in the SEACEN region, resembling the pattern of capital flows before the 1997 crisis. Due to the larger share of highly volatile short-term foreign capital, SEACEN economies are again, facing the risk of massive capital reversals. In order to prevent a repetition of the same problems in the future, SEACEN countries need to encourage more long-term capital inflows rather than short-term ones. To safeguard the financial system and the economy from speculative attacks, authorities need to implement more prudent regulations

and cautiously monitor potential areas of such attacks. In order to maintain a conducive monetary stability environment, central banks need to sterilise inflows with appropriate intervention measures.

Freer exchange rates allow for more capital flows in and out of the country. However, in the time of distress, the countries that have a free floating exchange rate regime may suffer from larger capital reversals. Therefore, a managed floating exchange regime may be more advantageous during a crisis.

The financial markets and economies of the SEACEN countries are currently affected by the global financial crisis, due mainly to external factors. In order to minimise further negative impacts of the crisis on various sectors of the economy including capital flows, to speed up the recovery process, and also to explore the possibility of inventing new economic drivers within the region, coordinated policy measures need to be implemented at the national as well as regional levels.