From 'Cardinal Sin' to Policy Agenda? The Role of Capital Controls in Emerging Market Economies: A Study of the Korean Case, 1997-2011

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Outline

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The Increase of Capital Inflows in EMEs

Frame subtitles are optional. Use upper- or lowercase letters.

- Capital Inflows post-GFC: "Carry Trade", QE, interest rates, and quick returns
- Country-specific factors.
- Plus Factors for Developing Nations: attractive financing for investment, diversify risks, promote inter-temporal trade, develop financial markets.
- Minus Factors for Developing Nations: high demand for local currency, currency appreciation, cause bubbles in assets, housing, stock markets.

The History of Capital Controls - From 'Cardinal Sin' to Policy Agenda

- Capital Controls: Measures taken by a government, central bank, or other regulatory body to limit the flow of foreign capital in or out of the domestic economy (i.e., taxes, tariffs, outright legislation, volume restrictions, market-based forces)

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The History of Capital Controls - From 'Cardinal Sin' to Policy Agenda

A Brief History:

- Introduction (1920s) – Strengthening (1929) – Permanant feature of the international monetary system during the Bretton Woods System (1945-1971) – Keynesianism displaced during the transitional period (1980-2008) – Abolishment of capital controls (cardinal sin) – Advocation of capital controls in the aftermath of the Global Financial Crisis (2008-2011)

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Capital Controls and the Asian Financial Crisis

- The mainstream view that capital controls were bad was challenged because of the following reasons:
- East Asian countries had yet to develop a financial and capital system with sufficient prudential safeguards;
- The 'Double Mismatch' of maturity and currency made them vulnerable to capital inadequecy and currency depreciation;
- Previous foreign capital inflows would exit the country rapidly (hot money).

IMF reverses its position on capital controls

Example

Jonathan D. Ostry, Atish R. ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reignhardt. 2010. Capital Inflows: The Role of Controls. International Monetary FUnd Staff Position Note, SPN/10/04: pp.3-30.

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Opening in Response to Foreign Pressures

- 1980s: Korea experiences rapid economic growth in the presence of capital controls.
- Late 1980s: Policy making for liberalization process begins in the face of US macroeconomic policies and pressure on Korea for improved market access for US financial service providers.
- 1994: Foreigh Exchange System Reform Plan unveiled under foreigh pressures for further financial regulation.
- 1995-1999: A series of multiyear financial sector policy plans promulgated, with Korea's 1996 accession to the OECD.

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Opening in Response to Foreign Pressures

Table 1. IMF Stand-By Arrangement: Section on Korea's Capital Account Liberalization

Capital Account Liberalization	
I.	Liberalize foreign investment in the Korean equity market by increasing the ceiling on aggregate ownership from 26 percent to 50 percent by end-1997 and to 55 percent by end-1998. The ceiling on individual foreign ownership will be increased from 7 percent to 50 percent by end-1997.
II.	Effective immediately, for foreign banks seeking to purchase equity in domestic banks in excess of the 4 percent limit requiring supervisory authority approval, the supervisory authority will allow such purchases provided that the acquisitions contribute to the efficiency and soundness of the banking sector; legislation will be submitted to the first special session of the National Assembly to harmonize the Korean regime on equity purchases with OECD practices (with due safeguards against abuse of dominant positions.)
III.	Allow foreign investors to purchase, without restriction, domestic money market instruments.
IV.	Allow foreign investment, without restriction, in the domestic corporate bond market.
V.	Further reduce restrictions on foreign direct investment through simplification of procedures.
VI.	Eliminate restrictions on foreign borrowings by corporations.

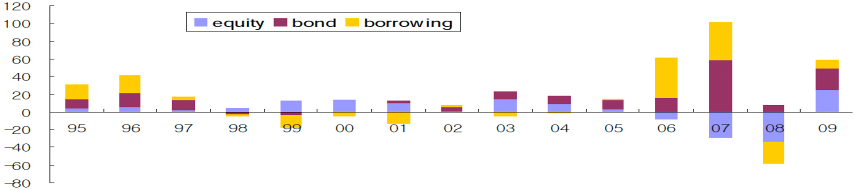
Source: *The International Monetary Fund*, IMF Stand-By Arrangement, Summary of the Economic Program, Republic of Korea, December 5, 1997.

Outline

Capital Flows Inflows and Outflows

- Consensus reached at home abroad upon sudden capital outflows in late 2008.

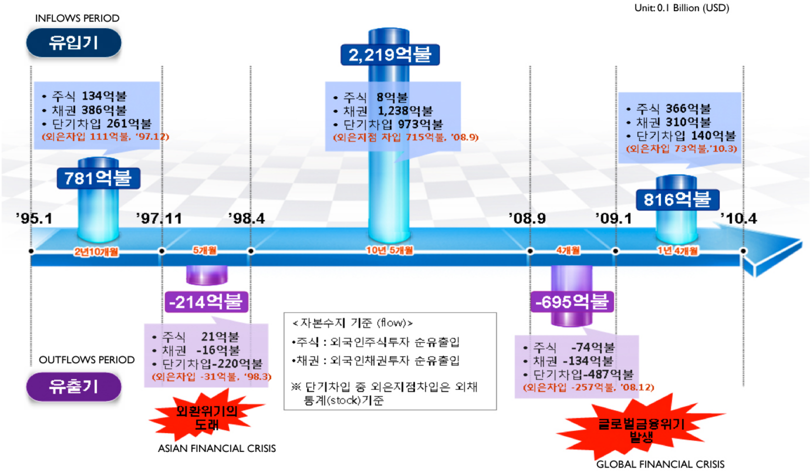
Figure 1. Capital Flows to and From Korea (1995-2009, Unit: Billion USD)



Source: *Ministry of Strategy and Finance, Republic of Korea, June 2010*

Capital Flows Inflows and Outflows

Figure 2. Foreign Capital Inflows and Outflows to Korea (1995-2010)



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Korea Limits Non-Deliverable Forwards Markets

- Non-Deliverable Forwards Markets (NDFs): a short-term, cash-settled currency forward between two counterparties.
- On the contracted settlement date, the profit or loss is adjusted between the two counterparties based on the difference between the contracted NDF rate and the prevailing spot FX rates on an agreed notional amount.
- 2004 - The South Korean Ministry of Finance and Economics (Mofe) introduced new regulations aimed at limiting activity in the non-deliverable forwards (NDF) market by onshore banks.
- The move is aimed at reducing the volatility in the Korean won exchange rates with other currencies.

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Korea Implements Macro-Prudential Levy

- The Partial Amendment Law to the Foreign Exchange Transactions Act was passed in the Korea National Assembly on April 5, 2011 and went into force from August 1, 2011.
- Ceilings on FX derivatives positions of all banks, a limit at 50% of their equity capital.
- Regulations on foreign currency bank loans (allowed for purchase of raw materials, FDI, repayment of debts, but limited use for domestic purposes)
- Prudential regulations for improving FX soundness of financial institutions (20 basis-point levy imposed on overseas debt maturing in less than one year)
- New policies under consideration (additional measures to discourage short-term borrowing abroad)

Summary and Conclusions

- Korea's policy direction and implementation (particularly in the G20 Seoul Summit) is not a drastic change; it is a step forward for macroprudential stability in the Korean economy in the aftermath of the GFC.
- The NDFs Limitation and Macro-Prudential Levy launched by the Korean government are in line with the global context of deploying capital controls.
- However, thus far, the actual effects of capital controls remain to be seen.
- As for policy recommendations, domestic efforts to strengthen financial monitoring and advisory system are strongly required in addition to efforts to control inflows from abroad.