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Managing the Hot Money Inflows of the People's Republic of China

Donghyun Park
Senior Economist
Macroeconomics and Finance Research Division
Economics and Research Department
Asian Development Bank

David Dole
Head
Economics Unit, PRC Resident Mission,
Economics and Research Department,
Asian Development Bank

Introduction

Despite strict capital controls, the People's Republic of China (PRC) is experiencing the biggest wave of speculative capital ever to hit a developing country. While the exact amount of hot money flowing into the PRC is not known, it has become large enough to be a major cause for concern among policy makers. One common method to estimate the flow of hot money is to subtract the sum of trade surplus and net FDI (foreign direct investment) flows from the change in foreign exchange reserves. According to this method, the amount of speculative capital flows into the PRC reached $130 billion in the first half of 2008. In terms of the accumulated stock of hot money, estimates range from $500 billion to $1.75 trillion.

There is a firm consensus that the speculative capital inflows are driven by two factors. First, the interest rate on yuan deposits exceeds that on dollar deposits. Second, there is widespread expectation that the yuan will continue to strengthen against the dollar. The combination of higher interest rates and rising yuan offers a risk-free profit opportunity. Three main risks are arising from the large and growing surge of hot money into the PRC—capital flow reversal, macroeconomic overheating, and financial instability. The central objective of this brief is to identify some concrete and specific policies for better managing capital inflows. An important first step in mapping out practical policy directions is to look at and learn from the past experiences of other developing countries.

Managing Capital Inflows: The International Experience

Developing countries can adopt a number of policy measures to manage capital inflows. Those policy measures acquire additional significance during episodes of large inflows. In this section, we examine the main macroeconomic and structural policy measures that developing country governments have used to cope with capital inflows, along with the empirical evidence on their effectiveness.

Capital Controls and Promotion of Capital Outflows

Perhaps the most direct way to control capital inflows is to impose capital controls. In a study of 109 episodes of large private capital inflows into emerging markets, Schadler (2008) uses the real effective exchange rate as an indicator of overheating. She finds that intensification of capital controls did not have a perceptible impact on the real exchange rate during a surge episode. Other surveys of the international evidence, such as Magud and Reinhart (2007) and Lopez-Mejia (1999), also conclude that capital controls fail to reduce capital inflows and dampen overheating pressures.

The amount of hot money flowing into the PRC has become large enough to become a major cause for concern among policy makers

Chile's experience with capital controls in 1988–1997 has been the subject of a great deal of international interest. The Chilean controls, which are in effect taxes on capital inflows, take the form of unremunerated reserve requirements (URRs) which mandate that a fixed percentage of inflows be deposited with the central bank for a fixed period of time. As Kawai and Takagi (2008) point out, URRs are suitable for countries with relatively open capital accounts which seek to manage rather than prevent capital inflows. A defining feature of URRs is that the amount of the tax on capital inflows falls with the time length of the investment. However, the empirical evidence on the effectiveness of Chile's controls as deterrents against hot money is mixed at best.

A second policy which could reduce net capital inflows is the liberalization of capital outflows. However, the greater ease of moving funds out of a country may encourage outsiders to move funds into the country (see Reinhart and Reinhart [1998]). Among the many Asian countries that have recently adopted various outflow liberalization measures, only the Republic of Korea has achieved significant success. In particular, Korea has experienced a sharp jump in portfolio outflows toward foreign equity. According to McCauley (2008), the main lesson from Korea is that liberalizing equity outflows has the greatest potential for promoting capital outflows.

Macroeconomic Policies

There are three types of macroeconomic policies for coping with large capital inflows—sterilization, exchange rate flexibility, and fiscal restraint. Sterilization involves the sale of domestic assets for foreign assets with the objective of reducing the impact of capital inflows on the domestic money supply. However, Schadler (2008) and the International Monetary Fund (IMF) (2007) fail to find a clear effect of sterilization on the real exchange rate. Exchange rate flexibility creates more uncertainty about the future movement of the exchange rate and may thus discourage speculative short-term capital inflows. However, the empirical evidence on the deterrent effect of greater exchange rate flexibility is inconclusive (see, for example, Reinhart and Reinhart [1998]). A moderation of aggregate demand due to fiscal tightening will lessen the inflationary impact of capital inflows. Systematic analysis of international data by the IMF (2007) and Schadler (2008) indicates that fiscal tightening can substantially reduce the inflationary pressures arising from capital inflows.

Financial Sector Reform

Financial sector reform is a structural policy that has the ultimate objective of building up a sound and efficient financial system. Financial sector reform is aimed at ensuring that capital inflows are allocated more efficiently rather than restricting the inflows. Weak and inefficient financial systems incapable of absorbing large capital inflows lay at the heart of the Asian financial crisis. A progressive deterioration in the quality of investments fueled price bubbles in the equity and property markets. Strengthening prudential regulation and supervision must be an integral part of financial sector reform in developing countries. A sound and efficient financial system can better intermediate inflows and thus mitigate both macroeconomic overheating and financial stability risks.

Concrete and Specific Policy Directions for the PRC

Having briefly surveyed the experiences of other countries in managing large capital inflows, we are now ready to discuss a way forward for Chinese policy makers to cope with "the biggest wave of hot money ever to hit an emerging economy." One concrete positive policy prescription is that the PRC should accelerate its financial sector reform efforts. Building up a sound and efficient financial system overnight is impossible. As such, financial reform cannot help the PRC cope with capital inflows in the short run. However, the PRC is also becoming more financially integrated with the rest of the world and this trend is a long-term process which will continue. Therefore, coping with capital inflows gives the PRC one more compelling reason to vigorously reform its financial sector. The ultimate objective is a financial sector capable of withstanding shocks and allocating capital to productive uses.

Another positive policy lesson which we can draw from the international experience is that the PRC should seriously consider further studying and learning from the Republic of Korea's success in promoting capital outflows. The Korean experience clearly shows that liberalizing equity outflows shows the biggest promise in promoting outflows. According to Kim and Yang (2008), equity investment abroad by Korean residents soared from \$3.6 billion in 2005 to \$15.2 billion in 2006. This suggests that the PRC should consider more actively easing its current restrictions against domestic residents' investing in foreign equity. In this connection, allowing residents to buy foreign equities via qualified domestic institutional investors under a new program introduced in June 2006 is a step in the right direction, but much more can be done.

Despite the PRC's growing integration into the global financial system, Yu (2008) points out that capital controls will remain a vital policy instrument in maintaining macroeconomic stability. More precisely, tight capital controls have allowed for relatively successful management of cross-border capital flows which, in turn, has enabled the PRC to achieve rapid growth and moderate inflation. The PRC government will continue to rely on monetary policy for short-run macroeconomic stabilization and capital controls contribute to monetary policy autonomy. The risk of financial instability further strengthens the case for controls. The PRC financial system is not prepared for full capital account liberalization yet. In short, the PRC should retain capital controls in the short run while moving toward a more open capital account in the long run.

The effectiveness of the PRC's capital controls has been greatly reduced because of rampant evasion. As such, one policy option for PRC policy makers is to make capital controls more effective. As Kawai and Takagi (2008) suggest, it may be more useful to move from transaction-based controls to investor-based prudential regulations which target financial institutions and large firms. Examples include reporting or approval requirements as well as limits on short-term external borrowing. Although coverage is limited, investor-based prudential regulations lead to lower monitoring and enforcement costs.

Finally, the PRC may also consider introducing greater exchange rate flexibility as a means of introducing greater risk for short-term speculators. There is also a plausible case for a sharp one-off appreciation which may kill off expectations of further appreciation. However, given the fast-deteriorating global economic outlook in the wake of the financial crisis, this option should be considered more seriously only after some semblance of normalcy returns to the world economy. It is certainly true that PRC's managed exchange rate regime has delivered big economic benefits, especially by promoting trade. Nevertheless, in the future the PRC would do well to fully take into account the potential macroeconomic costs of hot money in formulating its exchange rate policy.

Coping with capital inflows gives the PRC one more compelling reason to vigorously reform its financial sector

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Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444
information@adb.org
www.adb.org/documents/briefs

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