The Effect of Capital Flow Management Measures in Five Asian Economies on the Foreign Exchange Market

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Summary

Since early 2009, emerging markets (EMs) have been experiencing large capital inflows due to both cyclical and structural reasons. Capital inflows could pose macroeconomic and financial risks, in particular exerting huge upward pressure on exchange rates leading to asset price inflation bubbles. Inflows tend to be volatile and are typically concentrated in short-term maturity instruments. When risk sentiment changes, sharp reversals of capital flows could destabilise the exchange rates and asset markets.

Amid large capital inflows, EM policymakers use not only macro policies but also the capital flow management measures (CFMs) to alleviate the risks from large capital inflows. The aim of this paper is to clarify the effect of the eight CFMs introduced by the five Asian economies (Indonesia, Korea, Malaysia, the Philippines and Thailand) to deal with large capital inflows on the foreign exchange market from February 2010 to March 2011. The CFMs being introduced include both restrictions on inward capital flows such as taxes or reserve requirements, as well as the lifting of restrictions on outward capital flows. Empirical results suggest that four CFMs (introduced by Indonesia, Korea, Malaysia) stabilised the exchange rates by reducing their volatility. The CFM introduced by the Philippines had an effect on the exchange rate level. However, by comparing the realised exchange rate volatility with the currency option-implied volatility and risk reversals, their effects on the currency option market were mixed.