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Capital mobility brings many benefits to a country's economy but can also create instability and worsen crises. Measures can and should be put in place to curb the more risky forms of capital flow and foreign-exchange speculation.

For my generation of central bankers, the rapid growth of cross-border financial transactions and international capital flows is one of the most important economic developments we have experienced over the past 30 years. There is no question that capital mobility can bring multiple benefits, yet in a number of countries international capital flows have been closely linked to financial crises. It is little wonder that the subject of capital account liberalisation remains highly contentious. Perspectives differ because what is beneficial to some countries may make others more vulnerable. After the recent financial crisis, however, there is greater consensus on the costs and benefits associated with international capital flows and how such flows can be better managed.

Not all capital flows are created equal. International capital movements in the form of foreign direct investment create a win-win situation for the recipient country and the investing country. Short-term capital, however, is highly volatile. Large and sudden inflows of foreign capital lead to exchange rate overshooting, loss of trade competitiveness, domestic credit booms and asset price bubbles, all of which can elevate systemic risks and create financial fragility. Once the economic and financial conditions start to deteriorate, the direction of capital flows will reverse abruptly, with devastating consequences. The pro-cyclical nature of international capital flows also gives rise to concerns that foreign investors suffer from excessive optimism and are prone to herd behaviour, both of which amplify asset booms and busts.

From a theoretical perspective, an economy cannot simultaneously pursue monetary independence, exchange-rate stability and capital mobility. Each country, therefore, must strike a balance that will ultimately promote financial stability and foster long-term economic development. International capital flows present a set of macroeconomic and prudential policy challenges. There is no shortage of tools for meeting these challenges. Fiscal policy, monetary policy, exchange-rate policy, prudential regulation and capital flows management come immediately to mind. Yet the abundance of policy tools belies the difficulty of finding the appropriate policy mix.

Faced with a surge in capital inflows, prudential regulations that target specific segments of the economy can play a useful role in dampening the demand for speculative capital. Hong Kong, Singapore, South Korea and Taiwan, for example, have all recently introduced targeted prudential measures to curb real estate speculation as international capital inflows continue to put upward pressure on asset prices in these countries.

Allowing the exchange rate to adjust passively to capital flows is another possibility. But for small economies with deregulated capital accounts, this policy will lead to wild exchange-rate fluctuations that can create havoc for the tradable sector. For these countries, a better option would be to keep the nominal exchange rate flexible, while allowing the real exchange rate to reflect economic fundamentals. This will make it less attractive for currency speculators to take advantage of a rigid exchange rate regime and will soften the impact of volatile capital flows. Accumulating official reserves can also act as a buffer.

Capital management needed

For many countries, choosing the right exchange-rate regime and maintaining an appropriate level of foreign exchange reserves may not suffice. In the face of substantial inflows, macro and prudential policies should be complemented by some form of capital management. This sentiment is shared by a number of governments around the world. For example, Brazil announced in October 2009 that a 2% tax would be levied on foreign investment in local bonds and stocks. On June 13, 2010, South Korea unveiled measures to mitigate the volatility of capital flows and exchange rates, including setting ceilings on the foreign exchange derivatives positions of domestic banks and foreign bank branches at 50% and 250% of their capital, respectively. On June 16, Indonesia announced a series of measures to stabilise its financial markets, including abolishing the rule limiting banks' on-balance-sheet net open positions to a maximum of 20% of their capital, while maintaining overall net open positions at 20% of capital; widening the overnight inter-bank rate corridor and imposing a minimum one-month holding period for Bank Indonesia Certificates.

As a small and highly open economy, Taiwan recognises that unfettered financial liberalisation and unbridled international capital flows can put financial stability at risk. While many countries are busy debating which of the many government agencies should be responsible for monitoring systemic risks and financial stability, there is no ambiguity in Taiwan. Promoting financial stability and maintaining exchange rate stability are two of the four operational objectives set out for the central bank in Taiwan's Central Bank Act. Articles 19 to 31 and 33 to 35 of the act go as far as listing a variety of policy instruments that can be used to achieve those objectives, including targeted prudential regulations.

To prevent Taiwan's foreign exchange market from being disrupted by international capital flows and to ensure that exchange rates are determined by economic fundamentals rather than short-term capital movements, the Central Bank of the Republic of China (Taiwan), or CBC, has introduced a number of measures to manage foreign capital inflows. By way of background, foreign ownership accounts for 30% of Taiwan's stock market capitalisation. Although Taiwan has more than 10,000 registered foreign institutional investors (FINIs), roughly 20 are responsible for more than 40% of all FINI foreign-exchange transactions. The volume of FINI foreign-exchange trading tends to fluctuate wildly, frequently disrupting Taiwan's foreign-exchange market.

Under the current system, foreign capital invested in the local securities markets can move in and out of the country freely. However, some foreign portfolio investors have built up sizable Taiwanese dollar positions in low-yielding or non-interest-bearing investments. One suspects that these FINIs are more interested in currency speculation than securities investment. To prevent currency speculators from increasing exchange-rate volatility, the CBC constantly has to remind foreign investors to use Taiwanese dollar funds in a manner consistent with the declared purpose of securities investment. A reporting system is also in place to track large foreign-exchange transactions. These efforts have been largely effective, partly because the CBC has the power to carry out target examinations related to the implementation of foreign exchange and monetary policy.

Regional co-operation has a useful role to play in managing international capital flows. Because foreign investors are prone to herd behaviour, financial crises are often triggered by capital flows linked to the contagion effect. In these instances, events and shocks experienced by one country are quickly transmitted to another economy, an entire region, or the rest of the world. For example, the 1997-98 Asian financial crisis that originated in Thailand quickly spread to other Asian economies. More recently, the same phenomenon was also observed during the global financial turmoil and the European sovereign debt crisis.

Working together

As the world becomes increasingly interconnected, it is important for countries with similar macroeconomic characteristics to work together to mitigate the risks associated with international capital flows. As I pointed out during the 2010 Asian Development Bank annual meeting in Tashkent, Uzbekistan, there are several ways in which regional co-operation can promote financial stability, including mechanisms to monitor capital flows, financial support facilities and regional exchange-rate arrangements.

A number of east Asian countries have been co-operating under the framework of regional economic surveillance to monitor short-term capital flows. However, this co-operation has seldom moved beyond information sharing. If these countries can take concrete and concerted actions, it will help promote regional financial stability.

In terms of financial support facility, the Chiang Mai Initiatives Multilateralisation (CMIM) [a multilateral currency swap arrangement between 13 Asian countries] came into effect on March 24 this year with a reserve pool of $120bn. However, the CMIM should evolve into a comprehensive multilateral swap mechanism across Asia with a credible regional institution at the centre to serve as the primary intermediary.

Regional exchange-rate stability is conducive to promoting economic and financial stability. When exchange rates are stable, lower transaction costs and reduced uncertainty will boost growth in intra-regional trade and investment. Asian countries should set up a formal regional exchange-rate coordination mechanism through which stable currency relationships can be established.

Over the past few years, the world economy has faced unprecedented challenges. Governments from all over the world have adopted aggressive expansionary monetary and fiscal policies to deal with the worst economic recession since the 1930s. These decisive actions have produced positive results. Although Asian economies have fared well in the early recovery phase, we should be mindful that the global financial crisis has also exposed a number of vulnerabilities.

It is encouraging to see that on June 27, 2010, the G-20 economies pledged to strengthen the global financial system and build a more stable and resilient international monetary framework. The need for regional and multilateral efforts to deal with capital volatility and prevent crisis contagion, however, has been largely overlooked. The international community should work together to put the necessary measures in place to manage international capital flows more effectively so that each country can pursue appropriate policy and reforms to maintain financial stability and promote sustainable economic growth.