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Capital Inflows: Too Much of a Good Thing?

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What a difference 10 years makes. In 1997, money was leaving Thailand extremely fast to cover short-term debt repayments. A lot of that had to come from foreign exchange reserves—so much so that the country did not have enough to pay everyone. Investors banking on the Asian "Tigers" took their money out too, and that sapped the value out of the baht. The result—financial crisis.

Today, we have the reverse. The flow of money is in Thailand's favor, and if anything, the authorities are trying to control the pressures for the baht's appreciation in value. One might think that's a happy ending. But a surge in the amount of money (capital) coming in—and the appreciation pressures it can cause—can be a problem too. Just ask Thailand's exporters.

Lots of money coming in—or capital inflows—also can have deleterious effects on the domestic economy. Too much new money can be inflationary. And it can raise values of property or stock prices, for example, beyond what they should be. These can cause "asset bubbles" that a change in market sentiment could cause to burst.

So the lesson of the past 10 years is actually quite simple: authorities need to be cautious when applying the policy tools at their disposal, so as to maintain an appropriate balance between domestic and international economic policy objectives—in other words, maintaining financial stability in the face of potentially volatile markets.

When the financial crisis hit Asia's rapidly developing economies a decade ago, many pointed to the rapid surge in short-term capital inflows—much as short-term debt—as the trigger that ignited the crisis. As controls on capital movements were rapidly relaxed, it then became hard for monetary authorities across the region to stop the sudden outflows that came after the panic created by speculative attacks on the baht and other Asian currencies. Thus the dramatic exchange rate depreciations. Many domestic firms and banks that had large, unhedged, foreign currency debts—again much of it short-term—crumbled under the pressure to repay. Many of emerging East Asia's financial sectors were also structurally weak and inefficient. With exchange rates largely pegged to the US dollar, pressures to depreciate mounted. When speculators learned foreign reserves were scarce, they attacked the region's currencies and the crisis ensued.

Today, Asia's balance of payments has a huge surplus. Over $2.2 trillion in international reserves are held in emerging East Asia. Half of this is in China. And now most currencies in the region can float against the US dollar, though to differing degrees. The state of the region's banking systems and financial sectors in general are much stronger, with "financial soundness" indicators—such as return on assets and capital adequacy ratios—higher and nonperforming loan ratios lower.

But capital flows are in the spotlight once again, with large inflows worrying authorities about the potential pressure to hike interest rates if inflation accelerates. And there's the rise in, equities, real estate, and other asset prices.

Capital inflows into the six largest emerging economies in East Asia (China, Korea, Indonesia, Thailand, Malaysia, and the Philippines) reached a peak of about $140 billion in 1996, the year before the crisis. Last year, another peak was reached—$269 billion. As a percentage of GDP, inflows were 7.2% in 1996 and 6.2% in 2006. Can these levels be sustained? Or are we playing with fire—would a sudden reversal lead to another financial crisis?

At this stage, we don't think so. First, capital outflows have also been rising rapidly in recent years, as current account surpluses are recycled and continued capital market liberalization eases outflow restrictions. Also, the massive international reserves accumulated can certainly help fend off speculative attacks.

But there is another major change in emerging East Asia that can help it deal with potential economic shocks to the region. Aside from using the crisis as an opportunity to do the structural reforms and increase efficiency of financial systems, regional cooperation became the mantra by which authorities could consult and act together in addressing common problems. The ASEAN+3 Finance Ministers' process, for example, enhanced economic monitoring around the region, with many now using early warning systems and stress testing to spot potential problems before they occur. There's the Chiang Mai Initiative of emergency swap arrangements and the Asian Bond Markets Initiative to develop alternatives to bank lending, among other ASEAN+3 programs.

Major risks and challenges remain, however, and authorities must keep a close eye on the potential for future global shocks—such as abrupt drop in the current high levels of international liquidity, the sudden disruption that could result from rapid change in global payments imbalances, or in the case of any major future bouts of financial market volatility. All these could have serious repercussions across the region.

While there is no magic solution to managing capital inflows, it is important for monetary authorities to continue to carefully monitor trends to minimize the costs to the domestic economy. There are still useful tools in the monetary kit, whether continuing reforms and strengthening domestic financial systems through good governance and more effective and efficient regulations and supervision. Most important, monetary authorities need to construct the appropriate policy mix that satisfies both global trends and domestic needs. Whether this means allowing greater freedom to manage fluctuations in monetary aggregates through more exchange rate flexibility or not is up to local conditions.

The 1997/98 crisis was centered on the issue of debt. Today the issue is one of risk. Working together, being open with each other in addressing issues, and ensuring a transparency that brings confidence to our increasingly globalized markets—and market players—will reduce the risk of future financial instability.