

Asian Recovery Challenged by Rising Capital Inflows

Jiranit Chaowalit

Economist

International Economics Department

Monetary Policy Group

Following the global growth contraction, Asian economies appear to have rebounded more quickly than the rest of the world, thanks to large and effective fiscal stimulus, especially accommodative monetary policy, and improving export performance. Meanwhile, this favorable outlook for Asian economic growth has poses important challenges for Asian policymakers as a result of rising capital inflows.

With positive interest rate differentials between Asian and G-3 economies, part of the inflow has been encouraged by carry-trade investment, with the US dollar as the funding currency, to take advantage of higher asset returns in Asia.

Large capital inflows into Asia at this early stage of economic recovery are likely to complicate macroeconomic management in several ways.

The immediate crucial implication is the appreciation of local currencies that could undermine export price competitiveness during the early recovery period.

Moreover, these flows also pose risks of unexpected reversal either when the US dollar carry-trade unwinds and/or risk aversion increases when international financial market turbulence occurs, leading to exchange rate fluctuations.

Moreover, the recent re-emergence of speculative money has also led to equity prices rising in the region despite continued sluggish private investment.

The inflow has also spilled over into the real estate market in several Asian economies, such as China, Singapore, Taiwan and Korea, which have witnessed growing domestic demand for housing at the same time.

Real estate prices in these economies have shot up, raising concerns about potential house price bubbles and prompting authorities to adopt measures to safeguard financial stability.

For example, in response to an influx of capital, Taiwan has prohibited foreign investors from depositing foreign money in saving accounts at commercial banks.

The move is meant to dampen short term capital inflows and reduce currency appreciation pressures.

The Taiwanese government believes that speculative pressures have subsided due to this measure but admits that some hot money has still flowed into the Taiwanese market.

To step up efforts to rein in rising real estate values and potential bubbles, policymakers in a number of Asian economies have implemented prudent measures in the real estate sector. South Korea and Hong Kong have raised their loan-to-value ratios for homes and apartments; China has tightened its down payment requirement for home purchase, while Singapore has scrapped certain schemes that were introduced to stimulate the housing sector.

These prudent measures are deemed necessary to mitigate risks specifically in the housing sector, while monetary policy remains support of overall economic growth.

Although it is a big relief that the recovery in Asia has been confirmed, future sustainable economic growth depends largely on an appropriate policy mix on both the growth and stability fronts.

Looking forward, the prospect of further recovery will likely continue to attract capital into Asia, and capital flow and exchange rate volatility will likely complicate macroeconomic management during fragile recovery.

Therefore, the policy challenge at this early recovery stage is to strike a balance between bolstering the recovery while curbing emerging financial imbalances.

Large capital inflows into Asia at this early stage of economic recovery are likely to complicate macro-economic management in several ways. The immediate crucial implication is the appreciation of local currencies that could undermine export price competitiveness during the early recovery period.

(The views expressed are the author's own.)

Published in The Nation on Monday, December 07, 2009