Two sides of the financial coin

Updated: 2011-08-09 07:46

By Iwan J. Azis and Cyn-Young Park (China Daily)

Comments(1) Print Mail Large Medium Small 1

Nervous sell-offs in Asia's equity markets in response to debt problems in the United States and the eurozone underscore the region's growing links to financial events on the other side of the world. But with increased integration comes the increased threat of contagion. It is therefore not only in Asia's interest to promote global financial stability, but also its economic fate increasingly depends on it.

Asia was fortunate to escape the 2008-09 global financial crisis relatively unscathed. One critical reason was its limited exposure to subprime mortgages and other "toxic" assets in the US. The region's underdeveloped financial markets were relatively "clean" of complex derivative and securities deals.

There is no guarantee that the same will hold true next time around. In fact, the more financial deepening and globalization continue, the greater the likelihood that turmoil in one country will spread rapidly across other countries and regions, inflicting significant economic damage as it goes.

Already, global financial markets are so deeply intertwined that investors in Helsinki happily make money in Hong Kong, while a default in Madrid can make bankers lose hair in Mumbai.

In theory, freer capital mobility is welfare enhancing - it promotes better and more efficient allocation of financial resources worldwide. But history is witness to large and volatile short-term capital flows complicating macroeconomic management, destabilizing weak financial systems, and disrupting growth in emerging economies.

Financial markets in emerging Asia - the Chinese mainland, Hong Kong and Taiwan, and India, Indonesia, the Republic of Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam - have seen a flood of capital inflows over the past several years, accelerating the region's strong recovery and increasing investors' appetite for higher-yielding investments in the region.

The upsurge in capital flows has been a decidedly mixed bag. Emerging Asia attracts a sizeable share of total capital flows to emerging economies worldwide. While more than half of these flows are stable, long-term overseas direct investments, the bulk go to China. Excluding China, the region attracts a mere 10 percent of total overseas direct investment flows to emerging economies. In contrast, emerging Asia receives a far greater portion of total short-term capital flows - such as bank lending and portfolio investments - than any other developing region.

Historically, short-term capital flows are more volatile and far more prone to a "sudden stop" compared with long-term alternatives like overseas direct investment. For instance, as investors became unnerved by the unrest in the Middle East and North Africa, and fiscal trouble in Europe and the debt ceiling impasse in Washington, portfolio investment flowing to emerging Asia dropped sharply.

So how can emerging Asia's policymakers contribute to financial stability as the region's markets develop?

Financial integration and contagion are two sides of the same coin. It is unlikely that the trend of financial globalization will reverse. Thus, rapid financial liberalization must be accompanied by mechanisms to ensure the effective use of foreign capital. Some conditions are a prerequisite for rendering capital flows more stable and long-term (and hence less disruptive) to an economy. These include sound macroeconomic management, a high level of financial sector and market

Most Viewed Today's comments
Face up to debt woes
Cutting the flab
Owning up to one's crimes vital
Stricter supervision needed
Vendors not a menace
Transparent need for change
Two sides of the financial coin
One world, one healthy sports dream

Columnists

Op Rana
Mission 'democracy' is mission hypocrisy

Li Xing
Menial jobs help students become adults

Liu Shinan
Are we willing and able to work high-tech?

more

Specials

China Ready for 1st Aircraft Carrier

Guo Meimei and the Red Cross scandal

more

Forum
Should President Obama be re-elected?
Do you still believe foreign brands?
Tell me should I marry him or not?
WSJ: Why China may need a recession?
more