Asia Insight

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Capital Flows: Asia's Quiet Revolution

Over the last 15 years, a quiet revolution has changed the way Asia's regulators approach capital account controls. Regulators have slowed foreign capital flows in and out of liquid, local financial assets by imposing measures such as taxes, foreign exchange controls or legal prohibitions. Their primary concern has been the vulnerability of local borrowers to outflows of "hot money"—speculative investments that move in and out of markets quickly through bank loans or tradable bonds. Consequently, as many are aware, fixed income securities have generally borne the brunt of such restrictions. But less commonly known are the benefits derived from capital controls and the ways in which these measures are implemented as protections.

As a result of the hard lessons learned from past financial crises, policymakers in Asia are now careful to weigh the benefits of unfettered capital movements against the potential volatility that may result from such mobility. Although the concept of capital account controls is anathema to those weaned on free market principles, such controls may ultimately benefit long-term fixed income investors in Asia, excluding Japan.

Growing Appetite for Asia Bonds

The performance of fixed income securities in Asia ex-Japan has been supported by solid corporate and sovereign balance sheets. Credible central bank inflation-targeting mandates, rising foreign exchange reserves, sovereign fiscal health and respectable economic growth have also served as stabilizers to these markets. Emerging from the tumultuous global economic crisis three years ago, Asia's bonds generally saw a rapid recovery through October of this year. These bonds have found more favor as part of dedicated, emerging market bond allocations and total return portfolios as investors worry about such factors as a depreciation of the U.S. dollar.

On the other hand, yield-starved bond buyers in the West face low-to-negative real interest rates in their home countries. In sovereign bonds, they face potential credit downgrades posed by politically intractable fiscal deficits. Both factors have given many investors a nudge to overcome their "home country bias," and move away from unattractive home markets and toward strong performance in an emerging and fast-growing asset class. The diversification benefit to their portfolios is but a nice byproduct. Mutual funds, exchange-traded funds (ETFs), and—to a lesser extent—institutional players, such as pensions and insurers, have begun to participate in both the U.S. dollar-denominated and local currency bond markets in Asia ex-Japan. Ratings agencies have steadily upgraded Asian sovereign credits and downgraded Western sovereigns. However, we need to be aware of the significant risks, such as currency movements and the external risk that Europe poses to Asia's bonds.

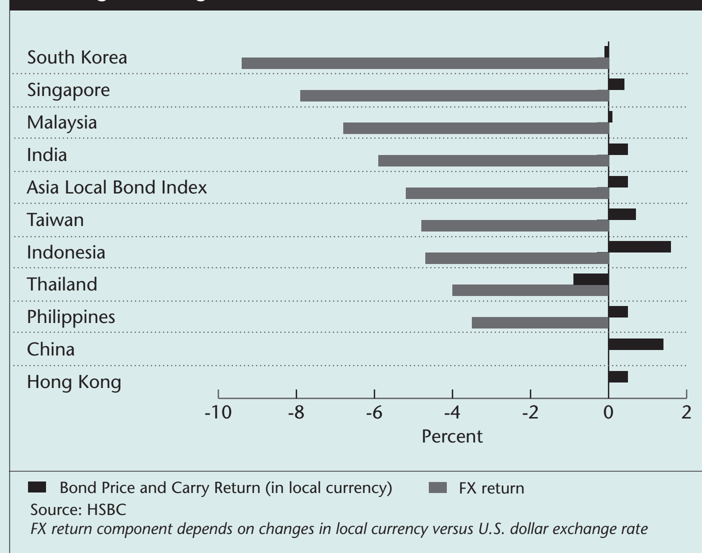
Currency Risk

In September of this year, foreign exchange volatility provided a brief but sharp reminder of these vulnerabilities. A large, across-the-board depreciation in Asian currencies drove total returns for local currency bonds into negative territory, even as the securities performed close to flat in local currency terms.

Currency risk has generally been the most volatile of the three primary risks facing fixed income investors—the relative risks of currencies, interest rates and credit. Sharp

Breakdown of Local Bond Returns, September 2011

Foreign Exchange, a Dominant Factor in Local Bond Index Returns



Source: HSBC

FX return component depends on changes in local currency versus U.S. dollar exchange rate

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"Although the concept of capital account controls is anathema to those weaned on free market principles, such controls may ultimately benefit long-term, fixed income investors in Asia ex-Japan."

currency depreciation often accompanies quick exits out of local fixed income assets by speculative investors. In this most recent period of Asian foreign exchange turmoil, local currency government bonds, as a group, held their ground, making only modest price declines. The 10-year Korean Treasury bond, for instance, returned –9.8% in U.S. dollar terms over the month, almost entirely as a result of the currency effect alone. So even in an environment in which local currency debt is stable in local price terms, currency volatility may raise the risks to foreign holders of such investments.

Due to the interlinked nature of the debt markets, fixed income markets in the region may suffer dramatic reversals from any crisis originating from the West. A flight-to-quality bid for U.S. Treasuries could result in large, quick withdrawals out of Asian fixed income markets. This could occur as speculative funds are repatriated or as Western banks shrink balance sheets by cutting off loans to Asian commercial borrowers, both of which occurred during the 1997–98 Asian Financial Crisis. To gauge the potential and severity of a capital flight scenario, let's examine the history and current framework of capital account controls.

Speculative "Hot Money"

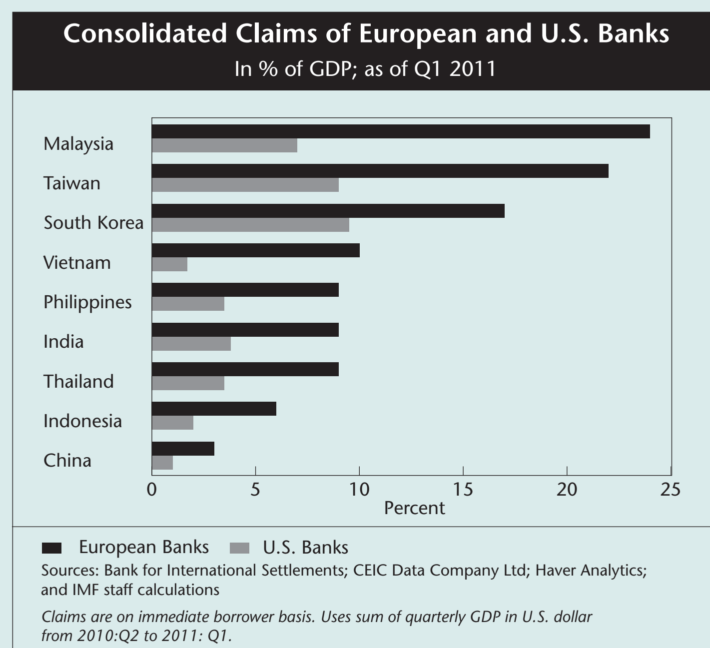
In the 1990s, the International Monetary Fund (IMF), the World Bank, and the U.S. Treasury were fresh from dealing with the market debacles in Latin America. One lesson these institutions promulgated within Asia was to liberalize capital accounts. Free capital movements were seen as most beneficial to both foreign investors and local economies, and the IMF recommendations were intended to create mutual benefits for both developed and developing countries. Unshackled from local rules and onerous taxes, foreign investors rushed to liberally extend loans to Asian borrowers. Unfortunately, for nations that heeded the IMF advice, their financial infrastructures did not keep pace with the inevitable credit expansion. They lacked the appropriate risk management mechanisms; rapid capital inflows caused currencies to appreciate; inflation rose; asset bubbles grew; and countries that had been running current account deficits went deeper into the red as exports slowed. When the financial collapse came in 1997-98, individuals and corporations defaulted on loans, and the problem was amplified in the case of foreign currency-denominated loans.

During the Asian Financial Crisis, foreign withdrawal from bank lending was a larger factor than any shunning of the local bond markets. Whereas capital controls have often been negatively viewed in the past, they are now being used more preventatively as a means of mitigating currency risks. Asia's capital markets are rapidly evolving to provide a deeper and more stable holder base for fixed income. Issuance of local currency debt has surged ahead of external currency issues since 2008. Both supply and demand dynamics have been responsible for this growth. From the demand perspective, pensions are growing in assets as the population ages. Moreover, as GDP per capita rises, growth in insurance as a "luxury good" has provided a demand pull for fixed income as well. These institutions generally have local currency liabilities against which they need to hold local currency fixed income assets. Taiwan (with a population of 23 million) alone has US$300 billion in insurance assets.

From an issuer perspective, U.S. dollar funding has remained tight, making it relatively expensive to issue U.S. dollar-denominated debt. The steady stream of demand from local institutions ensures that local currency debt issuance will continue to be greater than external currency debt issuance going forward.

Foreign Participation

Asian fixed income markets can have heavy foreign participation in both bonds and bank loans. The amount of participation from European banks is noteworthy in light of their exposure to European debt and the probability of shrinking balance sheets in the near future. European bank lending into Asia is greater than U.S. bank lending in the



Sources: Bank for International Settlements; CEIC Data Company Ltd; Haver Analytics; and IMF staff calculations

Claims are on immediate borrower basis. Uses sum of quarterly GDP in U.S. dollar from 2010:Q2 to 2011: Q1.

“For long-term buyers of Asian fixed income, frictional costs of capital controls may be an acceptable trade-off for less volatility.”

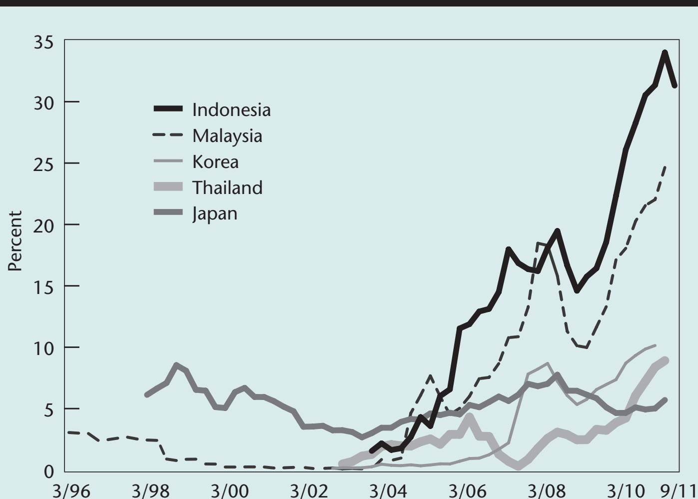
region; therefore, weakness in European bank balance sheets may tighten the financing environment for Asia's borrowers more so than similar weakness in U.S. banks.

China has the largest bank loan and bond markets in Asia, but the smallest amount of foreign participation. Stringent capital controls and massive foreign exchange reserves simultaneously insulate China from capital flight in its fixed income markets and lower the odds of a successful speculative attack against its currency.

Foreign participation in the local currency government bond markets can also be an indicator of the local market's susceptibility to hot money departures. Western investors have been attracted by yields in markets such as Indonesia. When interest rates are stable and the country's credit profile is improving, the longer duration of local currency debt can amplify the positive returns stemming from the local currency's yield.

Capital Controls: the Good and the Bad

For fixed income investors, volatility arising from the quick withdrawal of funds on the part of foreign investors is an inherent, short-term risk of investing in Asia. Capital controls have the effect of dampening volatility by placing frictional costs on the inflow and outflow of speculative money. Empirical evidence suggests that such controls may be effective. (Even the IMF itself has seemed to have reversed its position on capital controls it vehemently held over 20 years.)



Source: Asia Bonds Online

In the near term, market externalities could create more volatility ahead for fixed income markets in Asia. European solvency (of both bank and country balance sheets) continues to dominate headlines, but may quickly be displaced by other stressors and events outside of Asia. For instance, a faster-than-expected recovery of the U.S. economy may result in interest rate hikes that make U.S. fixed income markets more attractive. This could result in a tactical allocation shift away from Asia by the marginal yield-seeking U.S. or European investor.

As local bond markets in Asia deepen, we can expect capital controls to become less important. Japan's gradual and methodical loosening of capital controls since World War II suggests one possible path that China and other Asian countries may follow. China's case is unique in that it must have free flow of capital if it hopes to realize its goal of providing one of the world's reserve currencies.

In the developed markets, the irony is that regulators have become more pragmatic in their views on capital controls. Europeans are actively debating the levying of a financial transaction tax. Meanwhile, in the U.S., the Obama administration has floated the idea of a “Financial Crisis Responsibility Fee.”

Just as markets evolve, so do regulations. The reflexive rebuke of capital controls once voiced by Western regulators has given way to a more flexible approach in times of extreme volatility. Asia's regulators have observed the efficacy of volatility-dampening measures, and thus far, appear to have avoided the worst excesses. As fears continue over diminishing U.S. dollar power, Asia's bonds remain attractive diversifiers for their yields and good credit ratings. However, one should never forget the volatile history of currencies in Asia. This is precisely why we believe Asia's quiet revolution of the capital controls concept may be beneficial for long-term buyers of Asia's fixed income instruments. The frictional costs of these controls may be an acceptable trade-off for less volatility.

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