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Managing the Impact of Hot Money through Regulatory Coordination

In the aftermath of the 2008 financial turmoil, many economies, namely those in North America and Europe, were negatively affected, while emerging and East Asian economies appear to have avoided some of the effects. Stimulus packages aimed at encouraging economic growth and recovery were widely implemented, but the impact thus far has not been convincingly positive.

US economic growth since 2009 has not caught up with the decrease in 2008 thus far, despite recovery attempts. While the US Gross Domestic Product expanded at an annual rate of 2.50 percent in the 3rd quarter of 2010, the figure is lower than the first quarter of 2010, which may signal a potential recovery slowdown. Similar trends can also be seen in European economies, which in turn have led to the adoption of money easing policies in a bid to stimulate further and quickened economic recovery. For example, recently, the Federal Reserve of US has adopted 'quantitative easing' to the tune of USD 600 billion. In contrast, many of the Asian economies appear to have recovered from the ill-effects of the 2008 crisis: China, for example, has seen growth rates as high as 9.6 percent.

As a result of the difference in the speed of recovery from the crisis as well as policy reactions, interest rates in emerging economies have become relatively higher than those in the developed economies of Europe and North America. This widening of the interest rate spread, coupled with the globalization of financial markets across the world and the increase in risk and uncertainty worldwide, have led investors to the conclusion that their money is better invested in the emerging economies, even after accounting for the risks involved.

Evidence of Hot Money

As a result, investors are moving increasing number of funds into these emerging economies, leading to an inflow of hot money into these economies. Emerging market equity funds saw an inflow of more than 47 billion US dollars from January to early October this year, while emerging bond market funds experienced a similar inflow of about 57 billion US dollars for the same time period. In comparison, emerging bond market funds saw a comparatively smaller inflow of about 42 billion and 46 billion in the entire years of 2007 and 2009 respectively.

Similarly, the capital inflow into the equity markets of India, Indonesia, South Korea, the Philippines, Taiwan, Thailand, and Vietnam in the third quarter of 2010 alone was 11.5 billion US dollars, which led to an increase of equity prices in these markets by 8 to 23% in that quarter. Correspondingly, the exchange rates of the Korean won, Philippine peso, and Thai baht against the US dollar has increased by more than five percent, while the currencies of Malaysia, India, Indonesia, and other countries exhibited an appreciating trend.

Regulatory Responses

The fear among policy makers in these emerging economies is simply that the influx of hot money, if left unchecked, may lead to inflation in their economies. This influx may also cause a significant currency appreciation which may have a destabilizing effect on the economy through its impact on the trade balance, on which many emerging economies have based their growth policies. Similarly, an onset of increased money in the economy may result in cost of living increases and create a speculative mindset in various asset classes, such as in property or the stock market, which may prove to be more damaging to the economy when such bubbles eventually conclude.

Since many of the emerging economies are mainly export-driven, currency appreciation as a result of increased fund flows have been a major concern for regulators and policy makers. So are Inflationary pressures on real estates, and other goods and services. Concerns over these developments have prompted regulators to take measures to curb the effects of hot money.

Regulatory capital control responses thus far have also been similar, of which one of the most prominent is a tax on capital gains and interest earnings. Thailand has imposed a 15% withholding tax on interest and capital gains earned by foreign investors on Thai bonds, while South Korea plans to reintroduce a similar 14% withholding tax on interest earnings by foreign investors from government securities and a 20% capital gain tax.

Other measures, such as limiting the access and ease of buying and selling financial products, have also been implemented. For example, Taiwan has barred foreign investors from parking funds in time deposits, while Indonesia has implemented a mandatory holding period for government securities and made the central bank the only legal buyer of these securities if the securities were sold before the one month holding period. Korea has also imposed similar limits on financial institutions with regards to currency forwards and cross currency swaps.

ASIAN SHADOW FINANCIAL REGULATORY COMMITTEE'S RECOMMENDATION

In light of the developments as outlined above, we commend Asian policymakers for the targeted choice of capital controls, and wish to emphasize that hot money is not an issue that is limited to the recent financial crisis, or the quantitative easing initiatives implemented by the US Federal Reserve. The impact of hot money, and in concert, selective use of capital controls, is important for the long term development of financial markets and systems. Hence, capital controls, should be aimed not to discourage capital flow, but rather as a means of mitigating the adverse impact that an excess of hot money can have on an economy. We also urge Asian policymakers to consider regulatory coordination, rather than using capital controls indiscriminately. The benefit of taking this course of action is that it would enhance regulatory effectiveness on both national and regional levels, as well as avoid unhealthy regulatory competition and arbitrage which might undermine such regulatory initiatives.

Hence, the ASFRC recommends the following:

- Information sharing among Asian regulators on market conditions and financial institutions on various topics with an impact on financial systems. For example, regulators can share information on the identities and core business of international investors.

- Discussions among regulators on the rational and potential impact of impending regulatory changes within individual jurisdictions on the national and regional levels.

- Take initiatives to facilitate the understanding of decision making process and the legal and regulatory framework in different countries. For example, frequent exchange (short-term secondment) of regulatory officials among countries in the region.

- The establishment of a multi-lateral policy committee to study and implement coordinated financial regulatory policies among Asian regulators.

- That capital controls be used with extreme caution despite its attractiveness, and that it be recognised that capital controls may treat the symptoms but not necessarily solve the underlying economic problems.