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How to Tame Financial Speculators

Asian Countries Regulate Speculative Capital Flows

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Just days before the G20 summit in Toronto, 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.

The policy measures announced by South Korea and Indonesia assume greater significance because both countries are members of the G20. In 2010, South Korea chairs the G20.

South Korea Imposes Comprehensive Currency Controls

On 13 June 2010, South Korea announced it would be imposing currency controls which are much wider in scope than foreign exchange liquidity controls announced earlier in 2009. The policy measures have three major components:

First, there are new restrictions on currency derivatives trades, including non-deliverable currency forwards, cross-currency swaps and forwards. New ceilings have been imposed on domestic banks and branches of foreign banks dealing with foreign exchange (forex) forwards and derivatives. For Korean banks, there will be a limit on currency forwards and derivatives positions at 50% of their equity capital. For foreign banks, the ceilings will be set at 250% of their equity capital, against the current level of around 300%.

Under the existing trading rules in Korea, banks can buy forex derivatives contracts without any limits. Many banks also rely heavily on borrowings from overseas to cover potential losses arising from forward trading. As a result of this lax policy regime, the forex derivatives trading substantially contributed in the rise in short-term overseas borrowings and external debt during 2006 to 2007. According to official sources, almost half of the increase in country's total external debt of $195 billion during this year was due to the increase in forex forward purchases by banks.

In addition to new curbs on banks, the Korean authorities have also tightened the ceilings on companies' currency derivatives trades to 100% of underlying transactions from the current 125%.

The currency controls will come into effect from July 2010. But these will be implemented in a flexible manner. A grace period of three months has been allowed to avoid any sudden disruptions in derivatives trading markets and banks can cover their existing forward positions for up to two years if they exceed the ceilings.

Second, the authorities have further restricted the use of bank loans in foreign currency. This has been done primarily to make sure that foreign currency bank loans are used for

overseas use only. At present, bank loans in foreign currency are allowed for purchase of raw materials, FDI and repayment of debts. Only in certain cases, such loans could be used for domestic use.

Under the new rules, such loans will be restricted for overseas use only. As an exception, only the small- and medium-sized enterprises have been allowed to use foreign currency financing for domestic use, to the extent that total foreign currency loans remain within the current levels. This policy measure is hugely significant since excessive foreign currency bank loans are considered to be major sources of systemic risks in many emerging markets.

Third, the Korean authorities have further tightened the existing regulations on foreign currency liquidity ratio of domestic banks. The domestic banks will monitor the soundness of foreign currency liquidity on a daily basis and report it to authorities every month.

The authorities have also recommended foreign banks operating in Korea to establish liquidity risk management mechanisms as they are a major source of foreign currency liquidity. According to the Bank for International Settlements, foreign banks account for the bulk (60%) of short-term external liabilities of all banks operating in South Korea (McCauley 2008). Further, foreign banks are also the dominant players in inter-bank borrowing from abroad.

In addition to these policy measures, the Korean authorities also announced the establishment of a headquarter inside the Korea Centre for International Finance to regularly monitor capital flows as part of developing an early warning system.

The authorities have also supported the need for establishing global financial safety nets through international cooperation. The agenda of global financial safety nets will be pursued as part of the “Korea Initiative” at the Seoul G20 summit to be held in November 2010.

Meanwhile, the Korean authorities have explicitly ruled out imposition of any financial transactions taxes (such as in Brazil) or unremunerated reserve requirements (such as in Chile).

Why Currency Controls?

The imposition of currency controls by the Korean authorities has to be analysed against the backdrop of the global financial crisis. Despite its strong economic fundamentals, South Korea witnessed sudden and large capital outflows due to deleveraging 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.

South Korea’s export-oriented economy also suffered badly due to contraction in global demand in the aftermath of global financial crisis. Its economy shrank 5.6% in the fourth quarter of 2008, country’s worst performance since 1998 when it was hit by the Asian financial crisis.

Of late, the authorities have been concerned about sharp fluctuations in the South Korean won particularly in the wake of European sovereign debt crisis and their negative impact on Korean exports. On May 25, the won’s three-month implied volatility touched 36.6%, the highest level since January 2009.

Despite a relatively stable banking system, sharp currency fluctuations can make a small and open economy like South Korea highly vulnerable to sudden capital outflows.

The overarching aim of currency controls in South Korea is to limit the risks arising out of sharp reversals in capital flows, as witnessed during the global financial crisis. The controls are specifically aimed at regulating capital flows and stabilising its currency.

Short-term Debt

Another policy objective of these policy measures is to curb country's rapidly growing short-term foreign debt. Tight regulations have been imposed on banks on the amount of short-term loans they can obtain from abroad. South Korea's higher short-term foreign debt is a matter of serious concern. At $154 billion, its short-term external debt accounts for as much as 57% of its forex 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. The relationship between excessive short-term external debt (intermediated through the banking system) and subsequent financial crises is well-known. The Korean economy has suffered badly from the boom and bust cycles of short-term capital flows in the past.

It is too early to predict the potential impact (positive and negative) of currency controls and other policy measures announced by the Korean financial authorities. This prediction is made harder still because some policy measures are medium- and long-term in nature.

But it is expected that such restrictions will lead to a considerable reduction in short-term foreign borrowings. Foreign banks may not find it profitable to carry out arbitrage trade due to regulatory restrictions and therefore may look for opportunities elsewhere. While many analysts believe that ceilings on forward positions will limit the amount of short-term foreign debt and deter "hot money" flows, it nevertheless remains to be seen to what extent these policy measures will help in reducing currency volatility.

Indonesia Tames Short-term Capital Inflows

On 16 June 2010, Bank Indonesia, the country's central bank, announced the following policy measures to tame short-term capital inflows:

> With effect from 7 July there will be a one-month minimum holding period on Sertifikat Bank Indonesia (SBIs). During the one-month period, ownership of SBIs cannot be transferred. Issued by 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% in early June 2010) and greater liquidity than other debt instruments.
>
> The central bank will increase the maturity range of its debt instruments by issuing longer dated SBIs (9-month and 12-month) to encourage investors to park their money for longer periods. So far, the longest maturity of its debt was six months.

New regulations have been introduced on banks' net foreign exchange open positions.

The central bank has also widened the short-term, overnight money market interest rate

corridor and introduced non-securities monetary instrument in the form of terms deposits.

These new curbs are in response to growing concerns over short-term capital inflows. Given the historically low levels of interest rates in most developed countries, Indonesia has received large capital inflows since 2009. Unlike other Asian economies such as Singapore and Malaysia, the Indonesian economy showed some resilience during the global financial crisis. Despite hiccups in the financial markets, the Indonesian economy registered a positive growth of 6.0% in 2008 and 4.5% in 2009, largely due to strong domestic consumption and the dominance of natural resource commodities in its export basket.

Its 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% in 2009, the best performer in the entire Southeast Asian region. The rupiah rose 17% against the dollar last year.

Yet due to the massive speculative capital inflows, the Indonesian authorities remain concerned that its economy might be destabilised if foreign investors decide to pull their money out quickly. As a result, the steps taken by the central bank to maintain financial stability were of little surprise. As a balancing act however, the authorities have avoided any restrictions on long-term investment flows.

Analysts believe that these policy measures may deter hot money inflows into the country and monetary policy may become more effective. Yet they expect tougher measures in the future if volatility in capital flows persists. Some analysts also expect that the new curbs may shift capital flows to other financial assets such as government and corporate bonds.

Emerging Markets Facing New Challenges

Despite recovering faster than developed countries, many emerging markets are finding it difficult to cope with large capital inflows. There is a growing concern that the loose monetary and fiscal policies currently adopted by many developed countries are promoting a large dollar "carry trade" to buy assets in emerging markets.

Apart from currency appreciation pressures, the fears of inflation and asset bubbles are very strong in many emerging markets. Since mid-2009, stock markets in emerging economies have witnessed a spectacular rally due to strong capital inflows. In particular, Brazil, Russia, India and China are the major recipient of capital inflows.

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. In May 2010, for instance, Hong Kong and China imposed new measures in an attempt to curb soaring real estate prices and prevent a property bubble.

In emerging markets, strong capital inflows are likely to persist due to favourable growth prospects but the real challenge is to how to control and channel such inflows into productive economy.

Are Capital Controls An Alternative?

Contrary to the popular perception, capital controls have been extensively used by both the

developed and developing countries in the past. There is a paradox between the use of capital controls in theory and in practice (Nembhard 1996). Although mainstream theory suggests that controls are distortionary and ineffective, several successful economies have used them in the past (Nembhard 1996). 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 (on both inflows and outflows) as a policy response to deter short-term volatile capital flows. It is increasingly being accepted in international policy circles that due to limited effectiveness of other measures (such as higher international reserves), capital controls could protect and insulate the domestic economy from volatile capital flows and other negative external developments. Capital controls could also provide recipient countries greater leeway to conduct an independent monetary policy (Singh 1999).

Even the IMF is nowadays endorsing the use of capital controls, albeit temporarily and subject to exceptional circumstances (Ostry 2010). A recent paper prepared by the Strategy, Policy, and Review Department of the IMF stated "In certain cases countries may consider price-based capital controls and prudential measures to cope with capital inflows" (IMF 2010). This is a significant development given the IMF's strong opposition to capital controls in the past.

In October 2009, Brazil announced a 2% tax on foreign purchases of fixed-income securities and stocks. Taiwan also restricted overseas investors from buying time deposits. Due to this measure, Taiwan has witnessed a decline in speculative money from overseas. Russia is also contemplating similar measures as its economy is more vulnerable to swings in capital flows. 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 (Singh 1998).

Yet it would be incorrect to view capital controls as a panacea to all the ills plaguing the present-day global financial system. It needs to be underscored that capital controls must be an integral part of regulatory and supervisory measures to maintain financial and macroeconomic stability (Singh 2000). Any wisdom that considers capital controls as short-term and isolated measures is unlikely to succeed in the long run.

It remains to be seen how the G20 responds to the use of capital controls by its member-countries as a policy response to regulate speculative capital flows. Will G20 take a collective stand on capital controls?

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