ADB **News Release**

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EMERGING ASIA SHOULD BE READY TO ACT ON POTENTIALLY DESTABILIZING CAPITAL INFLOWS - ADB REPORT

MANILA, PHILIPPINES (18 May 2010) – Governments in emerging Asia should stay on guard and be ready to act if volatile capital inflows threaten to destabilize the region's financial markets, says a new report from the Asian Development Bank (ADB).

Emerging Asia's capital markets have posted rapid gains as economic recovery in the region has gathered pace, drawing massive investment from overseas. The impact of the escalating debt problems in Europe has been limited. However, economies and markets face a number of other risks with inflation, though manageable, edging up and as governments prepare exits from economic stimulus packages.

The *Asia Capital Markets Monitor*, ADB's annual assessment of the performance and outlook for the region's equity, bond and currency markets, said managing the hefty capital inflows into the region's markets is the key challenge.

Foreign investors have rushed back into emerging Asian markets, attracted by the region's swift recovery from the global crisis, a return of risk appetite and very low returns on assets in developed economies.

"While the return of capital flows is welcome, surges in short-term capital inflows could potentially leave countries vulnerable to a sudden reversal in portfolio investment and to sharp currency movements," said Srinivasa Madhur, Senior Director of ADB's Office of Regional Economic Integration which prepared the report.

"More broadly, the region is holding up well in the face of the debt crisis in Greece and its potential contagion effect," he added.

Emerging Asian equities yielded a 73% return in US dollar terms in 2009 while local currency bond issuance of $3.69 trillion was 41.4% higher than in 2008. The hefty investment from overseas has put significant upward pressure on the region's currencies.

Despite favorable cyclical developments, the strong performance of emerging Asian equities in 2009 limits the room for further gains, the report said. The yield curve in local government bonds has already steepened and that may continue on rising inflationary expectations and as monetary authorities increase official interest rates.

Emerging Asian currencies have strengthened to varying degrees against the US dollar. Appreciation pressures are likely to intensify as capital inflows continue, which may fuel volatility in some currencies.

The report said recent surges in capital inflows have been driven by portfolio equity flows as investors take advantage of widening earnings potential between emerging Asian and mature markets.

The use of capital controls may be appropriate in circumstances where capital inflows are transitory and are adding undue pressure on exchange rates and where effectiveness of macroeconomic policy measures to counter the inflows and the exchange rate movements is uncertain.

"Managing capital flows requires a wide array of policy measures; sound macroeconomic management, a flexible exchange rate regime, a resilient financial system and sometimes the use of temporary and targeted capital controls," Mr. Madhur said.

The *Asia Capital Markets Monitor* covers eleven economies of emerging Asia; the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

ADB, based in Manila, is dedicated to reducing poverty in Asia and the Pacific through inclusive economic growth, environmentally sustainable growth, and regional integration. Established in 1966, it is owned by 67 members – 48 from the region. In 2009, it approved a total of $16.1 billion in financing operations through loans, grants, guarantees, a trade finance facilitation program, equity investments, and technical assistance projects. ADB also mobilized cofinancing amounting to $3.2 billion.

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