Global Development And Environment Institute
Tufts University, Medford MA 02155

Globalization Commentaries

First published by the *Triple Crisis Blog*
April 5, 2013

The Political Economy of Managing Capital Flows in South Korea and South Africa

Kevin P. Gallagher

In the immediate aftermath of the global financial crisis, the world economy was characterized as experiencing a "two-speed" recovery. Industrialized nations, where the crisis occurred, saw slow growth whereas many emerging market and developing countries grew significantly. These growth differentials, coupled with significant interest rate differentials across the globe, triggered significant flows of financial capital to the emerging market and developing countries. As a result, many countries experienced sharp appreciations of their currencies and associated concerns about the development of asset bubbles.

Two of these countries were South Korea and South Africa. Between 2009 and 2011 currency appreciation in each country was from close to 20 and 40 percent respectively and stock prices doubled. This triggered significant political debates in each country over what to do. Interest groups lined up along predictable lines. In South Korea and South Africa the financial sector was dead set against any intervention by the government, as they perceived themselves to be "winners" of the cheap credit and cross-border finance entering and leaving these nations at will. In South Korea, exporters were split. Some were in lock-step with the financial sector, especially the shipping industry that was using the carry trade to not only hedge currency risk but also to speculate for more profit. Others, such as US auto firms operating in South Korea, were quite concerned about the impact of exchange rate volatility on their competitiveness and asked the government to take action. However, the financial authorities in South Korea still had the 1990s and global financial crisis in their memory and overpowered interest groups to create a set of traditional and innovative measures from taxes on inflows to limits on the speculative positions of foreign exchange derivatives.

There was also a significant debate within the African National Congress in South Africa. Trade Unions concerned about the already staggering 25 percent unemployment argued for capital controls on inflows to stem the harmful impacts of capital inflows. However, they were overpowered by the export and mining sectors that were worried that any gains from capital controls would be wiped out by punishment from global capital markets. The Finance Ministry and Central Bank sided with the private sector. Interestingly, rather than intervening more the South African government liberalized capital controls on capital outflows. This made the private sector very happy, as they were pushing for this for a long time. It was hoped that the move would not only signal to capital markets that South Africa was still open for business, but it was hoped that liberalizing outflows would reduce net inflows and thus stem some of the exchange rate appreciation and asset bubbles.

In a new paper with Brittany Baumann, we examines measures taken to mitigate the harmful effects of excessive capital flows in South Korea and South Africa. We econometrically analyze the effectiveness of these measures and find some limited evidence that both countries' measures were successful in lessening the appreciation and volatility of their exchanges rates. Though, these nations were less successful in stemming asset bubbles. These findings suggest that emerging market and developing countries can make the policy space to regulate cross-border financial flows. However, it should not be left to emerging market and developing countries to carry the burden. Industrialized countries should also steer credit toward productive use so as not to create negative spillovers to the developing world.