Research Institute of Economy, Trade & Industry, IAA

Perspectives from Around the World 023

# Entering the Uncharted Territory

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Asia is an irony. It has gone through a dramatic turnaround from excess investment during the pre-1997 Asian financial crisis (AFC) to excess savings during the post AFC, including the rise of foreign reserve accumulation. Yet, the region is having huge deficits in social and physical infrastructure.

The good thing is that Asia has become more resilient to external shocks as shown during the U.S. crisis following the collapse of Lehman Brothers in the Fall of 2008 and the subsequent eurozone crisis. The bad thing is that despite having a strong economic growth and much improved macro environment, the socio-economic and ecological conditions in many countries remain poor or have worsened: inequality increases, society has become more polarized, employment elasticity decreases, pollution and resource depletion and other environmental conditions deteriorate. Indeed, Asia is still far behind in adopting the so-called "triple bottom line" approach to human well-being.

The combined low interest rate and quantitative easing (QE) policy in industrial countries pose other tremendous challenges. Aside from being ineffective, the policy sparks capital flows to emerging markets including Asia as the latter exhibits strong pull factors through steady growth performance, stable economy and higher investment returns. Since the AFC, flows outside short-term foreign debt have been dominant. Gross inflows increased significantly but outflows have also been on the rise. Outward foreign direct investment (FDI) and equity investment have also increased, providing foreign assets buffer for the region when market becomes volatile. This has been shown to be the case in Korea during the global financial crisis (GFC). In net terms, capital flows in the region increased except in 2008 and 2011/12. Of the roughly $1 trillion in yearly net private capital flows to emerging market economies, about half of it is in Asia.

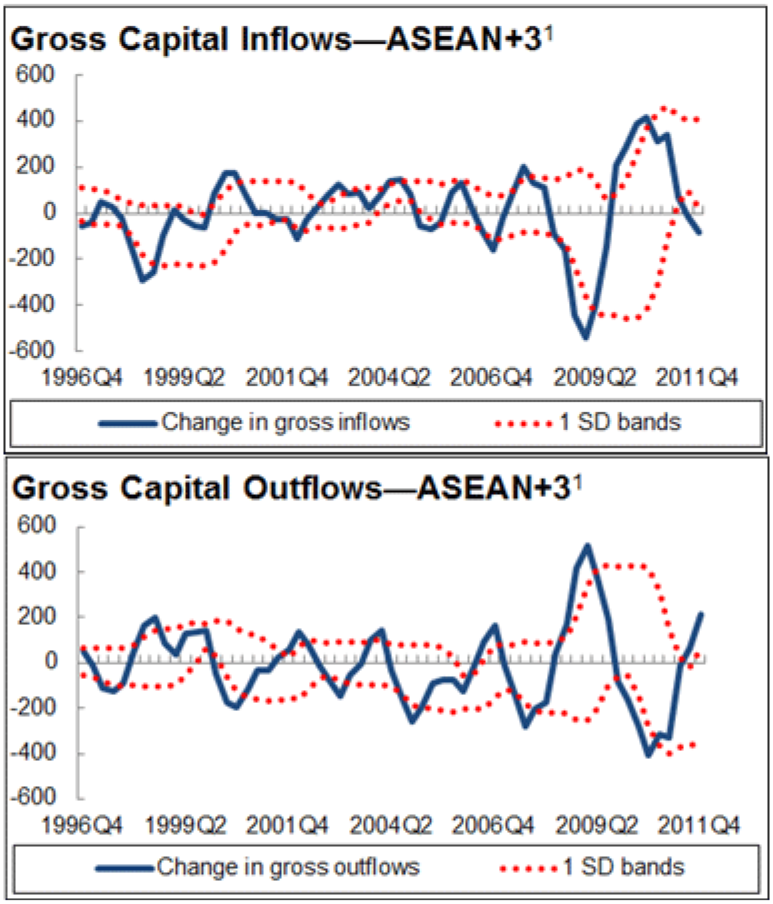
Thus, unlike during the Pre-AFC, this time increased capital flows in Asia occur while the region has excess savings. This complicates the issues and poses major policy challenges. Not only gross flows become far more important to track than net flows, but the size and types of the flows matter a lot.

FDI flows in Asia remain strong, much of which is absorbed by the People's Republic of China (PRC). East and Southeast Asia alone accounted for more than one-fifth of the entire global FDI flows. Resilient and growing production network in line with the supply-chain model is among the most important pulling factors.

The rebalancing process of moving towards more domestic-demand oriented growth also offers opportunities for investors to exploit growing domestic demand in the region. Flows through equity markets have also been strong due to global sentiment and reforms in many Asian countries. Foreign purchases of domestic stock surged, so did inflows through non-bank private creditors. In the current environment of low returns and slow growth in industrial countries, the steady growth of Asia's bond markets offers a good opportunity for foreign investors. In some countries, the foreign-owned share of local-currency bond markets is high—as much as one-third—and continues to rise. Increased bank deposits by non-residents add to the size of inflows, as the interest rate differential persists and even widens.

While rising capital flows can be beneficial to recipient countries, their volatile pattern and pro-cyclicality can act as a channel for the build-up of financial risks and imbalances. Compared to what happened during the 1997 AFC, recent flows following the GFC are larger in size (see Chart 1), and as the more detailed analysis below shows, they are also more volatile.

**Chart 1. Gross Capital Flows in Selected ASEAN+3 Countries**




*1) Includes Indonesia, Japan, Republic of Korea, the Philippines, and Thailand*

It is useful to classify gross inflows into "surges" when there is a sharp increase in inflows, and "stops" when there is a sharp decrease in inflows. For gross outflows, "flight" and "retrenchment" are used when outflows indicate a sharp increase and decrease, respectively. It is also useful to break down the flows into three types: (1) "equities" consisting of direct investment and equity portfolios; (2) "debt" comprising of debt securities and others including derivatives; and (3) "bank" flows (Note 2). Flows are considered as equities-led, debt-led, and bank-led if the increase in flows is mainly through equities, debt, and bank, respectively.

Using a one-standard deviation of the change in the mean capital flows as the limit (shown as the dash lines in Chart 1) beyond which capital flows are labeled differently according to their waves, the following episodes are observed in ASEAN+3:

> "Surge" in inflows: equity-led occurred during 2004Q2, 2009Q4-2010Q1; debt-led (excl. banking flows) occurred in 2003Q1, 2007Q3, 2010Q2-2010Q3; and banking flows-led emerged during 2000Q1-2000Q3, 2002Q4, 2004Q3.
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> "Stop" in inflows: equity-led happened in 2006Q3-2006Q4, 2008Q3; debt-led (excl. banking flows) in 1998Q3, 2008Q4-2009Q1; and bank-led in 1996Q4, 1998Q1-1998Q2, 2001Q4-2002Q1, 2005Q1-2005Q2.
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> "Flight" in outflows: equity-led were in 2003Q1, 2009Q4; and bank-led in 1997Q2-1997Q3, 2000Q1-2000Q3, 2002Q4, 2004Q3-2004Q4, 2007Q2-2007Q3, 2010Q1-2010Q3.
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> "Retrenchment" in outflows: there was no equity-led, while the debt-led took place during 1998Q2, 2006Q2-2006Q4, 2008Q4, 2011Q3-2011Q4; and bank-led occurred in 1998Q3, 2001Q4-2002Q1, 2003Q4-2004Q1, 2008Q3, 2009Q1.

Thus, the rising volatility of capital flows in the region has not been uniform, and bank-led flows occurred most frequently. This poses more difficult challenges to maintain financial and macro stability.

Three important implications are worth to note. First, macro prudential policy becomes prominent yet more difficult. In the case of the banking sector, for example, the policy is now focusing on both the asset side (e.g., reduce loan-to-value ratio) and the liability side (e.g., mitigate the rising trend of non-core liabilities through bank-led flows). The latter can affect the former by way of banks' shift towards more risk-taking behavior and higher leverage. In times of external shock, when deleveraging occurs as in the recent episode of eurozone crisis, the system may suffer a credit crunch. But the shock impact can be far greater than this. With a stronger currency as a result of capital inflows, the balance sheet position of borrowers improves, generating even greater risk-taking in the part of banks and stimulating further inflows through cross-border bank-led capital flows (Note 3). Various initiatives have been proposed in this context. Imposing some sort of levy to non-core liability is among those frequently discussed.

Secondly, there is a growing recognition that countries may need to depart from the First Best to the Second Best approach. The frictionless outcome of capital account liberalization is now seriously questioned, as the episode of financial crisis has become more frequent following liberalization. Even in industrial countries where the necessary institutional factors (often stated as the pre-condition for successful financial and capital account liberalization) are already in place, the First Best approach disappoints many of its proponents. In emerging Asia, those with a liberalized system began to impose some forms of capital controls (i.e., introducing new friction to offset the existing one). There are several justifications, most important of which is to avoid possible instability caused by the torrent of hot money. In the more export-oriented countries, ensuring competitive exchange rates is another reason for intervention. But controls can also have negative externalities that have some multilateral effects. Benefits that may accrue to countries imposing controls may have costly effects on other countries. The case of exchange rate intervention (competitive devaluation) is a notable example, from which the global financial stability can be affected. This is the reason why global institution like the International Monetary Fund (IMF) needs to set the best course of direction in terms of the type and nature of intervention member countries should take.

The third implication is on the need to have better policy coordination. On this front, unfortunately Asia did not have a good track record. There has been little formal coordination and cooperation in managing capital flows or any macroeconomic affairs for that matter. The clear trend of increased integration in trade and finance observed thus far has been more market-driven supported by unilateral policies, not the result of formal cooperation or coordination. Information sharing is the only significant form, exemplified by the Economic

Review and Policy Dialogue (ERPD) process in ASEAN+3. Gradually, efforts to harmonize rules and regulations emerge as the case in local currency bond markets within the context of the Asian Bonds Market Initiative (ABMI). But a joint and common enforcement seems still a long way to go, let alone a loss sharing commitment as usually happens in a federal state (e.g., common deposit insurance scheme). Cross-border banking regulation is always discussed, but progress has been close to none.

All three implications are worrisome. Asian policy makers should be concerned. At the very least they should take a note. Given the prolonged eurozone crisis and the uncertainty over the sustainability of the U.S. recovery, what seems certain is the growing strain in the global financial markets. In an interdependent global system, one should never underestimate the power of financial contagion. Co-movements get more significant, and synchronized volatility is observed. Unlike the goods market, the financial market is a different "animal," featuring complex interrelations with asymmetric information and high unpredictability that may generate seemingly non-rational decisions by agents.

Arguing that Asia is insulated from the GFC is a sign of complacency. Stating that the channel of contagion is only through trade, thus affecting only export-oriented countries, reflects a misinformed admission. Even acknowledging the negative impact of GFC on trade finance and remittances in Asia, as stressed by the World Bank, still undermines the broader impact of financial contagion. Not only the risk of banks' changing behavior from rising debt flows is real, the fact that the Asian financial markets are relatively open—thanks to a series of past financial and capital account liberalization—makes the region prone to practically any external shocks. Despite the growing recognition in recent years about the downside risks of financial liberalization, it is not possible to reverse policies already in place, at least not immediately. Introducing some frictions, even if viewed as capital controls, is the only measure most Asian countries can take. And they did.

A fairly detailed study recently conducted at OREI-ADB clearly shows that both the Lehman shock in 2008 and the subsequent eurozone crisis have affected the Asian financial markets (Note 4). Spillovers on the size of financial returns and volatility are significant in most countries under study. More importantly, the transmission works through other financial markets as well, making it impossible to contain the effect by focusing only on one market or asset class.

Sure, almost all countries have tried to strengthen the domestic financial safety nets. Macro prudential policies have been implemented across the board but with various degrees of effectiveness (confusion remains, however, over what constitutes macro prudential as compared to standard prudential policies). But the scale of capital flows this time is unprecedented. The "push" factors are so huge, emanating from two of the world's major economies, Europe and the United States. Asia is clearly entering an uncharted territory. The power of an individual country's safety nets is nowhere near the damaging force that these enormous flows can exert. In short, the capacity of domestic safety nets needs to be augmented by regional safety nets. In ASEAN+3, the Chiang Mai Initiative Multilateral (CMIM) is already in place, and India has been leading the efforts to set up similar regional financial safety nets for South Asia. So, does this mean Asia has no reason to worry? Plenty of reasons.

All these initiatives are far from ready because of either internal inconsistencies in the framework or simply insufficient recognition about the potential damage a financial contagion can create. Inconsistencies can and should be corrected, but failing to recognize the danger of contagion is far more difficult to deal with. Some argue that progress has been made, albeit gradual. But capital flows and volatility in financial sector are hardly gradual. Once they start, the intensity and effects can be amplified rapidly. This is the reason why financial crisis is explainable but not predictable. Does Asia need one to realize the danger of entering the uncharted territory?

**Notes**

1. ^ The views and opinions expressed herein are those of the author and do not necessarily reflect the views of the institutions he is associated with.
2. ^ See Forbes, Kristin J. and Francis Warnock (2012), "Capital Flow Waves: Surges, Stops, Flight and Retrenchment," *Journal of International Economics* 88, no 2. However, unlike in their analysis here, I distinguish "debt" from "bank" because the latter is more prone to deleveraging and pro-cyclicality and therefore it has a more direct impact on the real sector.
3. ^ Recent studies show the amplification of the effect of cross border flows on the supply of credit and hence financial risks through the changing risk behavior of banks. See, among others, Bruno, Valentina and Hyun Song Shin (2012). "Capital Flows and the Risk-Taking Channel of Monetary Policy," *BIS Working Papers* No 400, December 2012
4. ^ Azis, Iwan J. Sabiyasachi Mitra, Anthony Baluga & Roselle Dime (forthcoming). "Threat of Financial Contagion to Asia's Local Bond Markets: Spillovers from the Global Crisis," *ADB Working Paper Series on Regional Economic Integration*, Asian Development Bank.