

## **Emerging Asia: Thriving in the Global Financial System**

**By David Burton**

**Director of the International Monetary Fund's Asia and Pacific Department**

As global financial leaders converged on Washington for the 2007 World Bank-IMF Spring meetings last week, the Asia region once again stands out for its economic performance. Emerging Asia's economic growth rate reached 9 percent last year, led by the continued remarkable performance of China and India, while inflation remained generally under control. Moreover, Asia's financial markets proved their resilience during bouts of global market turbulence in mid-2006 and early this year—generally faring better than their counterparts in other regions. Investor sentiment toward the region remains positive.

Looking ahead, 2007 promises to be another good year. As discussed in the IMF's current *Asia and Pacific Regional Economic Outlook* (available at [www.imf.org](http://www.imf.org)), growth for emerging Asia is expected to moderate only slightly to 8½ percent this year. Exports, the prime engine of growth, showed some signs of slowing in late in 2006, especially in the information technology sector. But, while this development bears watching, export growth is expected to ease only moderately this year.

A modest rebalancing of growth toward domestic sources is also anticipated, highlighted by stronger investment in much of emerging Asia and a pickup in consumption in China. Of course, Asia remains exposed to downside risks from the global environment, especially a more pronounced slowdown in the U.S. than currently foreseen or a sharp rise in financial market volatility. Nevertheless, a decade of sound macroeconomic policies and deep structural reforms leaves the region well placed to weather such shocks.

What is the basis for Asia's remarkable success? While every country's story is unique, it is clear that Asia's transformation to an economic powerhouse is founded in large part on its integration into the global economy. Trade liberalization—both within the region and with the world—has played a key role in sustaining Asia's rapid growth. And we are now seeing an acceleration in financial sector integration as ongoing efforts to develop and liberalize financial systems and promote regional financial integration bear fruit.

Will financial integration bring the sorts of gains that trade liberalization has delivered? We know that capital market integration and liberalization can provide important benefits: helping countries access global savings; bringing financial know-how, risk management techniques, and new financial products from abroad; and allowing residents to diversify their portfolios by purchasing assets overseas. But the associated capital flows also bring risks, including the possibility that large inflows may lead to overvalued exchange rates or asset price bubbles, or that sudden stops or outflows of capital can wreak havoc on financial systems. What are the facts about the growth in capital flows? What can policy makers do to ensure that the benefits of capital market integration worth the risks?

*Both gross inflows to Asia and outflows from the region are at or close to historic highs. Gross inflows reached nearly 8 percent of GDP last year, higher than the peaks of the mid-*

1990s. Perhaps less well appreciated, capital outflows from the region are also larger than ever, increasing nearly fivefold in the last decade. This reflects ongoing portfolio diversification supported, in a number of cases, by the removal of restrictions.

*Although inflows and outflows have both grown rapidly, net capital inflows remain close to their long-term average, equivalent to about 2 percent of GDP.* And while Asian currencies have seen upward pressure and reserves have continued to accumulate in the region, sizable current account surpluses—not capital inflows—have been the major cause. Further rebalancing of growth in the region toward domestic demand, a process that is likely to go hand in hand with further real appreciation of some currencies over the medium-term, will put growth on a more sustainable footing and contribute to addressing global imbalances.

*But capital flows may still pose challenges for macroeconomic management for some countries.* Gross inflows and outflows have become more volatile in the region, reflecting both the increase in the size of inflows as well as the growing importance of portfolio flows and bank lending and derivative transactions. And surges in inflows in some cases have at times been associated with strong pressures on exchange rates or asset prices.

*There is no silver bullet for dealing with the challenges of more volatile capital flows, but a range of mutually reinforcing policies hold the best promise.* Greater exchange rate flexibility, with limited two-way intervention to smooth exchange rate movements, is one element. Strong monetary policy frameworks that can help keep inflation expectations in check are another. Policies aimed at strengthening risk management and developing domestic financial markets, including in the context of regional financial integration, can help financial systems cope with surges in capital flows. Further liberalization of capital accounts should go hand in hand with progress in these areas. The world of growing and quite volatile capital flows appears to be here to stay. But the right policies can help ensure that the benefits of financial liberalization are realized, that inflows are put to productive use, and the risks from volatility are limited.