Preface

Sustained economic growth can contribute significantly to poverty reduction, as evidenced by marked declines in poverty incidence for economies that have enjoyed long periods of economic growth. But a financial crisis could disrupt growth and frustrate such development. While crisis-hit economies will recover from the crisis, they may not return to the pre-crisis growth path. Because a crisis can have long-term development implications, the Asian Development Bank Institute (ADBI) is keen to make a contribution to the understanding of the causes of a crisis and to the formulation of policy measures that ADB's developing member countries could adopt to avoid a crisis.

Many fast growing economies in Asia suffered from a financial crisis in 1997–98, which could be attributed largely to their inability to deal with large capital flow volatility. Although few deny the benefits of capital inflows for recipient economies, they often create problems especially if they are substantial and volatile. Massive capital inflows can create too much bank lending, excessive investment, and speculative activities, which can lead to goods price inflation, asset market bubbles, and potential vulnerabilities in bank, household, and corporate balance sheets. Moreover, sudden stops or reversals in capital inflows could lead to a currency crisis, the bursting of asset price bubbles, investment collapse, banking sector stress, and economic difficulties.

Since the recovery from the Asian financial crisis, many economies in the region have experienced massive private capital inflows against the backdrop of current account surpluses over many consecutive years. Cognizant of the implications of potentially volatile capital flows for the sustainability of Asian economies' growth, Thailand's former Finance Minister Chalongphob Sussangkarn made a request at ADB's Annual Meeting in Kyoto in May 2007 to conduct a study on capital flows in Asia, the results of which could be inputs for the region's policymakers in managing capital flows from national and regional perspectives. In response, ADB tasked ADBI to conduct the study. ADBI's research proposal, which laid the groundwork for this book project involving experts from leading think tanks in the region, was presented at the informal meeting of the ASEAN Finance Ministers held in Washington in October 2007. Most of this study was conducted in the first half of 2008 before the visible eruption of the global financial crisis.

Following the failure of Lehman Brothers in September 2008, the world economy experienced the worst global financial and economic crisis since the Great Depression. The economies of several European peripheral countries were severely damaged by a sudden stop in inward flow, and/or withdrawal, of capital. Even though Asian economies were not affected much by capital flow volatility with a few exceptions, they were hit hard by the downturn in export demand. But Asian economies have quickly recovered and are now leading global growth. There are signs that capital of a largely short-term nature is returning to Asia in a significant way, raising serious concern among policymakers in the region who are trying to prevent rapid appreciation of their currencies against the US dollar and to contain inflation and increases in asset prices to stabilize their economies and sustain the recovery. Indeed, following Brazil's move, Taipei,China; Indonesia; and the Republic of Korea have recently imposed capital controls to limit speculative capital inflows.

These recent developments suggest that managing capital inflows remains an important policy issue for many emerging market economies that needs to be studied rigorously and debated openly. This study clearly benefited from lessons learned from the impact of the global financial crisis on international capital flows. With the publication of this book, ADBI hopes to contribute to the debate by providing analyses that can help policymakers develop a framework for managing capital flows that is consistent with prudent macroeconomic and financial sector stability.

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