

Capital inflow brings growth, but has downside risks too

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THE SHARP RISK AVERSION seen during the height of the financial crisis, coupled with tightened global liquidity and weak economic prospects, precipitated capital reversal from many emerging economies in 2008. Today, emerging market assets offer better returns and lower risk than mature economies' assets, further attracting capital inflows.

Fundamentally speaking, stronger economic growth in the second half of 2009 has been the driver of capital's return to Asia, as the region's output and exports have fared better than those of the developed economies and most other emerging economies.

Moreover, advanced economies have implemented fiscal stimulus and loose monetary measures to increase liquidity, which has in turn whetted risk appetite.

Capital has poured into emerging market assets as well as commodities, making this more of a global phenomenon driven by external market conditions rather than internal or country-specific factors.

However, many downside risks come with pronounced capital inflows.

Obviously, the currency may appreciate if money continues to enter the country.

The recent global stock market jitters in response to news regarding the eurozone debt problem, despite previous strong gains, also show just how vulnerable certain components of capital flow are to sentiment.

So far, Thailand has been able to keep capital flows in check through a policy mixture with short-term and long-term goals involving exchange rate flexibility, monetary policy, and risk management by the banking and real sectors.

Furthermore, the Bank of Thailand has recently announced some outflow liberalisation for certain transactions, including overseas direct investment, portfolio investment, hedging activities and corporate treasury flows.

Going forward, with the possibility of capital inflows turbocharging a growing economy, inflation and/or asset price bubbles may surface, jeopardising macroeconomic stability unless pre-emptive prudent measures are put in place.

Curbing price increases can be done via a hike in the monetary policy rate, but this may be a Catch-22-like situation as it may exacerbate interest-rate differentials, which would in turn bring about more inflows.

That said, emerging economies today are much more resilient to the macroeconomic effects of capital inflows than they were in the past, thanks to stronger economic fundamentals and improvements and improvements in financial sectors, especially in capital markets.

Despite susceptibility to short-term speculative activists, in theory capital markets provide debtors with new sources of funding and expose creditors to a broader range of investment alternatives.

However, emerging countries are generally endowed with smaller capital markets, and they are more likely to be prone to volatility during times of turbulent capital swings.

Prudent measures can only go so far in preventing the said risk, so continued capital market development may be among the best solutions in creating stability, as a deep and diverse market attracts "good" capital into its products.

Bigger markets tend to be more transparent too, which helps players in their access to information for better investment decisions.

These qualities are reflected in the capital markets' price adjustments, and in turn may help shelter the financial sector and the economy at large from the effects of volatile capital flows.

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

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