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Topics *Changes in capital flows to developing countries and Asia's response*

Capital flows to emerging Asian countries are expanding rapidly, and capital controls are one way of responding. The development of domestic financial and capital markets is also an issue of vital importance.

■ Expanding capital flows to developing countries and tightening of capital controls

With the global financial crisis, capital flows to developing countries decreased dramatically. However, since mid 2009, stock and other investments have increased at a rapid pace. This trend is also particularly noticeable among many Asian economies, such as China, India, Indonesia and Korea. The contributory factors include the fact that monetary easing prevails among developed nations, that the economic strength of developing nations is in clear contrast to the economic stagnation of industrialized economies, and that the interest rates of developing nations are relatively high. The expansion of capital inflows may lead to excess liquidity and economic bubbles. The economies of developing nations have long been at the mercy of repeated capital inflows and outflows from industrialized nations. Because there is expected to be an increasing interest in the Asian region on the part of investors in industrialized nations as well as Asian countries, the development of strategies in response to the situation is an issue of significant importance.

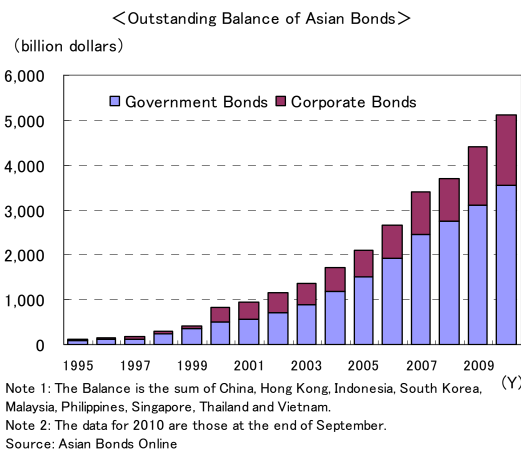
As regards the combination of exchange rate policies, monetary policies and capital controls, since the currency crisis of 1997, many Asian countries have maintained comparatively strict capital controls, and, while maintaining a level of freedom within their monetary policies, have taken steps to restrict the appreciation of their own currencies. Also, recently, there have been signs of moves to tighten controls and taxation in response to the expansion of capital inflows. For example, Indonesia introduced a measure in July 2010, requiring anyone who purchases SBIs (Bank Indonesia certificates) to hold them for at least one month. In Korea, changes of regulations were introduced in June and November, including the decrease of banks' FX forward position limits, and the decision was taken to revive the withholding tax, which was abolished in 2009, regarding foreign investors' investments in government bonds. Furthermore, in Thailand, the 15% withholding tax on non-residents' bond investments was reintroduced in October.

Based on the experience in the global financial crisis, it is clear that one of the most pressing issues in the future will be how to prevent the spread of turmoil that happens in the international financial markets. To that end, tightening of capital controls and lowering of dependence on capital inflows are measures that need to be considered.

The prerequisites for the liberalization of capital transactions include sound macro-economic policy management with flexible exchange rates, and the development of domestic financial systems. Capital account liberalization has many benefits, including improved efficiency in the global distribution of funds, and financial technology transfer from developed countries to developing countries. However, it is very difficult to make a clear distinction between speculative capital flows and non-speculative ones, and any sudden and drastic speculation-centric capital inflows and outflows are bound to exert a significant impact. Even if certain prerequisites are satisfied to some degree, full liberalization of capital transactions represents a serious risk for developing nations with small domestic markets.

The general position is that it is preferable for a country to ensure that it has the prerequisites in place and then implement the liberalization of capital transactions, and limit capital controls to short-term measures. However, there is a risk that frequent changes in capital controls will damage overseas investors' confidence in a particular market. Therefore, it may be considered the more prudent option to implement liberalization over the long term, and proceed cautiously.

＜Outstanding Balance of Asian Bonds＞



Note 1: The Balance is the sum of China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand and Vietnam.
Note 2: The data for 2010 are those at the end of September.
Source: Asian Bonds Online

■ Growing importance of the development of domestic financial and capital markets

The strengthening of domestic financial and capital markets is extremely important from the perspective of providing an adequate response to drastic capital inflows and outflows. In addition to maintaining financial soundness in the face of enlarged capital inflows, it is also important for a country's financial system to be able to maintain its functional integrity should international financial markets suffer from a crisis. From this perspective, at the time of the global financial crisis, the bond markets of many Asian countries were able to maintain a comparatively high level of normal functionality, and have been able to expand steadily in the periods following the crisis. Immediately after the crisis, there was an evident trend of holding back on the issue of government and corporate bonds. Subsequently, however, many financial institutions and large corporations that were finding it difficult to raise funds abroad tried to return to the domestic markets. With these developments, many Asian governments appear to have recognized anew that over-dependence on capital inflows is a problem, and that the development of their bond markets is an effective way of dealing with it.

Additionally, the IMF noted that, at the time of the financial crisis, as bank financing was curbed and the issue of corporate bonds expanded in the Asian region, the corporate bond market functioned as the banking sector's 'spare tire'. Since 2009, it has been particularly noticeable in India and Korea that the interest rates on corporate bond issuance have declined regardless of the widening of credit spreads, while the banks' prime lending rates have been reluctant to come down.

Nevertheless, the foregoing does not suggest that the development of Asian bond markets is complete. The IMF has stated that, in the future, the bond markets should function as a viable and deep source of funding even in normal times, particularly with regard to the ability of small and medium enterprises to issue bonds.

■ Post global financial crisis changes in the real economic situation in Asia and the importance of progress towards regional financial integration

Since the currency crisis of 1997, we have consistently been told that it is very important to develop Asia's financial system and mobilize Asia's savings for Asia's investments. However, the meaning of this idea has begun to change gradually. Immediately after the currency crisis, the priority for Asian countries was to reduce borrowing from countries outside of the region in order to alleviate the problem of “double mismatching” that resulted from the use of short-term foreign currency borrowings to fund domestic long-term investment. This is the issue of how to respond to capital flows discussed thus far.

In contrast, in these post global financial crisis days, attention has turned to the real economic aspect of increasing each country's domestic demand and making corrections to the export-led growth strategy. As a means to that end, the strengthening of financial systems is becoming more and more important. Also, as domestic demand expands among the Asian nations, regional real economic integration grows stronger, and the need to promote regional financial integration increases. The expression "mobilize Asia's savings for Asia's investments" contains the meaning of expanding intra-regional cross border transactions and reinforcing regional financial integration.

As part of the Asian Bond Markets Initiative (ABMI), which aims to develop and strengthen bond markets in the region, the ASEAN+3 Bond Market Forum (ABMF) has been set up with private and public cooperation to discuss ways of lessening barriers to the growth of cross-border transactions, and is stepping up its study of methods for harmonizing and integrating Asian bond markets and settlement systems.

In order to expand intra-regional cross-border transactions, it is important to realize necessary changes and harmonization of market infrastructure (trading platforms, clearing and settlement systems, hedging tools, etc.) and related regulations and institutions (laws and regulations, credit rating agencies, accounting and auditing standards, taxation systems, etc.). While these are certainly difficult issues, given the progress of the removal of international borders from corporate activities, and investors' rapidly growing interest in intra-regional investment, it can be said that the promotion of regional financial integration is becoming indispensable.

On the other hand, moves by the nations in the region to tighten capital controls and taxation on cross -border transactions are hindering regional financial integration. This alone would suggest that integration is not going to be an easy matter. There will surely be a need for deeper discussion on strategies for advancing capital account liberalization, while keeping an eye on management of capital flows.

(Satoshi Shimizu)

Korea *Agriculture support remains an issue as trade liberalization advances*

■ US-Korea FTA agreement

On December 3, 2010, the US and Korean governments reached significant agreement in their talks on a Free Trade Agreement (FTA). Basically, within five years, over 95% of industrial products and consumer goods will be free from customs duties. The two governments initially inked the deal in June, 2007, but the US senate expressed dissatisfaction with some of the details and the Agreement was never ratified, prompting the restart of talks. The focus of current talks was on how far the Korean government can 1) concede in the automobile sector, an area which had been seen as unfavorable to the US, and 2) accommodate US demands for the abolition of import restrictions on beef (in 2007, it was agreed that tariffs would be abolished within 15 years, but the Korean government still prohibits imports of US beef from animals over 30 months old).

Originally, an import tax (2.5%) on Korean made passenger cars (under 3,000cc) was to be abolished immediately after implementation of the Agreement, but as the result of the new talks, the tax will stay in place for four years, and, with certain conditions, cars that meet US safety standards will be able to be sold in Korea without special certification procedures. In addition the tax on US made vehicles will not be abolished immediately but will be lowered from the current 8% to 4% (maintained for four years), and then abolished in the fifth year after the Agreement comes into effect. Also, taxes on automobile parts and components will be abolished with immediate effect, as had been discussed already.

Exports of Korean made automobiles to the US are currently in excess of 200,000 vehicles. However, with the increase in locally produced models, there is a strong possibility that exports will decline gradually, in the future. This means that the delay in lowering tariffs on completed vehicles is disadvantageous to Korea. In order to make up for this, the Korean government succeeded in getting the US side to concede to 1) postponing the abolishing of tariffs on US pork from January 1, 2014, to January 1, 2016, and 2) excluding talks on the abolishing of beef import restrictions from the current Agreement.

＜Results of the Additional FTA Talks (Automobile)＞

Passenger cars	All tariffs on passenger car imports will be lifted from the 5th year of the FTA's going into effect. Until then, the U.S. will maintain its 2.5% tariff and Korea will lower its rate from 8% to 4%.
Safeguards	Apart from regular safeguards, safeguards exclusive to autos will be introduced based on related provisions in the Korea-EU FTA.
Safety standards	Up to 25,000 cars abiding by U.S. safety standards per carmaker will be recognized in Korea.

Source: Ministry of Foreign Affairs and Trade.

■ Agricultural support a domestic issue for Korea

Once the US - Korean FTA comes into effect, following the FTA with the EU (European Union, effective from July 1, 2011), Korea will have fully entered the FTA age. As it does so, support for the agricultural sector becomes an issue. In terms of import tariffs levied on pork, those on pork imports from the EU will be abolished within 10 years, those from the US much more quickly, and those from Chile (effective from 2004) in 2013.

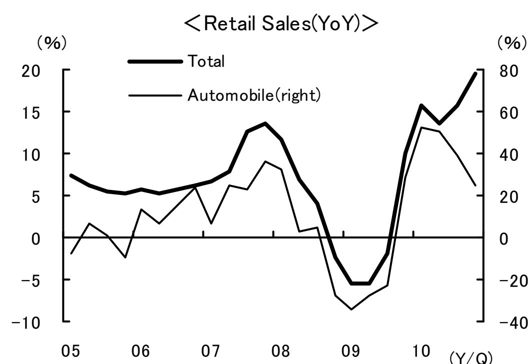
The government also is enhancing its measures in support of the agricultural sector. In addition to an investment plan worth some 119.3 trillion won, and implemented over a ten year span from 2004, a package of loans (for 61 applicable business categories) worth a total of 20.4 trillion won and implemented over a ten year span from 2008, was announced in November, 2007, as part of complementary measures designed to assist the forward movement of the US - Korean FTA. These support measures include 1) assistance in the improvement of the competitive strength (modernization of production facilities, education and training of brand management organizations, and improved distribution structures) of items under threat, 2) stabilization of incomes and expansion of business scale of specialist farmers, 3) education and support of growth-driver food industries (expanded production base of high quality, ecological agricultural production, and clustering of research organizations, universities and food producers), 4) the development of an efficient policy support system, and 5) system improvements designed to vitalize the agriculture industry and agricultural communities.

While it may be said that exports of agricultural produce are increasing as structural improvements in the agricultural industry progress, this does not mean that the anxieties felt by farmers have been completely alleviated. Much attention will be on future developments: will Parliament give its approval and will new measures be discussed? **(Hidehiko Mukoyama)**

Hong Kong *Increased capital inflow is cause for concern*

■ Domestic demand growth on target

Although foreign demand growth has slowed, Hong Kong's domestic demand is still strong. As for foreign demand, October's exports were up 13.8%, compared to the same period in the previous year, a softening in the tempo of expansion. Exports to the US and China both slowed down in the same period, growing 17.1% and 12.6%. Over 50% of Hong Kong's exports are transit trade, so slower growth in Chinese exports to the EU and US have resulted in a deceleration of growth in Hong Kong exports to mainland China. On the other hand, growth in the number of visitors to Hong Kong remained high at 18.0% in October.



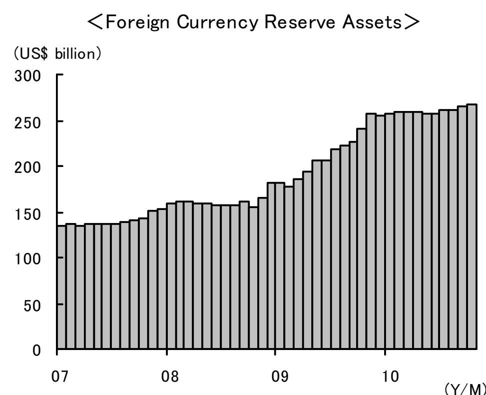
Note: The figures in 2010 Q4 are for October.
Source: Census and Statistics Department of Hong Kong

Turning to domestic demand, retail sales in volume for October grew at a faster pace, 19.5%, compared to the same period in the previous year. Automobiles grew at 24.3%, in October, a slight drop in pace but still a very high level. This has been due to the fact that, in addition to a stable employment environment, asset prices and income levels have gone up, and consumer sentiment has improved. In particular, housing prices grew 47.4% from the end of 2008 till the end of September, 2010, reaching the same levels as the former peak of 1997.

The unemployment rate (seasonally adjusted) for August to October was 4.2%, the same level as July to September. The same trends were observed among trade related industries, and finance and domestic demand related industries.

■ Concerns over increased capital inflow

In November, 2010, the Hong Kong government raised the stamp duty rate levied on housing purchases. The purpose has been to curb overseas investors' real estate investments, as well as Hong Kong residents' short term real estate investments. Since Hong Kong has no capital controls, a massive inflow of capital would lead to increased fears of an economic bubble.



Source: Hong Kong Monetary Authority

Capital inflow and outflow movements can be seen from the foreign reserves. Since Hong Kong in effect adopts the dollar pegging system, if investment capital flows inward from outside of the region, the Hong Kong authorities, in an effort to stabilize the exchange rate, intervene by selling Hong Kong dollars and purchasing foreign currency, so the foreign reserve increases.

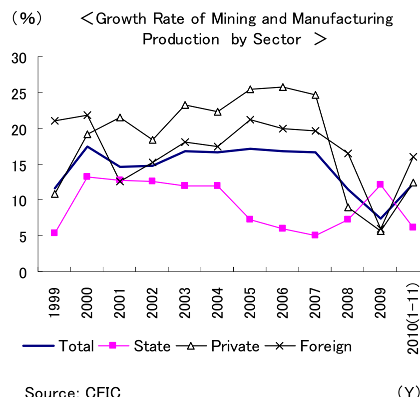
Foreign reserves swelled between late 2007 and early 2008, because of the announcement of the ending of restrictions on Chinese mainland investors' investments in Hong Kong stocks in August, 2007. Then, investment capital came flooding into the Hong Kong stock market. Subsequently, in response to a global financial contraction, some capital began to flow outwards, and foreign currency reserves decreased. In September, 2008, after the Lehman Brothers' collapse, China implemented easier monetary policies and bank loans increased by a significant margin, and some capital began to flow into Hong Kong's stock markets and real estate markets. From the end of 2009, the shift in China's financial policies caused bank lending growth to contract, and capital flow into Hong Kong settled. Nevertheless, foreign reserves at the end of October, 2010, were US$267 billion, 1.7 times the pre-Lehman collapse level. A rapid increase in the amount of liquid capital in the region will be a destabilizing factor, not only for real estate markets but also for domestic demand. If the raising of the stamp duty rate cannot curb capital inflow, Hong Kong government will introduce further measures in the months ahead.

(Shinichi Seki)

Vietnam Stabilizing exchange rate and commodity prices

■ Mining and manufacturing production up 13.8%, exports up 24.5%

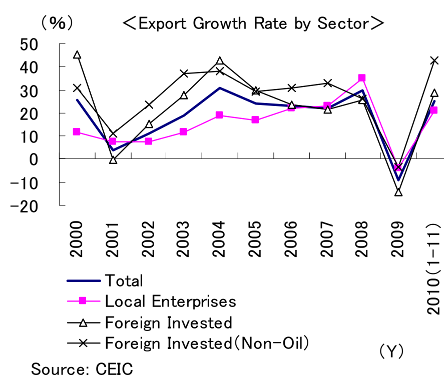
Vietnam's mining and manufacturing production grew 13.8% in the period January to November (flash report, may not match final data). In terms of specific sectors, the foreign and private sectors, which account for 40% of the total, grew strongly at 16.9% and 14.5%, respectively, over the same period, while the state sector could only manage 7.5%, similarly. As for individual items, crude oil production was down 11.5% in the same period, and the slump continues. However, natural gas (vapor) and liquefied gas were up 18.0% and 93.6% in the same period, and energy overall posted solid growth. In addition, beer (up 20.7%, similarly), cement (up 14.9%), refrigerators (18.8%) and motorbikes (13.6%) all grew solidly, indicating strong domestic demand. The retail value of consumer goods and services in the January to November timeframe, on an actual basis, was up 14.7% compared to the same period in the previous year.



Exports January to November were up 24.5%, compared to the same period in the previous year, at $64.3 billion (flash report). In exports also, foreign invested enterprises account for just over 50% of the total, and these exports grew a healthy 27.0%, compared to the same period in the previous year, with local enterprises also growing strongly at 21.6% in the same period. Turning to individual export items, 1) primary products such as marine produce (up 16.3%, similarly), rice (15.8%) and rubber (92.8%), 2) labor intensive products such as textiles (22.6%), footwear (25.3%) and wood products (33.1%), and 3) high added value products made by foreign invested enterprises, such as electronics related (28.5%), machinery parts and components (51.3%), electricity wire and cable (53.8%) and transportation equipment and parts and components (64.4%), all posted healthy growth figures. The export value for the four items following electronics related was $8.6 billion, reaching a level that is more or less shoulder to shoulder with Vietnam's biggest export item, textiles ($10 billion).

■ Consumer price index increase rate in double digits

At the close of parliament in late November, in addition to the debate on Vietnam's mid-term social and economic development strategies, the next Five Year Plan (2011 to 2015) and the next Ten Year Plan (2011 to 2020), the government's economic management policy for 2011 was also approved. Specifically, a set of targets including 1) raising the per capita GDP to $1,300, given a real economic growth rate of between 7.0 and 7.5% in 2011, 2) restraining the trade deficit to a maximum of 18% of exports, given an export growth rate of 10%, year on year, and 3) a consumer price index increase rate of 7% or lower, and 4) investment of 40% against GDP. It will be commodity prices and the exchange rate that will affect whether these targets can be achieved or not.



November's consumer price index increase rate (referencing 2009, final statistics referencing 2005) was 11.1% up compared to the same period in the previous year. In November, Central Bank raised the base interest rate to 8%, after having kept it at 7% since February. Interest rates in the interbank market rose rapidly, with the three month futures interest rate going up from 9.5% in September to 13.5% in November. The black market rate for the dong against the dollar on December 7 was 21,500 dong, still greatly diverged from the official rate (19,495 dong). It looks likely that Central Bank will need to tighten monetary policy still further in order to stabilize commodity prices and the exchange rate.

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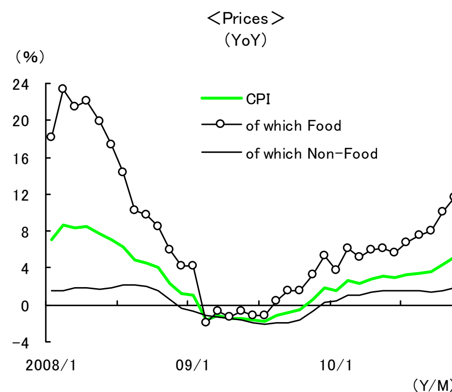
(Yuji Miura)

China *Enhancing price measures*

■ Consumer price index increase rate grows in 4% range for the first time in two years

China's consumer price index is rising at a faster pace. The consumer price index increase rate for October, 2010, was 4.4% up on the same month in the previous year, growing in the 4% range for the first time since October, 2008 (November's growth was 5.1%, similarly). The government has set a target of restraining consumer price index growth to around 3% in the previous year, but the rate has increased by over 3% since July, and the conclusion is that there is only a very slight possibility of achieving the target this year.



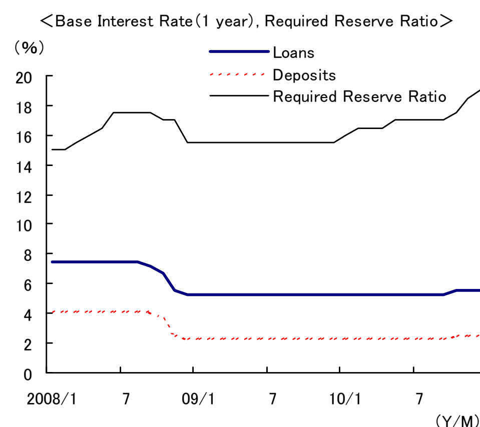
Source : National Bureau of Statistics, CEIC database

While growth in non-food prices was fairly stable in the 1% range compared to the same month in the previous year, the increase in food prices has topped 10%, pushing up overall prices. Under these circumstances, and concerned over the influence on households, the Hu Jintao administration has taken steps to enhance price measures.

On November 20, the State Council issued State Council Document No. 40 pertaining to the stabilization of prices. The document details 16 measures designed to alleviate the impact of price rises and includes 1) toll-free access to highways for trucks carrying fresh produce (from December 1), 2) the release of government stockpiles of foodstuffs and edible oil, 3) curbs on excessively speculative transactions about agricultural crops, and 4) a temporary increase in the price subsidies paid to those qualifying for social security in support of a minimum standard of living. In addition, while stressing that it will be 'as occasion arises', the document also suggests that price interventions will be implemented with regard to important necessities and production goods, giving a clear sense of the government's strong determination to keep prices under control. After the document was issued, related departments began to take concrete action to implement the measures described. For example, the Ministry of Industry and Information Technology issued notice to local governments urging them to lift restrictions on electrical power supply for the production of chemical fertilizer.

■ Shift towards tighter monetary policy

On the monetary policy front also, there has been a series of tightening measures. In October the major banks only were required to raise their required reserve ratio for a limited period, bringing the base interest rate up for the first time since December, 2007. The required reserve ratio was raised twice in November, and once in December.



Note: Required Reserve Ratio are Major Bank's figures
Source: The People's Bank of China

Subsequently, on December 3, the Political Bureau of the Communist Party of China decided to proceed with a 'prudent monetary policy'. Until now the official position had been an 'appropriately relaxed monetary policy', and although the shift may represent a course adjustment following economic recovery, it must also be seen as a bid to halt the recent upward trend of prices.

While these initiatives give rise to expectations of curbing inflation, they are also a cause of concern over possible cooling of the economy. At the moment, the government is pushing ahead with an expansionary fiscal policy, taking care not to be too devoted to a tight monetary policy, but the question of how to balance inflationary restraints and sustained growth will be one of the big issues of economic management in 2011. The Hu administration will need to be able to advance with the steady implementation of a balanced policy mix.

(Junya Sano)