Emerging Asia's integration has pluses and minuses

Since the early 20th century, emerging Asia has been subjected to the ebb and flow of lending from advanced economies. Since then the region has become more integrated into the global financial market, which has been exposed to the risk of capital flow reversals.

In the aftermath of the 2008 global financial crisis, capital has flowed into emerging economies, especially in Asia, in search of higher returns on investment.

Asia particularly saw an increase in portfolio investments—stocks, bonds, and other cash equivalents—as foreign investors regained their appetite for risk, currencies appreciated and stabilized, and economic fundamentals strengthened.

Low interest rates in advanced economies made Asia more attractive, with its higher interest rates promising bigger returns.

This worries the region's policy makers. Portfolio investments are more volatile and short-lived than long-term foreign direct investments. A surge in inflows harms recipient countries, as asset prices soar, and a sudden withdrawal of capital destabilizes markets.

From before the Asian financial crisis in 1997 until after the global financial crisis of 2008, the region's equity markets saw an increase in volatility. A shock in one economy would spread to its neighbors though the investor's risk aversion. This is the darker side of financial integration, with broader growth and market development needing to balance against internal risks.

During calm periods, the region's equities markets move in sync, reflecting stronger fundamental linkages. But during more volatile times, such as the global financial crisis, equity markets behaved similarly, which meant significant losses for investors.

Capital inflows are subsiding as the US economic recovers, although European Union sovereign debt must be monitored. A sudden withdrawal of capital would likely send shockwaves through all the region's developing countries and derail growth projections.

During times of market volatility, emerging Asia can benefit from measures that control large inflows of capital, particularly in equity markets.

The surge in foreign capital in emerging Asia in the aftermath of the global financial crisis has put more focus on measures to manage large capital inflows, exchange rates, and cash. The International Monetary Fund sees limits on capital flows as a legitimate policy tool.

Effective use of policy tools to calm volatile capital flows helped Indonesia; the Republic of Korea; the Philippines; Taipei,China; and Thailand to limit private sector foreign exchange exposure by restricting external borrowing, imposing withholding tax on bonds, and introducing minimum holding periods for portfolio investments.

The People's Republic of China; Hong Kong, China; and Singapore managed capital flows mainly to stem credit growth and to prevent bubbles in the housing market.

Sustained large capital inflows pose a challenge to monetary policy and management of capital flow in several ways.

They can make exchange rates appreciate excessively, hampering international trade and investment; they force governments to buy or sell their currencies to maintain stability; they impede governments' monetary systems; and they jeopardize financial stability by inflating prices in asset markets, provoking bank lending booms, stirring up foreign exchange markets, and reversing capital flows.

Capital inflows can lead to credit booms and overheat economies as rising inflation becomes more of a threat, while the risk of capital flows suddenly stopping or reversing can depreciate currencies or deplete foreign reserves.

Equity markets calm down when governments in neighboring countries control capital inflows. Capital controls are associated with less volatile spillovers among emerging Asian economies, suggesting the measure is effective in the medium to long term.

Asian countries have differing objectives and priorities, which complicate policy coordination in building regional resilience to shocks and managing multilateral crises.

Asia's economies are outperforming others, and a coordinated response to external shocks will increase regional bargaining power, with greater resilience making them less a victim and more a winner during downturns in developed countries.

This episode is based on research by former Asian Development Bank Institute research fellow Pornpinun Chantapacdepong, now assistant director at the Monetary Policy Group of the Bank of Thailand.

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