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Hot Money Finds Familiar Home for Euro Refugees: William Pesek
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Commentary by William Pesek

May 6 (Bloomberg) -- It feels a lot like 1996.

It was then, a year before the region plunged into chaos, when investors were rushing to Asia with nary a concern about hot money overwhelming developing economies. It ended in tears for governments, households and financiers alike.

The good news is that Asia is standing its ground amid the global crisis. The bad news is that Asia is home to the next great asset bubble as tidal waves of capital rush its way.

Expect lots of interest-rate volatility as central banks search for a balance between healthy growth and too much. And don't be surprised if capital controls are a big part of the process.

Yes, that bane of investors' existence is coming at least moderately into vogue. That was clear in Tashkent, Uzbekistan, this week as policy makers at the International Monetary Fund and Asian Development Bank appeared less hostile to the idea of limiting the movement of money.

As Asia goes full circle from the late 1990s when capital controls were the financial equivalent of a mortal sin, investors are left with no choice but to adapt. That may not be as big a problem as many think. Anything that provides a shock absorber to keep Asia from overheating will be welcome.

"I, as an investor, loathe capital controls in all forms, but we will certainly see more of them," Robert Parker, London- based senior adviser at Credit Suisse Group, told me in Tashkent, where the ADB held its annual meeting.

Capital Controls

When I asked Naoyuki Shinohara, deputy managing director of the IMF, he admitted the institution is now more open to such barriers on capital. The key, of course, is not to go too far by inhibiting growth and scaring off foreign investment that's needed to support it.

It's a breathtaking sea change when you consider how the IMF was militantly against controls 12 years ago. Back then, Malaysian Prime Minister Mahathir Mohamad was an international pariah for implementing them. In late 2006, investors chastised Thailand for slapping controls on markets.

The shift speaks to Asia's predicament over the next couple of years.

Asia has weathered the financial crisis, as just about anyone visiting Tashkent agreed. China and India beat the odds and continue to grow strongly. South Korea confounded the skeptics anew, as did Indonesia. Japan's persistent malaise aside, Asia is hot and getting hotter. The trouble is, all this good press means Asia may have too much of a good thing on its hands.

Greece's Woes

As the U.S. grapples with unemployment, the euro area is trying to avoid disintegration. Greece’s woes are reverberating through markets. There’s little confidence in Asia that a recent $146 billion bailout will be the last in Europe. The buzz in Asia is who’s next?

Even if concerns about contagion from Europe are overdone, Asia must brace for the opposite: fast-accelerating capital flows from West to East. With official interest rates in the euro area, U.K., U.S. and Japan close to zero, world markets are awash in liquidity searching for higher yields.

For many, that means Asia. Emerging markets need to take “urgent action” on the surge of liquidity and capital flowing into their economies because they could spur inflation and trigger another crisis, according to a report last week by Standard Chartered Plc.

Debt Markets

One area for concern is debt markets. While vastly improved since the 1990s, Asia still hasn’t built the deep, liquid bond arenas needed to stabilize growth. It means that lots of the capital flowing Asia’s way will end up in stocks and property.

In a perfect world, investors would move into bonds as asset prices get frothy. The lack of dynamic secondary debt markets means many may just leave Asia, as opposed to diversifying into the region’s fixed-income investments. It makes Asia more volatile than it should be in 2010.

Capital controls could help ameliorate the problem. One way to go is to implement “targeted controls,” says Masahiro Kawai, head of the Tokyo-based Asian Development Bank Institute.
He points to Brazil as an example.

In 2009, Brazil implemented a tax on foreign purchases of stocks and fixed-income investment in a bid to stem the currency’s advance. Markets took the step much better than Thailand’s 2006 moves, which sent stocks plunging.

A point lost on few is that China and India, which have more conservative regulations than the West, weathered the crisis. With the Group of 20 nations dragging their feet on crafting a safer international financial system, governments will feel pressed to do what they can to tame markets.

Unlike in 1996, Asia knows a tsunami of cash is coming its way and that it comes with risks. Carefully employed, capital controls could siphon some of the heat from Asia’s latest hot- money challenge.

Free-market champions are unlikely to concede that any curbs on money flows are appropriate. Smart people can, and will, debate this issue. It’s inevitable, though, and the sooner markets learn to live with it, the better.

(William Pesek is a Bloomberg News columnist. The opinions expressed are his own.)

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