PRESS POINTS FOR CHAPTER 4: *THE YIN AND YANG OF CAPITAL FLOW MANAGEMENT: BALANCING CAPITAL INFLOWS WITH CAPITAL OUTFLOWS*
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Key Points

- Large swings in foreign capital inflows have been less disruptive in countries where they lead to financial adjustment (changes in reserves or capital outflows by domestic residents) rather than real adjustment (changes in the current account).
    - Historically, emerging market economies (EMEs) have tended to experience disruptive real adjustment: surges in capital inflows leading to domestic booms and current account deficits, followed by disruptive crises when inflows reversed.
    - But over the past decade a number of EMEs have demonstrated increased resilience as a result of greater financial adjustment: when foreign investors pulled out of the country, domestic residents stepped in and repatriated assets invested abroad. During the global financial crisis, these EMEs experience much more stable GDP, consumption, and unemployment.
- Resilient EMEs that have absorbed fluctuations in capital inflows through financial adjustment were characterized by the following mutually reinforcing features:
    - Stronger institutions, with credible central banks and countercyclical fiscal and monetary policy;
    - Stronger financial supervision and regulation; and
    - More flexible exchange rate regimes and limited restrictions on capital flows.
- The analysis suggests a path of reforms that can help less resilient EMEs deal more effectively with volatile capital inflows.[1] These reforms, by encouraging private financial adjustment, balance the yin of capital inflows with the yang of capital outflows.

[1] See http://www.imf.org/external/pubs/ft/survey/so/2012/POL120312A.htm for a discussion of other work by the IMF on dealing with volatile capital inflows.

Capital flows to EMEs are a source of particular and enduring concern to many policymakers. These concerns stem from bitter experience, best exemplified by the 1997–98 Asian crisis, when surges in capital inflows fueled excessive credit growth, expanded current account deficits, appreciated exchange rates and a loss of competitiveness. When the inflows reversed, there was a painful adjustment characterized by severe financial disruptions.

But these reactions are not common to all EMEs. In several EMEs, capital inflows led not to current account blowouts but to financial adjustment, whereby gross capital outflows by domestic residents tend to offset volatile gross capital inflows by foreign investors. When foreign investors move capital into the country, domestic residents tend to make investments abroad; and when foreign investors liquidate their positions, domestic residents tend to repatriate their foreign assets. This acts as an automatic stabilizer for net flows and thus prevents large swings in the current account.

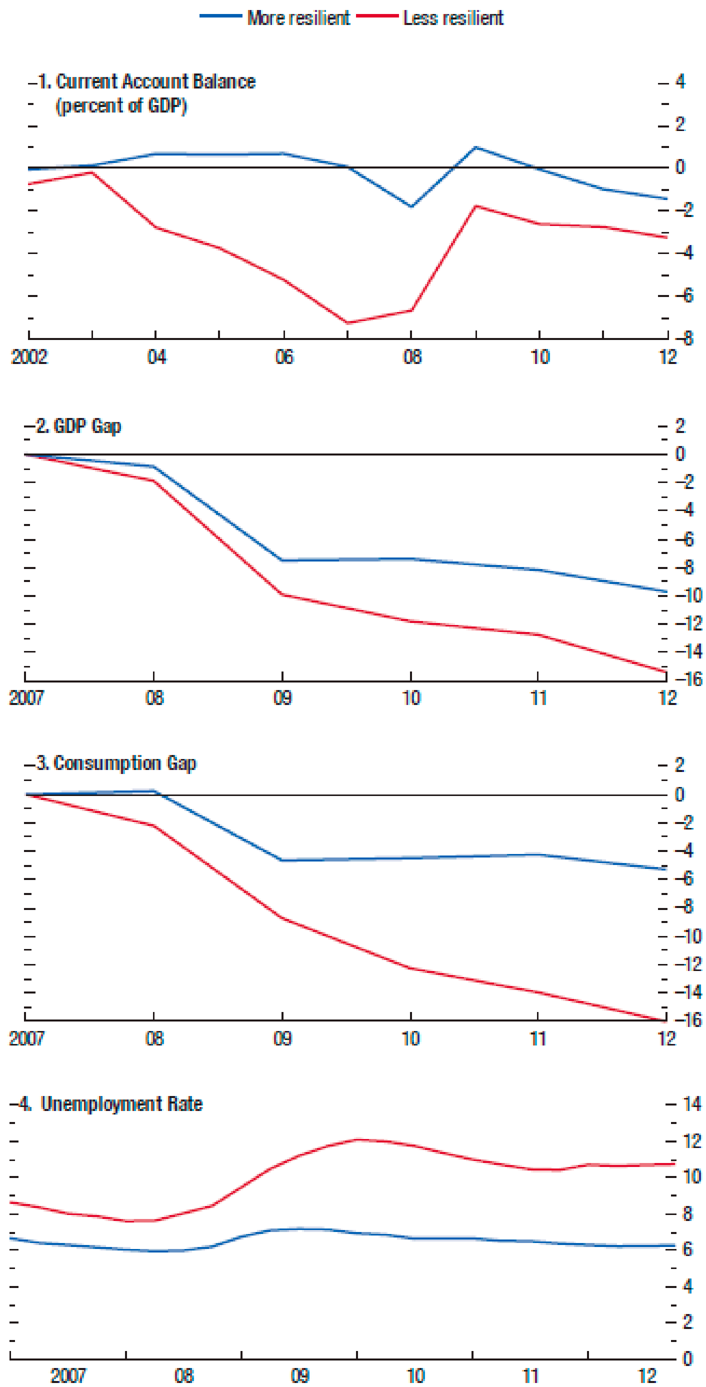
EMEs that displayed greater financial adjustment to volatility in gross capital inflows fared considerably better during the global financial crisis. Figure 4.2 shows that these countries proved to be much more resilient. They experienced smaller fluctuations in current accounts, lower reductions in GDP and consumption growth, and smaller increases in unemployment.

The chapter identifies some key characteristics that differentiate more resilient EMEs (that benefit from financial adjustment) from less resilient EMEs (that suffer greater real adjustment). More resilient countries tend to have better institutions, with credible central banks and countercyclical fiscal and monetary policies. They also have better financial regulation and supervision that prevent financial intermediaries from taking undue risks during periods of strong capital inflows. Finally, they have more flexible exchange rate regimes and limited restrictions on capital flows, so that local residents can efficiently move capital across borders and have the appropriate incentives to do so.

The analysis suggests a path of reforms that can help less resilient EMEs encourage greater stabilizing financial adjustment. Based on case studies of Chile, the Czech Republic, and Malaysia, the chapter suggests that countries should begin by strengthening their financial sectors and policy institutions.

Figure 4.2. Current Account, GDP, Consumption, and Unemployment
(Percent, mean)

Less resilient countries witnessed a large deterioration of the current account in the years preceding the global financial crisis and a subsequent sharp reversal. Those countries also experienced a much stronger contraction of GDP and consumption relative to precrisis trends and a larger increase in unemployment.



Source: IMF staff calculations.