ADBI Working Paper Series

Managing Capital Flows in an Economic Community: The Case of ASEAN Capital Account Liberalization

Yung Chul Park
and Shinji Takagi

No. 378
August 2012

Asian Development Bank Institute

Yung Chul Park is distinguished professor at the Division of International Studies, Korea University. Shinji Takagi is professor of economics at the Graduate School of Economics, Osaka University.

An earlier version of this paper was presented at the Policy Research Institute PRI)/ Asian Development Bank Institute (ADBI) conference on "Achieving Financial Stability—Lessons from the Eurozone Crisis for Macroeconomic and Financial Stability," held in Tokyo on14 March 2012. The authors thank Professor Hwee Kwan Chow and other conference participants for useful comments on an earlier draft. They remain solely responsible for any remaining errors.

The Working Paper series is a continuation of the formerly named Discussion Paper series; the numbering of the papers continued without interruption or change. ADBI's working papers reflect initial ideas on a topic and are posted online for discussion. ADBI encourages readers to post their comments on the main page for each working paper (given in the citation below). Some working papers may develop into other forms of publication.

Suggested citation:

Park, Y. C. and S. Takagi. 2012. Managing Capital Flows in an Economic Community: The Case of ASEAN Capital Account Liberalization. ADBI Working Paper 378. Tokyo: Asian Development Bank Institute. Available: http://www.adbi.org/working-paper/2012/08/30/5223.managing.capital.flows.asean.account.liberalization/

Please contact the author for information about this paper.

Email: yungcp@korea.ac.kr; takagi@econ.osaka-u.ac.jp

Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

Abstract

The paper uses the emerging Association of Southeast Asian Nations (ASEAN) Economic Community as a motivation to explore the issue of capital flow management in an economic community. Although there is an increasingly shared view that capital flow management measures should be part of the routine policy toolkit of emerging market economies, the logic of an economic community appears incompatible with extensive controls on capital flows. Substantial, if not complete, capital account liberalization must therefore take place across ASEAN. Few ASEAN countries are expected to have dismantled all capital account restrictions by 2015, thus requiring little need to introduce an entirely new set of capital flow management measures. Over the longer term, the ultimate requirements of an economic community seem to dictate that any remaining measures be market-based and not residency-based. Regional cooperation would be useful in enhancing individual country efforts, including collectively agreeing on the definition of a crisis and affirming the right of a member country to introduce an emergency measure in the event of a crisis. Our assessment is that most of the inflow restrictions could be removed quickly without creating additional risks; controls on private capital outflows could also be relaxed, albeit more judiciously, if for no other reason than to promote regional financial integration.

JEL Classification: F33, F36, O53

Contents

1. INTRODUCTION

This paper explores the issue of capital flow management in a region committed to free capital mobility, using as a case study the economic community currently being formed by the Association of Southeast Asian Nations (ASEAN).[1] The ASEAN leaders, meeting at the 12th Summit in 2007, affirmed their commitment to the creation of an ASEAN Economic Community (AEC) by 2015 and "to transforming ASEAN into a region with free movement of goods, services, investment, skilled labor, and freer flow of capital." The AEC is meant to transform ASEAN into a single market and production base by (i) accelerating regional integration in the priority sectors, (ii) facilitating the movement of business personnel, skilled labor and talents, and (iii) strengthening its institutional mechanisms. Regional financial integration, which involves the two pillars of capital account liberalization and financial services liberalization, would constitute a critical component of this process.

This policy-driven process of financial integration in ASEAN comes against the background of an on-going paradigm shift in the way we think about international capital flows. Use of capital controls and other capital flow management measures, once condemned by the mainstream thinking of the economics profession, has assumed greater respectability in recent years (IEO 2004). Especially following the global financial crisis of 2007–08, it has become increasingly accepted as a legitimate tool of protecting domestic financial markets from the vicissitude of cross-border capital flows (Ostry et al. 2011); the Group of Twenty (G20) finance ministers and central bank governors in October 2011 stated that these capital flow management measures (CFMs) "may constitute part of a broader approach to protect economies from shocks" and "can complement and be employed alongside, rather than substitute for, appropriate monetary, exchange rate, foreign reserve management and prudential policies."[2]

The logic of an economic community, however, appears incompatible with maintaining extensive controls on regional, if not global, capital flows. An economic community means that economic agents residing in any member state can freely engage in any region-wide economic activity, including lending and borrowing; such economic freedom would be restricted if legal or administrative formalities were imposed to curtail the movement of capital. Although the AEC does not entail the complete removal of restrictions on cross-border capital flows (the commitment is only to "freer" flow of capital), it nevertheless must require capital mobility within the region to be largely free. Given the low degree of capital account openness in some

[1] ASEAN is made up of the following 10 countries of Southeast Asia: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.

[2] "G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences," as endorsed by G20 Finance Ministers and Central Bank Governors, dated 15 October 2011.

ASEAN countries, as shown in the paper, this means that substantial capital account liberalization (CAL) will have to take place relatively quickly across ASEAN. But what is the degree of openness they should aim to achieve in order to create a working economic community, while protecting themselves from the risks of capital flow volatility?

The need for freer capital mobility becomes even greater as regional economic integration progresses further under the AEC. Free movement of investment presupposes the ability to transfer funds across national borders. Free movement of skilled labor necessitates the ease of transferring funds from one country to another for a variety of purposes, as the sphere of economic activities becomes increasingly regional, not national. In turn, regional capital mobility promotes further regional trade integration by facilitating payment for current transactions through cross-border lending and borrowing. Substantial CAL must therefore accompany the concurrent efforts to allow free movement of goods, services, investment, and skilled labor, as envisioned by the aims of the AEC. Here, the experience of the European Union (EU) is paramount—in creating a single market, the EU member states have dismantled all barriers to the free movement of capital. In fact, CAL was completed almost a decade before the launch of a single currency, the euro, in the original 11 countries of the euro area.

The challenge posed by regional financial integration is that, as long as some ASEAN countries are fully open to global capital flows, the sphere of integration inevitably becomes global. The fungibility of money makes it difficult to discriminate explicitly against non-ASEAN market participants (even if it were possible under international conventions), but ASEAN's integration process in any case upholds the "principles of an open, outward-looking, inclusive, and market-driven economy consistent with multilateral rules." ASEAN countries thus face the imperative of dismantling restrictions on cross-border capital flows while making sure that they are protected from the volatility of global capital flows. This they must do in a manner consistent with the ultimate requirements of an economic community. This paper is a modest attempt to suggest a possible way forward for ASEAN countries, individually and collectively, as they continue to liberalize their capital accounts as part of establishing the AEC.

The rest of the paper is organized as follows. Section II considers the benefits and risks of free capital mobility as well as the emerging consensus on the need for capital flow management. Section III discusses the pace and sequencing of CAL, reviews agreements under ASEAN's existing frameworks on CAL, and assesses the capital account openness of ASEAN countries in an attempt to see how far they must move to achieve CAL. Section IV, in considering safeguard measures that can be used in a liberalized capital account environment, reviews prudential measures introduced recently by countries in the region, including the Republic of Korea; it then proposes a framework of regional cooperation as well as some concrete steps ASEAN countries could take to liberalize their capital accounts over the coming years. Finally, section V presents concluding remarks.

2. RATIONALES FOR CAPITAL FLOW MANAGEMENT

2.1 Benefits of Capital Flows

In neoclassical economics, the case for free capital mobility is similar to the case for free trade: it promotes an efficient allocation of savings across national borders, hence greater economic growth and welfare (Fischer 1998). However, there has been surprisingly little conclusive evidence to date to either support or refute such a view. Much of recent empirical work has addressed this issue from the standpoint of the effect of capital liberalization on economic growth (see Edison et al. 2002 for a survey). The debate remains inconclusive insofar as such empirical studies inherently involve a joint test of the effect of liberalization on growth and the particular method of quantifying the degree of liberalization. The inconclusiveness of these studies may also be due to a fundamental misspecification of the way they test the benefits of capital account openness. It may be that the growth-enhancing effect of openness is a one-time event. A series of studies that directly tested the one-time benefit of a discrete change in capital account policy—which Henry (2007) calls the policy-experiment approach—have drawn a much less ambiguous conclusion about the positive impact of stock market liberalization on growth and investment. The positive impact of capital account openness has also been shown to be less ambiguous for foreign direct investment (FDI) flows, even if the conventional approach is used (Reisen and Soto 2001).

Recent studies argue that the benefits of free capital mobility arise not so much from the greater availability of financial resources as from the enhanced productivity associated with foreign capital (Prasad and Rajan 2008). It follows that a country must be above a certain "threshold" of institutional and economic development to be able to translate foreign capital into productivity growth. Kose, Prasad, and Taylor (2009) present evidence that financial depth and institutional quality are the two most important variables that allow foreign capital inflows to have a positive effect on growth. Other studies have focused on the indirect benefits of CAL, such as financial sector development, institutions, governance, and macroeconomic stability. There is increasing evidence that financial openness promotes the development of the domestic financial sector, impose discipline on macroeconomic policies, generate efficiency gains among domestic firms, and unleash forces that result in better public and corporate governance (Kose, Prasad, Rogoff, and Wei 2009). Then, CAL helps build the very conditions that will contribute to making the process productive.

2.2 Risks of Capital Flows

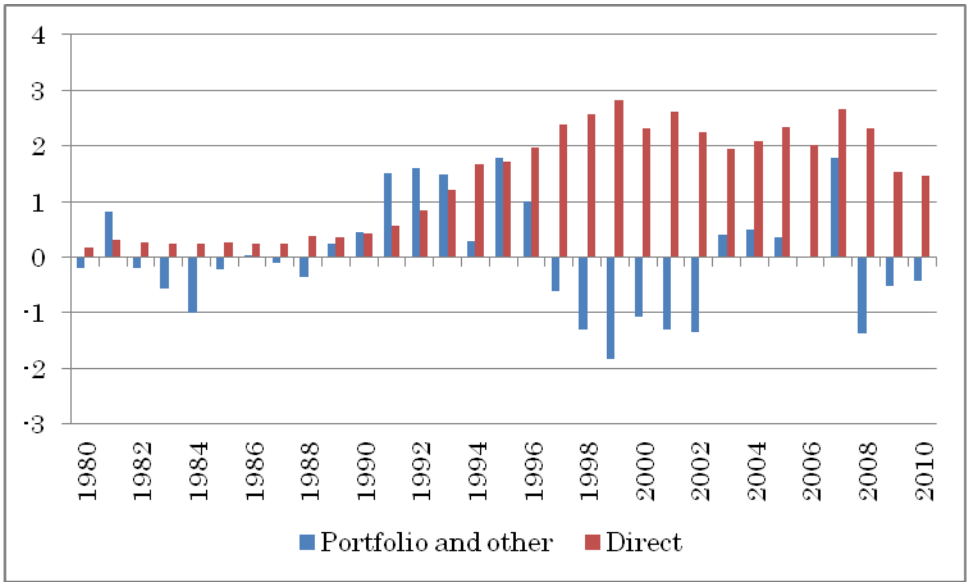
It must be acknowledged that emerging market and developing countries are inevitable recipients of capital inflows in the process of building their capital labor ratio up to the levels prevailing in mature economies, but in reality the recipients of large capital inflows have typically been concentrated in a handful of emerging market economies, especially in East Asia and Eastern Europe (Grenville 2010). This suggests that pull factors have played a particularly important role in determining the direction and size of global capital flows. At the same time, the pattern of capital flows seen in many individual countries has also corresponded remarkably well to the pattern of global capital flows into emerging and developing countries. Thus, the importance of push factors is also evident.

Added to the global factors are regional factors. Recent experience suggests that there is a geographical component to the pattern and size of net capital inflows, which Schadler (2010) calls the “neighborhood” effect. Conversely, when sudden outflows cause a currency crisis, contagion often has a regional focus, as was the case in Asia at the time of the 1997 crisis or Europe at the height of the 2008 global financial crisis. Part of the reason must be related to the strengths of interconnectedness among the neighboring economies of a region. But at the same time, some see in this the role of speculation, herd behavior and other non-economic factors (Cooper 1999). In emerging stock markets in particular, there is empirical evidence to show that foreign investors display greater herding behavior than domestic investors (Bikhchandani and Sharma 2001).

As a result, capital flows have been highly cyclical at the global level and, at the level of individual emerging markets, highly procylical. Globally, cross-border capital flows to emerging and developing countries have seen three cycles of about 10 years each over the past three decades (Figure 1). In the early 1980s net capital inflows dried up and turned negative, in the aftermath of the developing country debt crisis. This was followed by a surge in net capital inflows, which lasted until the Asian financial crisis of 1997–98. Net capital inflows then turned negative until the mid-2000s. Net capital inflows surged in 2007 before collapsing after the global financial crisis. It should be pointed out that this cyclicality does not apply to FDI, at least to the same extent. Though net FDI inflows do exhibit fluctuations, they have consistently been positive during 1980–2010. Moreover, the size of net FDI inflows relative to GDP has seen a substantial and permanent increase over this period.

Figure 1: Net Private Capital Inflows to Emerging and Developing Economies

(% of GDP)



Source: IMF, WEO database

At the country level, a collective action problem appears to operate in the dynamics of emerging financial markets. When an economy enters into the upswing phase of a business cycle, banks and other non-bank financial institutions expand their lending in the belief that credit risk has decreased. Traditional retail deposits (core liabilities) do not often keep pace with asset growth and banks turn to other funding sources, such as domestic and international wholesale funding markets (non-core liabilities) to finance their lending, causing a surge in capital inflows. Hahm et al. (2012) use Korean data to demonstrate that the non-core bank liabilities are indeed more procyclical than the core liabilities. A large share of the lending so funded is often allocated to financing the construction of residential houses and commercial estates, setting off a boom and a bubble in the real estate markets.

A credit expansion feeds, and is often fed by, an asset market boom. Banks and other financial institutions may realize that their lending operations could indeed create an asset market boom, sowing the seeds of a bubble, which will eventually burst. It would be in their interest to restrain their lending collectively, but there is no market mechanism to bring about such an agreement among financial institutions. Eventually, the expansion phase comes to an end and the economy enters the contractionary period of the business cycle. At this point, foreign lenders become conscious of the potential increase in the credit risk of their exposure and begin to recall the existing loans while refusing to extend new ones. There follows a sudden stop of capital inflows and, worse still, large capital outflows. Because all foreign financial institutions and other lenders behave the same way, they end up deepening the contraction in the process.

2.3 The Emerging Consensus

With the recognition that capital inflows are procyclical and that global factors play a critical role in the propagation of cyclicality, there is now a developing consensus that emerging market economies can (or should) impose capital controls and other capital flow management measures. In particular, departing from its long-standing position, the IMF (both its staff and the Executive Board) has recently come out for advocating the imposition of what they now call "capital flow management measures (CFMs)" under certain circumstances (Ostry et al. 2010, 2011; IMF 2011a). Faced with the potential damage a sudden surge in capital inflows could cause, the IMF argues, emerging economies may be justified in introducing controls especially on the risky forms of foreign borrowing, to prevent a large and unsustainable currency appreciation and to fend off a currency or banking crisis that may ensue.

The controversial aspect of the IMF's position concerns the hierarchical approach it proposes—or the sequence by which different measures are to be implemented. IMF (2011a), for example, proposes to break down CFMs into (i) residency-based CFMs (often called capital controls) and (ii) other CFMs, which in turn consist of (a) prudential measures that differentiate transactions on the basis of currency; and (b) others. On this basis, they suggest guidelines for policymakers who are faced with a surge in capital inflows: (1) the first line of defense is macroeconomic policies, such as tighter fiscal policy or greater exchange rate flexibility; (2) the second line of defense is targeted CFMs that do not discriminate transactions on the basis of residency; and (3) as the last resort, residency-based CFMs may be used. CFMs must also be proportional to the specific macroeconomic or financial stability concern at hand. For example, residency-based CFMs may be appropriate for flows that are not intermediated by regulated financial institutions; prudential measures are more appropriate for flows that are intermediated by regulated financial institutions.

In this hierarchical framework, the timing of moving from lower-type to higher-type measures is determined by the perceived nature of the problem (whether macroeconomic or prudential) as well as by the available policy space (Ostry et al. 2010). If the problem is macroeconomic (for which net flows are relevant), macroeconomic policy should be the first line of defense; if it is prudential (for which gross flows become more relevant), prudential policies could be the first to be employed. It is only when (i) the economy concerned is operating near potential, (ii) the level of reserves is adequate, (iii) the exchange rate is not undervalued, and (iv) the flows are likely to be transitory, use of residency-based CFMs (i.e., capital controls) is justified. The use of capital controls should come after the use of other tools has been exhausted, given the risk that they may be imposed for beggar-thy-neighbor reasons. Ostry et al. (2011), however, note that when inflows bypass markets and institutions, capital controls could be the best option.

Some object to the attempt by an international organization to establish a "code of conduct" for capital flow management; in particular, they reject the notion that a country can use capital controls only as a last resort after having exhausted the more conventional macroeconomic measures. Batista (2012), for example, argues that macroeconomic measures are often not sufficient to deal with a surge in capital inflows and that the beggar-thy-neighbor type effect of capital controls has been exaggerated. Likewise, Mohan (2012) proposes that CFMs should be part of the normal toolkit of overall macroeconomic management. These might include taxes and unremunerated reserve requirements (URR), special licensing requirements on external borrowing, and even outright limits or bans on foreign borrowing; they could cover all inflows or might differentiate between different types and maturities.

Conspicuously lacking in this discussion, however, is the need (or the lack thereof) to manage capital outflows. Ostry et al. (2010, 2011) appear to assume that controlling inflows would be sufficient to moderate capital outflows, thereby mitigating the procyclicality of net foreign borrowing. But when foreign lenders and investors head for the exit, the size of potential capital outflows is given by the *existing stock* of foreign liabilities. As international creditors deleverage, an emerging market economy could experience a fall in risk tolerance, a tightening of financing constraints, and plummeting asset prices. Foreign banks may then cut off credit lines and refuse to roll over short-term loans; foreign investors may cash in their holdings of bonds and equities; local banks and other financial institutions may lose access to global wholesale funding markets. As a result, the economy under strain is likely to face shortages of reserve currency liquidity, mostly US dollar funding, stemming from the shrinkage of their *stocks* of foreign liabilities.

When faced with a massive outflow of capital, what should the authorities of emerging market economies do? They could withdraw some or all of the CFMs on inflows, the kinds proposed by Ostry et al. (2010, 2011) and others, which may well succeed in discouraging the outflow of certain types of capital. This, however, will not prevent the outflow of the foreign liabilities not covered under the CFMs, including foreign holdings of domestic bonds, equities, and other derivative products. The capital flow reversal may call for direct intervention on the part of the authorities to control the outflow of foreign capital. That is to say, if there is a need for controlling capital inflows, there is also a need for controlling capital outflows.

3. CAPITAL ACCOUNT LIBERALIZATION IN ASEAN

3.1 Pace and Sequencing of Capital Account Liberalization

The idea that capital account liberalization must be managed properly forms the basis of the new orthodoxy that emerged in the aftermath of the capital account crises of the late 1990s. The new orthodoxy favors a gradualist approach, emphasizing the need for sequencing and for establishing preconditions (Ishii et al. 2002). While there are no simple rules for sequencing, the broad principles are to pursue macroeconomic policies and structural reforms that promote financial sector stability, while gradually liberalizing the capital account as preconditions are met. Elements of sound macroeconomic policies might include fiscal discipline, prudent external debt management, a flexible exchange rate, and transparency in the conduct of monetary and exchange rate policies. Financial policies must be designed to promote prudent risk management, supported by a strong capital base, strict disclosure requirements, and well-designed liquidity management. To develop broad, efficient, and liquid domestic financial markets would be particularly important.

Within the context of ASEAN, the AEC Blueprint (under “Freer Flow of Capital”) calls for the following specific actions as preconditions for CAL: (i) achieve greater harmonization in capital market standards in ASEAN in the areas of offering rules for debt securities, disclosure requirements and distribution rules; (ii) facilitate mutual recognition arrangement or agreement for the cross recognition of qualification and education and experience of market professionals; (iii) achieve greater flexibility in language and governing law requirements for securities issuance; (iv) enhance withholding tax structure, where possible, to promote the broadening of investor base in ASEAN debt issuance; and (v) facilitate market driven efforts to establish exchange and debt market linkages, including cross-border capital raising activities.

The Blueprint, for the liberalization of capital movements, has furthermore established the following guidelines:

- Ensuring an orderly capital account liberalization consistent with member countries’ national agenda and readiness of the economy;
- Allowing adequate safeguard against potential macroeconomic instability and systemic risk that may arise from the liberalization process, including the right to adopt necessary measures to ensure macroeconomic stability; and
- Ensuring the benefits of liberalization to be shared by all ASEAN countries.

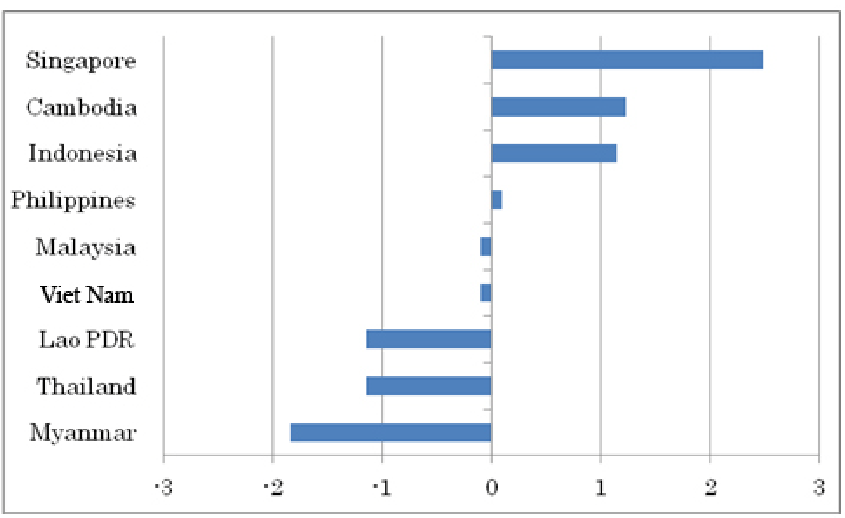
In addition to these broad guidelines, the timeline of various measures have been put forth by three ASEAN frameworks on capital account liberalization, namely: (i) the AEC Strategic Schedule, through 2015; (ii) the ASEAN Capital Market Forum (ACMF) Implementation Plan, through 2015; and (iii) the Working Committee on CAL (WC-CAL) Work Plan, through 2015. A reading of these documents suggests that nothing concrete or binding has yet been agreed on. In particular, the ASEAN Strategic Schedule appears to be quite general, while the WC-CAL Work Plan is still at an early stage, with lists of specific rules said to be being prepared. The principles of harmonization and mutual recognition are advocated by the ACMF Implementation Plan as a means of promoting the regional flow of financial products. It is not clear what is envisioned for the years beyond 2015, as it is unrealistic to expect full capital account liberalization to be achieved by 2015 in all countries.

3.2 Assessing Capital Account Openness

Identifying areas where existing capital account restrictions might be removed in the coming years would require assessing the existing capital account openness of individual member countries. At least, this will give an indication of how far they must go to achieve CAL. A good starting point for this purpose is the index of capital account openness developed and periodically updated by Chinn and Ito (2009) based on the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (Figure 2). As of 2009, the capital account openness of ASEAN countries ranged widely, from -1.844 for Myanmar, a bona fide financially closed economy, to +2.478 for Singapore, a bona fide financially open economy (though the index is not calculated for Brunei Darussalam , we believe it is similar to Singapore's as the two countries are almost fully integrated financially). Between these are three groups of countries: (i) Cambodia (to which Brunei Darussalam might also be added); (ii) Lao PDR and Vietnam; and (iii) Indonesia, the Philippines, Malaysia, and Thailand.

The first group represents financially open economies, but this largely reflects the lack of a deep domestic financial system, and hence the lack of (and need for) legal infrastructure to regulate cross-border financial flows. The challenge for them is to develop domestic financial markets over time while maintaining financial stability as they become subject to the volatility of capital flows. The second group represents countries with a need to develop domestic financial markets while they dismantle capital account restrictions. The third group has high de facto capital account openness, but these countries are in the intermediate range of de jure openness. By liberalizing certain administrative rules and according greater freedom to additional types of financial flows, they could contribute the most to the process of ASEAN financial integration without necessarily incurring additional risks.

Figure 2: Capital Account Openness in ASEAN Countries, 2009



Source: Chinn and Ito (2009).

A detailed reading of the latest issue of the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (IMF 2011b) suggests the following features of the ASEAN capital account regime. First, though some countries are highly open, many still maintain various restrictions on capital flows. Second, controls are tighter on outflows for most countries. As emerging market and developing economies, it is not surprising that they have a net external debtor position. What is surprising is the small gross creditor position in such countries as Indonesia (only 5% of GDP, including direct, portfolio and other investments), the Philippines (16%), and Thailand (18%).[3] The region's bias toward inflows has had the effect of discouraging capital inflows from within ASEAN, but has acted to encourage inflows from advanced countries outside the region.

Third, although all countries except Myanmar have accepted the obligations under Article VIII of the IMF Articles of Agreement (thus agreeing not to impose restrictions on the making of payments and transfers for current account transactions), many countries maintain current account-related payment restrictions, such as the repatriation or surrender requirements and strict verification procedures for service payments. Fourth, almost all countries have restrictions on the offshore use of their currencies, possibly as a safeguard against speculation. While this is a legitimate reason, if all countries restrict the offshore use of their currencies, it could act as an impediment to the promotion of regional financial integration.

Fifth, many countries place more restrictions on external borrowing than portfolio inflows; likewise, many, including Singapore, place some restrictions on external lending, especially in their national currencies. The authorities may have drawn a lesson from the Asian crisis that short-term bank borrowing is easily reversible, but in a bank-dominated financial system, regional financial integration will not progress very far unless banks are allowed to do their business more freely. Sixth, many countries limit the ability of investors to hedge foreign currency risks, including the use of derivative transactions. Legitimate hedging for trade or investment purposes are often allowed, but too much of a grip on autonomous financial transactions could limit market liquidity and runs counter to encouraging financial integration.

4. COPING WITH THE RISK OF CAPITAL FLOW VOLATILITY

4.1 Safeguard Measures

It is both unreasonable and unrealistic to expect all ASEAN countries to have achieved full capital account liberalization by 2015; many of these countries will likely retain some, if not all, of the restrictions they now impose on capital transactions. ASEAN capital account

[3] These numbers are obtained from the international investor positions of these countries at the end of 2008, as reported in IMF, *International Financial Statistics*.

liberalization will be an ongoing process over the coming years, with the end goal of achieving a high degree of capital account openness while preserving adequate financial stability. In most countries, therefore, there is little need to introduce an entirely new set of capital flow management measures. But it is useful to consider the types of CFMs that the countries may want to introduce or retain in order to maintain financial stability in a highly liberalized environment, given the ultimate requirements of an economic community.

We propose that the following two principles should guide the selection of capital flow management measures to employ when ASEAN has substantially achieved capital account liberalization:

- Non-resident ASEAN economic entities should have the same access to all national markets within ASEAN as the resident counterparts. This means that residency-based measures should be avoided, even if it is possible to treat non-national ASEAN entities more favorably than non-ASEAN entities.
- In terms of facilitating the ability of ASEAN-based entities to do business across ASEAN, they should not be subjected to approval requirements for engaging in capital transactions. This calls for market-based measures.

ASEAN must agree on these and other principles governing which capital flow management measures are compatible with the AEC.

Until such time as domestic financial markets become sufficiently deep and risk management skills fully developed, possible safeguard measures could include: (i) requiring cross-border flows to be effected through authorized domestic intermediaries;[4] (ii) routine ex post reporting requirements; (iii) requiring transactions to be registered with the central bank; (iv) placing limits on the open foreign exchange positions of banks and corporations; and (v) allowing differential reserve requirements on foreign currency deposits. Prudential regulations aimed at domestic institutions, such as tighter loan-loss provisions and capital requirements (e.g., with respect to external lending), could also serve as a safeguard measure (Park 2011). Some of these measures are already in place in some countries.

It is instructive in this context to review some of the measures introduced recently by countries in Asia, against a renewed surge in capital inflows that occurred in the aftermath of the global financial crisis. From June 2010 to July 2011, for example, Indonesia introduced several measures to lengthen the maturity of short-term capital inflows through central bank

[4] Prasad and Rajan (2008) suggest in this context that household flows should be channeled through institutions at an early stage of capital outflow liberalization. For example, the government could authorize closed-end mutual funds to issue shares denominated in the domestic currency, the proceeds from which could then be invested in foreign assets. In this set up, the central bank can control the timing and amount of outflows by stipulating the amount of foreign exchange it would make available to the mutual funds in a given period. A similar arrangement could be considered by the low-income ASEAN countries as they begin to liberalize controls on outflows.

certificates (SBIs); to reduce short-term external borrowing; and to reduce currency mismatches in bank balance sheets (Table 1). In announcing the first of these measures, in June 2010, Bank Indonesia stated that they were not intended to "control foreign exchange" but to "shore up financial system stability and encourage financial market deepening."

Table 1: Capital Flow Management Measures in Indonesia, 2010–11

Dates of announcement or implementation	Measures
June 2010	Imposed a one-month holding period for SBIs while announcing the introduction of longer-term (9–12 months) SBIs (from August/September); introduced new regulations on banks' net foreign exchange open positions in order to deepen the domestic foreign exchange market
January 2011	Re-introduced a cap (in relation to capital) on oversees short-term borrowing by banks while requiring banks to set aside a higher percentage of their foreign exchange holdings as reserves
May 2011	Lengthened the one-month SBI holding period to six months
July 2011	Restricted investment by banks in foreign currency bonds issued in the domestic market in circumvention of measures to restrict foreign currency loans

Sources: relevant central bank publications and press reports.

Likewise, the Republic of Korea has used a wide range of instruments, including: re-imposition of limits on lending in foreign currency to Korean firms and restrictions on the ability of foreign banks to swap dollars borrowed abroad for won (2007); limits on foreign exchange derivatives positions, in relation to the capital base, and tightening of regulations on the foreign currency liquidity ratio of domestic banks (June 2010); introduction of a cap on the foreign exchange forward positions of domestic banks and branches of foreign banks (October 2010);[5] and re-instatement of withholding tax on interest income (14%) and capital gains (20%) from foreign investments in domestic bonds, which had been exempted in 2008 (January 2011).

Perhaps the most ingenious of these has been the introduction, in August 2011, of a macro-prudential stability levy on the non-core liabilities of financial institutions, defined as the sum of foreign exchange liabilities and wholesale bank funding (Table 2). The idea is supported by Shin and Shin (2011), who found the procyclicality of non-core liabilities to be a good indicator

[5] Banks sometimes fund their long-term won-dollar forward positions by borrowing US dollars short term to avoid the foreign exchange risk. The interest rate differential between home and foreign markets brought about a large increase in short-term dollar loans to finance investments in forward dollars sold by ship builders and other domestic firms in 2011. In response, the Korean authorities imposed limits on currency forward positions by domestic banks to 50% of their equity capital while restricting foreign banks' positions to 250%. On 19 May 2011 the ceiling on the foreign exchange forward position was cut from 250 to 200% for local branches of foreign banks and from 50 to 40% for domestic banks. These ceilings took effect from 1 June, with the grace period of one month.

of vulnerability to crisis. The levy rises as the maturity increases, for example: 0.2% for less than a year and 0.05% for more than five years. Thus, the levy is intended to curtail especially short-term external borrowing by banks, as would a traffic congestion levy be expected to moderate rush hour traffic (Shin and Shin 2011). The levies collected are used to fund a foreign currency liquidity facility.

Table 2: Macro-prudential Stability Levy in the Republic of Korea, August 2011

Category	Description
Applicable foreign liabilities	Non-deposit foreign currency liability balances [1]
Applicable institutions	All financial institutions
Rate imposed	Less than 0.5% as determined by the maturity of non-core liabilities; the government can impose a maximum surcharge of 0.5% that varies according to net capital inflows; the overall levy cannot exceed 1%
Fund use	Used to supply foreign currency liquidity in the event of crisis
Collection and management	-Supervising agency: Ministry of Strategy and Finance -Collection and management of levy: Bank of Korea

Note: [1] Defined as foreign currency liabilities less foreign currency deposits, excluding certain liabilities arising temporarily from foreign currency transactions, which are deemed not akin to borrowing.

The philosophical question of whether capital flow management measures should or could be used under certain circumstances is different from the practical issue of whether they are effective. The effectiveness of controls as a means of moderating capital inflows has long been and will likely remain a controversial topic, to which neither theory nor empirical evidence has been able to provide definitive answers, especially in the context of an imposition of controls by countries that already have a largely open capital account. After all, the authorities themselves must decide in the context of their own country what works best and what they must to do make any measure they adopt work better. Effectiveness ultimately depends, among other things, on the country's administrative capacity, the willingness of market participants to comply with the requirements, and the scope for substitution and circumvention, as determined by the coverage of the measure as well as country-specific conditions (Hebermeier et al. 2011).

In contrast, it is difficult to conceive of an effective means of controlling capital outflows in the event of a crisis. Even if such a measure existed, foreign creditors, anticipating its imposition, would counteract by choosing shorter maturities or avoiding the country altogether as the destination for investment. In many emerging economies whose currencies are not internationalized, there is little alternative to accumulating foreign exchange reserves to deal with a shortage of reserve currency liquidity sudden capital outflows would cause. Inflow controls are of little use in taming capital outflows, in particular at the time of a crisis. When an economy is engulfed in a crisis, free floating often fails to serve as the first line of defense, because a large depreciation of the exchange rate triggered by a capital outflow could put it on an implosive trajectory. The global wholesale funding market is likely to freeze up, and international commercial banks may refuse to roll over their short-term reserve currency loans to emerging economies, which could suffer more if foreign investors dump their holdings of securities at a loss.[6]

4.2 Regional Cooperation

The foregoing discussion makes clear that capital flow management measures are no panacea, and that the authorities may need to resort to direct administrative intervention to stem the flight of capital at the time of a crisis. In the meantime, as the capital account is opened more fully, ASEAN countries are placed under increasing pressure to pursue sound macroeconomic policies. Such policies, characterized by price stability and fiscal discipline, are the proven way to minimize vulnerability to a sudden reversal of capital. Countries pursuing sound macroeconomic policies would be better able to prevent an asset bubble from occurring when there is a surge in capital inflows. Such countries are seldom subject to a speculative attack when investor sentiment matters in creating vulnerability to crisis. When their economic fundamentals are strong, the adverse impact of a sudden flight of capital can also be more manageable.

Regional cooperation can enhance the individual country efforts. After all, ASEAN capital account liberalization is a regional initiative and therefore requires regional cooperation to make it successful. ASEAN could, for example, agree on the definition of a crisis and affirm the right of a member country to introduce an emergency measure in the event of a crisis. Such emergency measures might include an administrative suspension of (certain types of) normal capital flows, temporary capital inflow controls (e.g., URR), and exit levies. We may recall what happened on 18 December 2006, when Thailand imposed a 30% URR on all equity and short-term securities investment inflows with maturities of less than one year: faced with a sudden outflow of capital from the equity market, the Thai authorities were forced to lift the measure for equity flows on the next day. A regional approach could have been helpful by removing the adverse signal of a unilateral measure.

Regional cooperation would be useful in two other ways. First, it could create scope for legitimately treating intra-ASEAN and non-ASEAN capital flows differently. For example, a regional tax arrangement could allow ASEAN-based investors to be exempted from the application of withholding tax on interest income and capital gains from holding ASEAN member country securities; such regional mechanisms as common standards, regional credit

[6] The Republic of Korea in 2008 offered government guarantees to foreign lenders and withdrew withholding tax on foreign holdings of domestic bonds but failed to stem the tide of capital outflows (Park 2011).

rating agencies, and mutual recognition could be used by a member country to allow its residents freely to invest in securities issued in other ASEAN countries, even when it still largely restricts capital outflows to the rest of the world.[7]

Second, given the biding impossible trinity, the government of an ASEAN member country must increasingly choose between a stable exchange rate, on the one hand, and independent monetary policy, on the other, as capital mobility is liberalized across the region. Regional exchange rate and monetary policy coordination is the only way to allow greater exchange rate flexibility vis-à-vis the rest of the world while retaining intra-ASEAN exchange rate stability, a feature that will become even more important as the AEC fully comes into force.

4.3 A Possible Way Forward

As financial markets and institutions are further developed, regional cooperation efforts move forward, and safeguard instruments are perfected, ASEAN countries must continue to dismantle more of the remaining restrictions on capital flows. Our earlier observations suggest, for example, that almost all of the existing current account and FDI related measures could be liberalized quickly. These include Malaysia's surrender requirements for export proceeds and Thailand's similar requirements for both exports and invisibles; and restrictions placed on outward FDI for entities with domestic currency borrowing in Malaysia and the Philippines. Myanmar must soon do away with the foreign exchange budget (used to allocate foreign exchange among competing ends) and set in motion the procedure for accepting the obligations under Article VIII of the IMF Articles of Agreement.

Likewise, most of the existing inflow control measures could also be removed quickly. Advanced ASEAN countries already have a high degree of de facto capital account openness because the most important channel of capital inflows—purchases of domestic securities by non-residents—is almost fully open; the additional risk of removing the remaining restrictions on inflows should therefore be marginal. In Cambodia and Lao PDR, the explicit or implicit restrictions on the ability of residents to issue securities abroad should be eased, as it will take a considerable amount of time before the domestic capital markets are fully developed; it would be beneficial for domestic entities to be able to raise funds in foreign markets, especially in ASEAN financial centers.

With respect to capital outflow controls, there are two opposing considerations. On the one hand, the conventional wisdom on sequencing suggests that outflows should be liberalized at the end; lifting of restrictions on outflows should therefore proceed judiciously. On the other hand, many ASEAN countries are now net exporters of capital (with the public sector largely

[7] Of course, the asymmetric treatment of ASEAN and non-ASEAN transactions would create an incentive for evasion, for example by locating resident intermediaries in an international financial center within ASEAN. Thus, how to design these mechanisms would be critical.

playing the intermediary role), so that a case can be made for promoting private capital outflows in order to mitigate appreciation pressure. Moreover, the asymmetry of inflow and outflow controls means that, unless some ASEAN countries become significant creditors to the rest of ASEAN, no meaningful regional financial integration would take place. On balance, some easing of outflow controls is called for, especially in higher income member countries.

5. CONCLUSION

This paper has used the emerging ASEAN Economic Community as a motivation to explore the issue of capital flow management in an economic community. The policy-driven process of financial integration in ASEAN comes against the increasingly widely shared view that use of capital controls and other capital flow management measures should be part of the routine policy toolkit of emerging market economies. But the logic of an economic community appears incompatible with extensive controls on regional, if not global, capital flows. Given the low degree of capital account openness in some ASEAN countries, this means that substantial capital account liberalization will have to take place relatively quickly across ASEAN. The challenge is made even greater by the presence of international financial centers within the region, which could serve as a conduit that diminishes the distinction between regional and global flows. ASEAN countries thus face the imperative of dismantling restrictions on cross-border capital flows while making sure that they are protected from the volatility of global capital flows. This they must do in a manner consistent with the ultimate requirements of an economic community.

After reviewing the benefits and risks of free capital mobility, the emerging consensus on the need for capital flow management, and the pace and sequencing of capital account liberalization, we have assessed the capital account regime of individual ASEAN countries in order to see how far they must move. Our conclusion is that most of the current account and FDI related restrictions should be removed as quickly as possible; most of the capital inflow controls could also be removed quickly without creating additional risks; though some judiciousness is required private capital outflows could also be promoted, at least in the more advanced ASEAN countries, if for no other reason than to promote regional financial integration. Even in the most optimistic scenario, no ASEAN country (with the possible exception of Singapore) is expected to have dismantled all capital account and related restrictions by 2015. This means that ASEAN countries have little need to introduce an entirely new set of capital flow management measures in order to maintain financial stability.

In retaining or introducing these and other measures, the ultimate requirements of an economic community seem to dictate that they be market-based and not residency-based. Though a variety of measures are conceivable, as has been experimented with in recent months by several countries to deal with a renewed surge in capital inflows, they are no panacea. Especially on the outflow side, no measure is likely to be effective. Regional cooperation would be useful in removing the stigma of a unilateral intervention and in enhancing individual country efforts more generally. ASEAN could, for example, agree on the definition of a crisis and affirm the right of a member country to introduce an emergency measure in the event of a crisis. Regional cooperation would also be helpful in creating potential scope for legitimately treating intra-ASEAN and non-ASEAN flows differently, and allowing countries to introduce greater exchange rate flexibility in response to capital inflows while retaining intra-ASEAN exchange rate stability, a feature that will become even more important as the AEC fully comes into force.

REFERENCES

Batista, P. N. 2012, The IMF, Capital Account Regulation, and Emerging Market Economies. In: *Regulating Global Capital Flows for Long-run Development*, edited by K. P. Gallagher, S. Griffith-Jones, and J. A. Ocampo. Pardee Center for the Study of the Longer-Range Future, Boston University, 93–102.

Bikhchandani, S., and S. Sharma, 2001, Herd Behavior in Financial Markets. *International Monetary Fund Staff Papers* 47: 279–310.

Chinn, M. D. and H. Ito, 2009.The Chinn-Ito Index: A De Jure Measure of Financial Openness. http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

Cooper, R. N. 1999. Should Capital Controls be Banished? *Brookings Papers on Economic Activity* 1: 89–125.

Edison, H. J., M. Klein, L. Ricci, and T. Slok, 2002. Capital Account Liberalization and Economic Performance: Survey and Synthesis. IMF Working Paper 02/120.

Fischer, S., 1998, Capital Account Liberalization and the Role of the IMF. In: Should the IMF Pursue Capital Account Convertibility?, edited by P. B. Kenen. *Princeton Essays in International Finance* No. 207.

Grenville, S. 2010. Central Banks and Capital Flows. In: *Managing Capital Flows: The Search for a Framework*, edited by M. Kawai and M. Lamberte. Cheltenham, UK and Northampton, MA: Edward Elgar.

Henry, P. B., 2007. Capital Account Liberalization: Theory, Evidence, and Speculation. *Journal of Economic Literature* 45: 887–935.

Habermeier, K., A. Kokenyne, and C. Baba, 2011. The Effectiveness of Capital Controls and Prudential Policies in Managing Large Inflows. IMF Staff Discussion Note 11/14.

Hahm, J-H, F. S. Mishkin, H. S. Shin, and K. Shin. 2012. Macroprudential Policies in Open Emerging Economies. NBER Working Paper No. 17780.

Independent Evaluation Office (IEO), 2004. The IMF's Approach to Capital Account Liberalization. Evaluation Report. International Monetary Fund.

International Monetary Fund (IMF). 2011a. Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Guidelines. SM/11/30.

International Monetary Fund (IMF). 2011b. *Annual Report on Exchange Arrangements and Exchange Restrictions*.

Ishii, S., K. Habermeier, J. I. Canales-Kriljenko, B. Laurens, J. Leimone, and J. Vadasz, 2002. Capital Account Liberalization and Financial Sector Stability. IMF Occasional Paper No. 211.

Kose, M. A., E. Prasad, K. Rogoff, and S.-J. Wei. 2009. Financial Globalization: A Reappraisal. *International Monetary Fund Staff Papers* 56: 8–62.

Kose, M. A., E. S. Prasad, and A. Taylor. 2009. Thresholds in the Process of International Financial Integration. NBER Working Paper No. 14914.

Mohan, R. 2012, Capital Account Management: The Need for a New Consensus. In: *Regulating Global Capital Flows for Long-run Development*, edited by K. P. Gallagher, Kevin, S. Griffith-Jones, and J. A. Ocampo. Pardee Center for the Study of the Longer-Range Future, Boston University, 23−33.

Ostry, J. D., A. R. Ghosh, K. Habermeier, M. Chamon, M. S. Qureshi, and D. B. S. Reinhardt. 2010. Capital Inflows: The Role of Controls.IMF Staff Position Note SPN/10/04.

Ostry, J. D., A. R. Ghosh, K. Habermeier, L. Laeven, M. Chamon, M. S. Qureshi, and A. Kokenyne. 2011. Managing Capital Inflows: What Tools to Use? IMF Staff Position Note 11/06.

Park, Y. C. 2011. The Role of Macroprudential Policy for Financial Stability in East Asia's Emerging Economies. In: *Asian Perspectives on Financial Sector Reforms and Regulations,* edited by M. Kawai and E. Prasad. Washington, DC: Brookings.

Prasad, E. S., and R. G. Rajan. 2008. A Pragmatic Approach to Capital Account Liberlization. *Journal of Economic Perspectives* 22: 149–172.

Reisen, H., and M. Soto, 2001. Which Types of Capital Inflows Foster Developing-Country Growth? *International Finance* 4, 1–14.

Schadler, S, 2010. Managing Large Capital Inflows: Taking Stock of International Experiences. In: *Managing Capital Flows: The Search for a Framework*, edited by M. Kawai and M. Lamberte. Cheltenham, UK and Northampton, MA: Edward Elgar, 105−128.

Shin, H. S., and K. Shin, 2011. Procyclicality and Monetary Aggregates. NBER Working Paper No. 16836.