

## **Edward S Robinson: Managing external shocks - Asia's shifting experience with capital flows**

Remarks by Mr Edward S Robinson, Deputy Managing Director (Economic Policy) and Chief Economist of the Monetary Authority of Singapore, at the 2024 Beijing Financial Street Forum on "Improving Modern Central Bank Systems, Enhancing Macro-Governance", Beijing, 18 October 2024.

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Distinguished speakers and guests, good afternoon

### **Introduction**

It is an opportune time to address the impact of US Fed policy on the global economy and on Asia. After a series of negative shocks, from the Covid pandemic, to supply chain disruptions, to the rapid tightening of interest rates in industrialised economies, Asian economies are now facing the more favourable prospect of falling interest rates in the US, Europe and elsewhere. Lower rates should help boost local economies, improving the outlook for capital inflows and creating space for Asian central banks to loosen policy domestically, should local conditions warrant it.

But every opportunity comes with risks. These include the possibility that inflation will resurge, the chance of recession as still-restrictive monetary policy continues to percolate through some markets, and the disconcerting spectre of global fragmentation. In considering how these risks might propagate through the global economy, I would like to focus on the effects of capital flows, historically a major channel for transmission of shocks.

### **Primacy of the Global Financial Cycle**

Asia's open trading economies have been susceptible to waves of sometimes destabilising capital flows, from surging inflows in boom times to sudden stops when risk appetite drops. Driving the flows, at least in part, were economic conditions in the large, industrialised economies and the monetary and fiscal policy settings associated with them. Experience from the Asian financial crisis, the Global Financial Crisis, and other episodes suggests that policymakers can be severely constrained in responding to these surges and stops, and that responses tended to be procyclical – loosening policy in the face of inflows and tightening to limit outflows. This history has led some researchers to propose the notion of a global financial cycle that can dominate financial conditions in emerging and smaller industrialised economies. On a strong interpretation of this view, the power of the global financial cycle has compressed the traditional trilemma of international economics into a dilemma, forcing a choice between an open capital account or monetary policy autonomy.<sup>1</sup>

### **Experiences with Capital Flows**

However, the experience of Asian economies in the recent tightening cycle points to an increased latitude in managing the impact of the global financial cycle while maintaining some policy autonomy. ASEAN economies weathered the post-pandemic round of interest rate hikes in industrialised economies surprisingly well, avoiding the capital surges and sudden stops they had suffered through during the earlier shocks. What conjunctural and structural factors might explain this apparent improvement?

First, the common global inflation shock and resulting synchronicity of monetary tightening across developed and emerging market economies reduced the risk of destabilising capital flows or currency fluctuations. The inflation cycle in ASEAN was also somewhat more contained than in the advanced economies. ASEAN economies reacted to the global inflation shock earlier, and their pre-emptive monetary tightening reined in domestic inflation and reduced incentives for capital outflows. Improved communication and orderly transmission of higher policy rates also supported risky asset classes, such as emerging market bonds and equities.<sup>2</sup>

Second, ASEAN economies had stronger buffers against outflows than in previous cycles. They maintained broadly balanced current accounts and benefited from positive foreign direct investment trends, terms of trade tailwinds and continued recovery in key sectors. With generally strong external positions, ASEAN economies also reduced their reliance on foreign capital, deepening their local currency asset markets and increasing domestic participation in these markets.

Third, ASEAN economies relied on expanded toolkits to reduce financial stability risks and dampen the impact of the global monetary cycle. Over the past few years, most have deployed macroprudential measures to reduce leverage, limit balance sheet mismatches, and discourage the formation of asset bubbles. When regional currencies faced depreciation pressures earlier this year, ASEAN policymakers engaged in discretionary policy management, accepted some currency flexibility, and used targeted foreign exchange interventions and administrative measures to temper currency volatility and capital outflows.

Extending our perspective to the last 30 years, recent research by MAS<sup>3</sup> confirms that capital flows to emerging markets in Asia – both in debt instruments and more generally – were heavily influenced by the external global financial cycle during the period from 1995 to 2010 – from the Asian financial crisis through the global financial crisis. On average, about 45 percent of the variation in capital flows during this period was attributable to external or global factors. However, our research also shows that this influence has diminished over the past 15 years, to the point where a much-reduced 10 percent of the variation in flows can be ascribed to external "push" factors. That looks like good news for policymakers in the region, who could reasonably conclude that they now have more policy space to address domestic shocks. Some of the policy initiatives already mentioned – notably the increased use of macroprudential measures and stronger commitment to inflation targeting – likely contributed to this encouraging development.

## **Global Synchronisation is Intact**

This transition to seemingly more benign capital flows is not the whole story, though. While capital flows might be less linked to the global financial cycle than they once were, the same cannot be said for some important domestic economic variables. For example, the influence of the external cycle on GDP growth appears to have increased rather than decreased in the more recent period. Domestic interest rates have also become more rather than less dependent on the global cycle.

An apparent implication is that other markets or channels may have taken over the role of traditional portfolio and other capital flows in transmitting external shocks to emerging economies. Possible alternative channels could include trades in currency and interest rate derivatives, which have grown significantly since the Global Financial Crisis. Other channels, including trade channels, may be doing more to transmit external shocks, although the evidence for this is preliminary. Further, it may be the case that emerging market economies pre-emptively adjust monetary policies to major shifts in interest rate cycles of monetary-dominant advanced economies, in addition to internal balance factors.

While the increased independence of capital flows from the global financial cycle is a promising sign for the development of policy autonomy and countercyclical policy space, it is clear that global factors are still important determinants of domestic prices and activity in Asian emerging market economies.

## **Policy Considerations**

Policymakers in the region recognise that we do not have the luxury of adopting a neat, textbook approach to the world. We cannot assume that capital flows will always respond to push the economy towards equilibrium.

Capital flows ought to respond to fill in savings-investment gaps, and exchange rates shift to reduce imbalances in the external sector. But we are often in a second-best world, in which fund flows are more driven by the short-term search for yield through carry trades, and by push factors related to the particular fiscal-monetary policy mix of the sending countries.

In these circumstances, inflation targeting remains an appropriate policy to respond to external shocks, supported by a credible fiscal policy framework. Policies to support economic and financial resilience include maintaining an adequate level of foreign reserves and building capital and liquidity buffers to shield the financial system against outflows. When markets overreact, when policy credibility is limited, or when balance sheets are overextended, some supplementary measures may prove useful. These could include foreign exchange interventions and macroprudential adjustments.

Clearly, emerging market currencies may sometimes overshoot, undershoot, or present financial stability risks. Hence the need for foreign exchange interventions. It could be a form of Jeffrey Frankel's "systematic managed floating", where the central bank regularly responds to pressures on the exchange rate by allowing them to be partly reflected in currency movements but also as changes in official reserves.<sup>4</sup> While we recognise the benefits of exchange rate flexibility as an effective shock absorber, the

currency should not become a propagator of volatility itself. In this sense, policy frameworks and calibrated interventions facilitate emerging market economies' continued, constructive engagement with the international economy and capital markets.

## **Singapore's Price and Financial Stability Approach**

In Singapore, the Monetary Authority of Singapore (MAS) is responsible for both price and financial stability. We hold the view that as a small open economy, a hub for both regional trade and financial flows, Singapore requires stability in both dimensions to ensure market confidence. MAS' mandate for both monetary and macroprudential policy means there is room to explore and exploit complementarity between the two policies. We have found it efficient to assign monetary policy to price stability, and macroprudential policy to financial stability.

The choice and effectiveness of monetary policy instrument have been substantially shaped by Singapore's circumstances - especially the high degree of openness to trade and capital flows. The exchange rate is the policy instrument, and it is managed against a trade-weighted basket of currencies, which is normally significantly less volatile than individual bilateral exchange rates. The currency is also managed within a policy band. This allows the trade weighted exchange rate to fluctuate and absorb temporary shocks, including the pressures of volatile capital flows; it provides us the flexibility to manage the exchange rate in line with price stability, while allowing some market determined movements. Conversely, macroprudential policies tend to be directed at preventing an excessive build-up of credit especially for property market transactions, to which the domestic banking system has important exposures. Macroprudential policies are complemented by comprehensive microprudential regulation that ensure individual banks' soundness.

## **Concluding Observations**

I would like to conclude with two observations.

First, price and financial stability are public goods and are secured in the global commons. Domestic policies alone cannot provide full protection against external shocks. Some degree of international cooperation will always help to improve outcomes. There are gains from cooperative engagement at the regional and international level. In monetary policy, this implies measures like standing or emergency swap lines from major economies and international institutions to provide liquidity during periods of heightened risk aversion. These proved useful during the last few global crises, and are likely to remain so as the world adjusts to a new monetary policy trajectory.

Second, in the final analysis, it is important that the suite of macroeconomic, macroprudential, and structural policies work in concert to promote a stable environment in which investors and domestic private agents are encouraged to adopt a long-term planning and investing horizon that promotes sustainable economic growth.

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<sup>1</sup> Miranda-Agrippino and Rey (2020), "U.S. monetary policy and the global financial cycle", *The Review of Economic Studies*, Volume 87, Issue 6.

<sup>2</sup> Hardy, Igan and Kharroubi (2024), "Resilience in emerging markets: what makes it, what could shake it?", *BIS Bulletin*, No 88.

<sup>3</sup> The key findings will be published in MAS' forthcoming Financial Stability Report in November 2024.

<sup>4</sup> Frankel (2017), "Systematic Managed Floating", *National Bureau of Economic Research Working Paper No. 23663*, August 2017, p. 2.