Choongsoo Kim: Coping with volatile capital flows – Korea's experience and the challenges ahead

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the European Union Chamber of Commerce in Korea (EUCCK) Annual Seminar, Seoul, 27 October 2010.

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Greetings

It is a great pleasure for me to be here with you today at this "Annual Seminar of the EUCCK (European Union Chamber of Commerce in Korea)". This is all the more so as your organization contributes so greatly to the growth of bilateral business activities between the EU and Korea.

Korea and Europe will get much closer to each other as the Korea-EU FTA takes effect from July of next year. With experiences of living in Europe for nearly four years on two different occasions, I'd love to enjoy high-quality European wine at a cheaper price thanks to the Korea-EU FTA.

Let me take this opportunity to express my very deep thanks to all seminar participants, and especially to President Jean-Marie Hurtiger, for this invitation to address you.

Today, I wish to share with you Korea's experiences with volatile capital flows and our related policy responses over the last decade. I will then mention some of the policy challenges that lie ahead of us.

As all of you are aware, last weekend, we were able to come up with an agreement on currency issues as well as other critical global issues at the G20 Finance Ministers and Central Bank Governors Meeting at Gyeongju. I find it a win-win result for all parties concerned.

In particular, I'd like to remind you that the communique includes the following statement, "these actions will help mitigate the risk of excessive volatility in capital flows facing some emerging countries". Such a statement has a significant policy implication for a country like Korea, whose day-to-day currency fluctuations are much higher than those of other G20 member economies.

Stylized facts on capital flows and the impossible trinity

I'd like to begin my speech by presenting some stylized facts on capital flows and a few words about the impossible trinity.

Korea, like most other emerging market countries, has in recent years become rapidly integrated into international financial markets, through capital account liberalization and market opening. To give an idea of the scale of this movement of capital in the world economy, cross-border capital flows to emerging markets increased almost eight-fold between 1994 and 2007.[1]

The case for opening the capital market is that foreign capital inflows contribute to economic growth – not only directly, through capital accumulation, but also indirectly, through the associated benefits of the improvement of financial infrastructure.

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[1] They expanded from 220 trillion US dollars to 1,726 trillion US dollars during the period according to International Financial Statistics of IMF.

But there are many instances where large capital flows have proved to be something of a double-edged sword. They bring great benefits, but also pose risks and policy dilemmas. Here the words of IMF Managing Director Dominique Strauss-Kahn are very apt. Last week in Shanghai, he warned that "capital flows can lead to exchange rate overshooting, credit booms, asset price bubbles, and financial instability".

What then are the risk factors inherent in international capital flows? Firstly there is the pro-cyclicality of these flows, and secondly, there is the dilemma countries face in their policy responses to them.

Pro-cyclicality of capital flows

Once their capital markets are liberalized, capital flows bring about increased economic volatility. Capital flows are essentially pro-cyclical. Put more simply, capital inflows surge greatly during economic booms, but decline or go into reverse during economic slowdowns.

In boom periods, large-scale capital inflows can trigger internal imbalances by driving inflation up and increasing asset prices. At the same time they can cause or worsen external imbalances as well, for example, by widening a current account deficit through currency appreciation. Massive surges in capital flows can also increase systemic risk in the financial sector by aggravating maturity and currency mismatches between assets and liabilities of financial institutions.

In an economic downturn, or when exuberance turns to "angst", in contrast, foreign capital flows out rapidly. This brings in its train currency depreciation and a sudden drop in foreign reserves. Real sector economic activities also slow further, due to balance sheet effects arising from currency depreciation as well as a double drain of liquidity – from both the domestic financial and foreign exchange markets.

There was an abrupt and massive outflow of capital after the global financial crisis erupted. The emerging market economies experienced very severe turbulence in financial markets, even though they were not at the epicenter of the financial crisis.

The impossible trinity

Another problem arising from cross-border capital flows is the worsening of conflicts between a country's internal and external policy goals. In an open economy, it must seek to resolve what is termed the "impossible trinity". In this, one of three desirable goals – capital market opening, fixed and/or stable foreign exchange rate, and monetary policy autonomy – must be sacrificed if the two others are to be achieved. Thus, once capital market opening has progressed, a dilemma arises – a choice between foreign exchange stability and monetary policy autonomy.

The first option for responding to capital flow volatility may be to use the exchange rate as an automatic stabilizer under a freely-floating regime. Allowing the rate to move freely at all times can prevent excessive inflows by dampening appreciation expectations. But the real economy may be unable to adapt to large exchange rate swings within a short period and may be negatively affected.

A country may intervene to limit exchange rate volatility or to slow the currency's appreciation. But siphoning off the liquidity injected through sterilization may damage the central bank's balance sheet and attract further inflows by maintaining a gap between domestic and international interest rates.

As a last resort, capital controls may also be considered as a few countries have introduced recently. But as a recent IMF study notes, decisions on their use should be made very

carefully. The distortions and costs capital controls incur must be compared with their benefits, though they may form a useful part of the policy toolkit.[2]

Experience of capital flows and policy responses of Korea

In this vein, I would like to look back over Korea's experiences with volatile capital flows and policy responses.

Capital inflows during the early and mid 2000s

After Korea pulled out of the Asian currency crisis of the late 1990s, capital flows shifted back to an increase beginning in the early 2000s, due mainly to foreign portfolio investment rather than direct investment, which is inherently more stable.

Equity investment led the portfolio inflows in the first half of the last decade. This was encouraged by the prevalent low interest rates in advanced countries, abundant global liquidity, and Korea's sound economic fundamentals. Between 2006 and 2007, however, bond investment inflows took on a more dominant role than equity investment, greatly helped by the increased arbitrage incentives for bond investment.

As a result of these large capital inflows, pressures for the appreciation of the Korean won persisted.[3] This coincided with an expansion of private sector credit and a steep run-up in housing prices.

In response, beginning in the first half of 2006, the Korean government introduced policies to promote capital outflows, making it much easier for Korean residents to invest abroad. Thanks to these policies, residents' overseas portfolio and direct investment soared, offsetting the foreign capital inflows.

Moving on, though, the hedging of the FX risk on these investments abroad, as well as heavy forward selling by exporters, especially shipbuilders, brought about a large rise in foreign borrowings by foreign exchange banks. This led to an expansion of the nation's foreign liabilities that was primarily short-term in nature.[4]

Sudden reversal in capital flows after Lehman Brothers' failure

After the Lehman Brothers' collapse in September 2008, Korea experienced a hemorrhage of foreign capital outflows, as there was a rapid increase in repayments of external borrowings by domestic banks and Korean branches of foreign banks.

What is termed a "sudden stop" thus occurred. I should point out here that this was triggered not by domestic factors, as Korean fundamentals remained sound, but principally by overseas factors in the form of the global credit squeeze and massive de-leveraging. The turmoil in the financial and FX markets spread rapidly to the real sector. The roll-over ratio of banks' external borrowings declined sharply to less than 30 percent at one point, and the won/dollar exchange rate and CDS (Credit Default Swap) premium surged, fueled by pessimism about the Korean economy. Real sector economic activities also shrank, and GDP growth in the second half of 2008 was negative.

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[2] See IMF Staff Position Note 10/04(Feb. 2010).

[3] By end-2006, the won had risen 36 percent against the US dollar compared to end-2000.

[4] Short term external debt, in particular, increased from 65.9 billion dollars at the end of 2005 to 189.6 billion dollars as of end-September, 2008. Accordingly, the ratio of short term in total external debt rose from 35.1 percent at end-2005 to 44.5 percent at end-September, 2008.

Stepping up to the plate, the Bank of Korea (BOK) and Korean government swiftly provided FX liquidity to the FX money market, while supporting the working of the market mechanism in determining exchange rate movements.

At the height of the global financial crisis in October 2008, the BOK entered into a 30 billion-dollar swap agreement with the US Federal Reserve, and the announcement of this triggered a dramatic reversal of market sentiment. About half of this facility was drawn down and channeled to the market, preventing it from seizing up.

Hard on the heels of this, the BOK signed currency swap agreements with the Bank of Japan and the People's Bank of China, in a bid to strengthen regional cooperation in the face of the global crisis. These actions are judged to have helped Korea overcome the financial turmoil more quickly than most other countries.

Recent developments

As the global financial turmoil eased, large portfolio inflows to Korea then resumed starting in April of 2009. This trend has continued, and can be attributed to the return of global investors' appetite for risk, quantitative easing policies in developed countries, and Korea's rapid economic recovery.

In contrast to the period before the global financial crisis, the recent capital inflows to Korea have had the following features. First, while banks' borrowings have increased only slightly, equity and bond investment inflows have both expanded on a large scale. Second, the proportion of long-term bond investment has increased. In terms of region, meanwhile, the source of inflows has diversified to include Asian countries as well.

Influenced by the abundant capital inflows, domestic stock prices have risen sharply, the Korean won has appreciated against the US dollar and long term interest rates have fallen. This has led to a tri-polar bull market – in FX, equities and bonds. The other side of the coin is that the financial market could turn highly unstable upon any sudden negative shift in domestic or international conditions.

As part of a bid to forestall such an eventuality, the BOK worked with the Korean government to introduce, this June, macro-prudential measures to mitigate the volatility of capital flows. The main goal of the measures is to minimize systemic risk in the Korean economy and bolster its macro-prudential soundness.

A new system of ceilings on banks' FX derivatives positions was built to curb excessive short-term overseas borrowings.[5] FX derivatives positions traded before its introduction will of course be allowed to continue to maturity.

Regulations on foreign currency loans were tightened as well, to guard against the possibility of increased demand for them due to the recent strong economic growth. Since July, their use has been restricted to overseas purposes only.

Challenges ahead

Having run through Korea's experiences with capital flows, let me close my remarks by briefly outlining the challenges that lie ahead.

In light of our past experience, we have no choice but to be concerned about the problems capital inflows pose for macro-economic management in dealing with the impossible trinity I mentioned earlier and the risk of a "sudden stop".

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[5] The ceilings were set and applied as 50% of previous month capital for domestic banks, and 250% for foreign bank branches, starting from October 9.

As Managing Director Strauss-Khan of the IMF recently pointed out, there is no one-size-fits-all solution to problems associated with volatile capital flows. While we cannot resolve these problems entirely, we can try to mitigate them. In that spirit, I would like to put forward some policy options for effectively sustaining stable growth and moderating external shocks.

Sound macro-economic policies are the first line of defense in reducing countries' vulnerability to external shocks. Events that might trigger a crisis situation such as an overhang of short-term external debts or lack of foreign reserves should be promptly resolved. Over the long term, we must seek to develop foreign exchange markets to ensure that exchange rates do not fluctuate greatly over short periods of time due to sharp swings in capital flows. As a second step, it might be helpful to look into macro-prudential options for moderating the volume of capital flows. Properly-designed and well-implemented macro-prudential frameworks could play an effective role in alleviating the pro-cyclicality of capital flows.

Last but by no means least, it is necessary to strengthen international cooperation. Given the current environment of financial globalization, it is no longer possible for any individual country to fully manage cross-border risk on its own. And in this regard the global financial safety net, which at Korea's initiative has been placed on the agenda for the upcoming G20 Summit, can, I feel, effectively complement precautionary foreign reserves and lead to capital market stability eventually.

In two weeks, the G20 Summit will take place in Seoul. I have high expectations that leaders will reach agreements on many critical global issues, which will help overcome and prevent crises. I trust the G20 Seoul Summit will serve the purpose of guiding a new vision for a post-crisis economic paradigm that will definitely mitigate the uncertainty in the market. And alleviating this uncertainty is essential for currency volatility reduction and financial market stability.

Thank you very much.