Capital Inflows and Asset Prices: Evidence from Emerging Asia

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June 2012

Summary

Over the recent years emerging market economies experienced large swings in net capital inflows. Capital inflows lower the costs of funding, help raise the standard of living and thus facilitate convergence with advanced economies. Likewise, cross-border flows, by offering investment opportunities and extending the set of available assets, contribute to economic efficiency and risk sharing also in the source countries. Nevertheless, capital inflows often have many unwarranted effects. First, they can lead to a real exchange rate appreciation that undermines competitiveness in the tradable goods sector. Second, by preventing the central bank from tightening monetary policy, they can lead the economy to overheat, generating inflationary pressures. Third, they can trigger and prolong asset price bubbles and amplify financial fragility.

The latter impact is the focus of this paper. In light of the recent financial crisis that originated in a housing price bubble in the U.S., researchers and policymakers focus again on the housing market as a key indicator for financial imbalances and macroeconomic risks. This paper studies the response of property prices in emerging market economies to an inflow of foreign capital. Our contribution is threefold.

First, we estimate a panel vector autoregression on a set of Asian emerging market economies for which the waves of inflows were particularly pronounced. A panel approach is best suited to summarize the data in light of the short sample period available after the disruptions of the Asian financial crisis. Second, we identify capital inflow shocks that can best be interpreted as an unexpected increase in foreigners' demand for domestic assets. The driving forces behind international capital flows are often classified in terms of push and pull factors. Push factors, defined as financial and macroeconomic conditions in advanced economies, lead investors in advanced economies to send funds to emerging markets. In contrast, pull factors are given by conditions in the recipient countries attracting foreign investors. The capital inflow shock identified here is consistent with a shock to push factors. Third, we light on cross-country differences in the responses of both types of asset prices, i.e. house prices and equity prices, to capital inflow shocks.

Our results suggest that capital inflow shocks had a significant effect on real house price appreciation. A shock that increases net capital inflows relative to GDP by one percentage point leads to an increase in real house prices of 0.5%. Although capital inflow shocks account for only a moderate small portion of overall house price changes, about 10% to 15% depending on the specification, this fraction is about twice as large as what has been found for OECD countries.

The shocks we identify capture the capital flight in 2008 and the massive return of capital coinciding with the unconventional monetary policies in industrial countries since 2009. To corroborate these findings, we also estimate the responses of equity prices to capital inflow shocks and restrict capital flows to portfolio inflows only. Finally, we find important cross-country differences in the sensitivity to capital flow shocks, which cannot be explained by mortgage market characteristics or property market regulation.