ISAS Brief

No. 113 – Date: 1 July 2009

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Booms and Busts in Private Capital Flows to Emerging Asia since the 1990s[1]

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A decade or so after the financial crisis that hit Asia in 1997-98, the region once again experienced a severe capital account shock in 2008-09. How different has this boom and bust cycle of international capital flows been from the previous one? This brief examines the balance of payments dynamics in emerging Asia to understand the magnitude and types of private capital flows to and from the region between 1990 and 2008.[3]

Dynamics of Private Capital Flows in Emerging Asia since the mid 1990s

The search for higher returns led to a surge in foreign capital inflows into emerging Asia in the first half of the 1990s, averaging about 2.4 percent of the region's gross domestic product (GDP), peaking at almost four percent of GDP by 1996 (Figure 1).[4] Structural or trend factors leading to an influx in global capital flows to emerging markets included rapid improvements in telecommunications and information technologies; the proliferation of financial instruments, the institutionalisation of savings; and the internationalisation of investment portfolios (mutual and pension funds) in search of opportunities for risk diversification. The attractive growth prospects, along with stable exchange rates, sound domestic macroeconomic policies (actual or perceived) and progressive financial and capital account deregulation in many of the (East) Asian economies were forces pulling capital flows specifically into the region in general at that time. In terms of the types of capital flows, while foreign direct investment (FDI) grew steadily during the first half of the 1990s, and portfolio flows (bonds and equities) were more volatile, there was a notable jump in the "other" net private capital flows in 1995 and 1996. This component of capital flows included net short-term lending by foreign commercial banks as well as foreign currency deposits and trade credits.

The subsequent loss of confidence in these economies resulted in a massive turnaround in private capital flows in 1997, that is, the boom was followed by bust. The data reveal that

1 This brief is based on ongoing work on international capital flows in the Asian region by the author.

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3 We do not discuss official capital flows such as the International Monetary Fund (IMF) lending.

4 As defined by the IMF, emerging Asia encompasses China, India, the newly industrialising economies of Hong Kong, South Korea, Singapore and Taiwan, and the ASEAN-5 of Indonesia, Malaysia, Philippines, Thailand and Vietnam.

emerging Asia experienced a sharp reversal in net private capital flows in 1997 and 1998 – net private capital flows dropped by more than half in 1997 (compared to 1996) and then actually turned into outflows in 1998. This reversal was primarily due to the "other" net private capital flows. This component, which peaked at 1.2 percent of GDP in 1996, turned into net outflows by 1998. These outflows accelerated thereafter to -4 percent of GDP in both 1998 and 1999 as international banks became unwilling to roll over existing short-term debts to the region. This sudden reversal in bank lending is often presented as providing strong evidence in support of a bank panic model. However, a less emphasised feature of this period was the decline in portfolio flows (equities plus bonds) following the initial bank panic as investors also tried to scale down their exposures in the region, resulting in a marked slowdown in such flows. In contrast, FDI flows remained remarkably stable throughout the period under consideration.[5] In fact, FDI inflows experienced a jump up in 1998 and 1999, likely driven by fire-sale of assets in the region as well as greater inflows to China.

Looking at total net private capital flows, the region remained relatively unattractive to foreign capital between 2000 and 2002 for various reasons. In 2000, the reason was primarily due to sustained outflows in the other investments component as the deleveraging process in the region persisted from the previous two years. Despite the fact that these bank outflows finally abated and turned into inflows in 2001 and 2002 – as many regional economies, including Korea, China and some ASEAN (Association of Southeast Asian Nations) economies successfully issued bonds internationally[6] – overall net private inflows still remained rather modest, largely because of the information technology-induced global downturn in 2001 which led to sharp portfolio capital outflows as well as a slowdown in FDI inflows from its 1998-99 peak.

By 2003, after a prolonged period of restructuring and deleveraging, emerging Asia finally recovered from the Asian crisis of 1997-98. While there was a resurgence in net capital inflows to the region between 2003 and 2005, total net private capital inflows were still well below the pre-crisis period (1990-96) average. This is true even if one excludes the massive booms in 1995 and 1996 where one might reasonably argue there was somewhat of an artificial surge in "other investments" to Thailand and other economies, driven by the "carry trade" phenomenon (that is, borrow in low interest countries such as Japan and invest in higher yielding assets in Thailand). The primary reason for this difference in the magnitude of total net capital flows in the two periods appears to be because of the relative slowdown in net portfolio inflows in the post-crisis period compared to the pre-crisis one.[7] This is despite the surges in equity inflows to such countries as China and India. What was the reason for this relatively disappointing performance in net capital flows to emerging Asia as a whole?

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[5] Three caveats should be noted. One, Indonesia was the only exception, FDI having collapsed due to significant socio-political uncertainties. Two, the implicit assumption is that there is little or no relationship between the various types of capital flows. Three, there appears to have been a shift in the type of FDI from the Greenfield to mergers and acquisitions.

[6] While not readily apparent from the data, it is generally reported that the average maturity of bank loans has lengthened. This, along with the reserve stockpiling, has resulted in the regional economies experiencing declines in short-term debt to reserves and short-term debt to external debt ratios. Another important characteristic of debt inflows to Asia is the growing share of marketable debt instruments (that is, bonds). This is a result of a deliberate decision by these economies to develop and upgrade their bond markets as a means of diversifying their financial systems and instruments.

[7] Portfolio flows also appear to have become far more volatile post-Asian crisis.

Asia as a Source of Capital

To explain the foregoing seeming conundrum, one needs to go behind the *net* private capital flows data to consider *gross* private capital inflows and outflows. It is readily apparent from Table 1A that across all types of capital, the region received more gross inflows post-crisis compared to the pre-crisis period. Notably, however, the region also experienced much greater gross outflows of all types of capital post-crisis. As is clear from Table 1B, these outflows were particularly large in the case of portfolio flows as well as other investments (especially in the form of foreign currency deposits). Clearly some of these outflows might have been recycled intra-regionally, while the rest were invested outside the region. Importantly, despite these relatively lower capital account surpluses in the region as a whole,[8] emerging Asian economies accumulated foreign exchange reserves at record levels (accounting for about half of the global total of US$6,500 billion), due largely to the persistent current account surpluses run by many of the East Asian economies (Table 2). While the bulk of the Asian central banks have been channeled into US government securities (typically United States Treasuries), since the mid-2000s, many other capital exporting developing countries consciously began to look for more systematic ways of raising returns on their international reserves on a longer-term basis. Some did so by creating Sovereign Wealth Funds (SWFs) which are broadly designated pools of assets owned and managed by governments and predominantly (but not exclusively) invested globally (Table 3).[9] More aggressive outward investments by emerging Asian economies in 2006 and 2007 is apparent from the data, especially in the case of portfolio flows (Table 1B).

The Global Financial Crisis of 2008-09 and Asia

While data are not available, the wave of gross outflows from Asia likely intensified in 2008 as the initial response of some Asian investors, especially SWFs, was to invest aggressively in selected United States and European financial and related assets believing them to be grossly underpriced. However, as the crisis worsnd and the SWFs were being faced with significant capital losses on their investments in the developed world with the collapse of major financial institutions and overall asset prices, these gross outflows from Asia likely tapered off if not reversed completely. However, the heightened risk aversion worldwide, particularly following the Lehman Brothers collapse and near collapse of AIG in September 2008, also led to an abrupt about-turn in gross capital inflows from all emerging economies. Looking at net capital flows data (Figure 1), while the 1997-98 bust was due largely to the reversal in short-term bank loans, the crisis in 2008-09 has been driven somewhat more so by sharp reversals in portfolio flows, though inevitably there were also retrenchments by many international banks in response to the financial stresses faced in their headquarters in the United States and Europe.[10]

Asia has clearly not been buffeted by the global economic slump and dislocations. However, going forward, the large international reserve holdings in Asia, the region's relatively more flexible exchange rates, the lower levels of leverage especially with regard to external short-term foreign currency debt in the region, along with stronger balance sheets of Asian

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8 Individual countries such as India and Korea ran current account deficits.

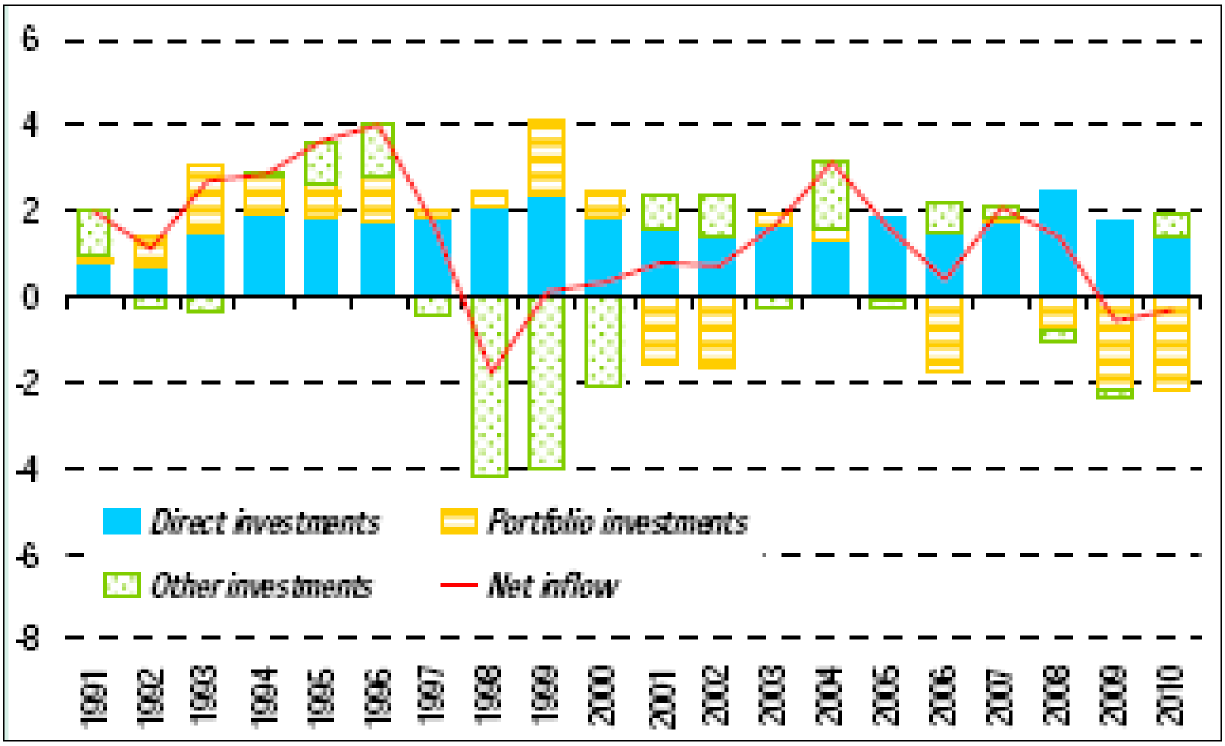
9 While SWFs have been around since the 1950s, they have only recently attracted much public attention, especially with the creation of the China Investment Corporation (CIC) in September 2007.

10 The boom and bust faced by some Eastern Europe economies in 2008-09 shares many similarities with East Asia in 1997-98 (that is, the surge in short-term bank lending and subsequent reversal and economic collapse).

corporates and financial institutions will work in tandem to ensure the capital account shock will not have long-lasting effects on Asia this time unlike in 1997-98. Positive signs – so-called green shoots – are already emerging, with the thawing of credit markets, declining risk aversion, stabilisation of output and trade, and recovery in international capital flows into the region, especially for countries such as India and Korea.

It looks likely that the economic recovery in emerging Asia will outpace the rest of the world. However, given the prolonged structural changes and deleveraging that must happen in the United States and Europe, if emerging Asia is to hope to return to a period of sustained robust growth, it must place greater emphasis on generating domestic and regional demand. This in turn necessitates significant boosts in consumption and investment which will almost inevitably mean a decline in regional current account surpluses and possibly a recycling of a greater share of external surpluses to the rest of the region. Promising investment opportunities in the region abound, with fast-growing Asian countries such as India needing massive infusions of new investments in infrastructure and supporting facilities over the coming years.

Figure 1: Net Private Capital Flows to Emerging Asia,[1] 1991-2010[2]
(percent of GDP)



Notes:

[1] "Emerging Asia" refers to China, India, the newly industrialising economies of Hong Kong, South Korea, Singapore and Taiwan, and the ASEAN-5 of Indonesia, Malaysia, Philippines, Thailand and Vietnam.

[2] 2009 and 2010 are projections.

Source: IMF (2009). Regional Economic Outlook -- Asia and Pacific Global Crisis: The Asian Context, Washington, DC.

Table 1A: Gross Private Capital Inflows to Asia and other Emerging Economies, 1990-2007 ***(US$ billion)***

	Annual averages		2005	2006	2007
	1990–97	2002–06			
Emerging market economies[1]					
Total inflows	210	456	599	824	1,347
Direct investment	81	220	270	332	400
Portfolio investment	70	94	127	164	432
Equity	24	54	71	95	193
Debt	47	40	57	69	239
Other investment	60	142	202	328	515
Banks	27	67	77	176	231
Other sectors	33	75	124	152	284
Memo: Current account balance	*–58*	*252*	*349*	*453*	*507*
Change in reserves[2]	*–54*	*–382*	*–470*	*–603*	*–1,040*
Official inflows	*–20*	*–24*	*–28*	*–45*	...
Asia[3]					
Total inflows	102	221	270	375	681
Direct investment	46	106	130	145	154
Portfolio investment	20	55	66	90	350
Equity	10	38	46	60	...
Debt	11	17	20	30	...
Other investment	36	61	74	140	177
Banks	16	30	21	88	...
Other sectors	20	31	53	51	...
Memo: Current account balance	*–13*	*170*	*202*	*319*	*445*
Change in reserves[2]	*–34*	*–247*	*–264*	*–353*	*–641*
Official inflows	*4*	*–5*	*–5*	*–2*	...

Table 1B: Gross Private Capital Outflows from Asia and other Emerging Economies, 1990-2007 ***(US$ billion)***

	Annual averages		2005	2006	2007
	1990–97	2002–06			
Emerging market economies[1]					
Total outflows	76	327	435	681	830
Direct investment	16	68	71	157	182
Portfolio investment	17	118	159	283	400
Equity	8	25	28	48	69
Debt	9	93	131	235	331
Other investment	40	143	212	251	248
Banks	20	44	73	116	124
Other sectors	17	99	140	135	124
Memo: Official outflows	*0*	*–3*	*–6*	*2*	...
Asia					
Total outflows	51	139	177	316	502
Direct investment	10	26	30	54	77
Portfolio investment	9	57	58	166	335
Equity	6	15	17	31	...
Debt	3	42	42	135	...
Other investment	29	58	97	105	90
Banks	13	21	44	47	...
Other sectors	13	38	53	59	...
Memo: Official outflows	*1*	*1*	*0*	*2*	...

Notes: "Other sectors" comprises non-financial corporations, insurance companies, pension funds, other non-depository financial intermediaries, private non-profit institutions and households.

[1] Comprises the regions below plus Russia, Saudi Arabia and South Africa.

[2] A minus sign indicates an increase.

[3] China, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.

Source: D. Mihaljek (2008). "The Financial Stability Implications of Increased Capital Flows for Emerging Market Economies," Bank for International Settlements, mimeo.

Table 2: Global Current Account Balances *(US$ billion)*

	2007	2008	2009f	2010f
United States	-731	-673	-313	-307
Euro area	19	-136	-152	-161
Japan	213	159	86	98
Other Mature Countries	11	81	-9	20
Emerging Economies(IIF 34*)	634	697	331	441
Africa/MidEast (ex.GCC)	11	10	-32	-29
Gulf Cooperation Council	205	297	10	87
Latin America	24	-9	-55	-26
Emerging Europe	-28	-29	-20	-18
o/w Russia	75	102	22	39
Emerging Asia	422	428	428	427
o/w China	372	426	380	400
Global Discrepancy	145	128	-58	91

Notes: Based on 34 economies tracked by the IIF. Emerging Asia here is limited to China, India, Indonesia, Malaysia, the Philippines, South Korea and Thailand.

Source: Institute of International Finance (2009). "Capital Flows to Emerging Market Economies," Washington, DC, 11 June.

Table 3: Estimated Size of Largest SWFs, End 2007 ***(billions of US dollars)***

Country	Name of Fund	Assets (range)	
I. Oil and Gas Exporting Countries		Lower	Upper
UAE	Abu Dhabi Investment Authority	250	875
Norway	Government Pension Fund-Global	380	380
Saudi Arabia[1]	No designated name	289	289
Kuwait	Reserve Fund for the Future Generations	213	213
Russia	Reserve Fund National Welfare Fund	125 32	125 32
Libya	Libyan Investment Corporation	50	50
Qatar	State Reserve Fund / Stabilisation Fund	30	50
Algeria	Reserve Fund / Reserve Regulation Fund	43	43
USA (Alaska)	Alaska Permanent Reserve Fund	40	40
Brunei	Brunei Investment Authority	30	30
Kazakhstan	National Fund	21	21
Malaysia	Khazanah Nasional BHD	19	19
Canada	Alberta Heritage Savings Trust Fund	16	16
Nigeria	Excess Crude Account	11	11
Iran	Oil Stabilisation Fund	9	9
Azerbaijan	State Oil Fund	2.5	2.5
Oman	State General Reserve Fund	2	2
Timor-Leste	Petroleum Fund of Timor-Leste	1.4	1.4
Venezuela	FIEM-Macroeconomic Stabilisation Fund	0.8	0.8
Trinidad & Tobago	Revenue Stabilisation Fund	0.5	0.5
II. Emerging Asia			
Singapore	Government Investment Corporation	100	330
China	China Investment Corporation	200	200
Singapore	Temasek Holdings	108	108
Korea	Korea Investment Corporation	30	30
Taiwan, P.O.C.	National Stabilisation Fund		
		15	15
III. Other Countries			
Australia	Australian Future Fund	54	54
Chile	Economic and Social Stabilisation and Pension Funds	16.4.	16.4
Botswana[1]		4.7	4.7
Kiribati		0.4	0.4
Total		**2,093**	**2,968**
Memo:		Estimate	
Pension Funds		28,500	
Mutual Funds		27,300	
Insurance Funds		19,100	
Hedge Funds		1,900	
Private Equity		800	

Source: Based on International Financial Services London (IFSL) (2008). "Sovereign Wealth Funds 2008," IFSL Research, April and International Monetary Fund (IMF) (2008). "Sovereign Wealth Funds – A Work Agenda," 29 February.

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