



International Capital Flows into Asia

Ramkishan S. Rajan



After a period of consolidation and recovery (including the IT-induced global downturn in 2001), there has been a resurgence in net capital inflows to the Asian region since 2003. While improving fundamentals have *pulled* inflows into Asia, large-scale global liquidity, relatively benign interest rates in industrial countries and a seemingly low-risk aversion have *pushed* capital from industrial countries to emerging economies in general.

International capital flows to Asia reached US\$ 88 billion in 2006, compared to US\$ 60 billion in 2005 and they are expected to remain high in 2007 despite the temporary market correction in May-June. Inflows of all types of capital inflows to China have been particularly high, although capital flows to India, South Korea and much of Southeast Asia have also picked up sharply, supported by rising credit ratings of emerging market issuers over the past few years.

After the outflow and deleveraging recorded between 1998 and 2001, debt to developing countries stabilised in 2002 and rose markedly in 2003 as many regional countries, including South Korea, China and some ASEAN economies have successfully issued bonds internationally. International creditors are once again actively participating in international syndicated loans in the region. While not readily apparent from the data, it is generally reported that the average maturity of bank loans has lengthened. This, along with 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. This is a result of a deliberate decision by these countries to develop and upgrade their bond markets as a means of diversifying their financial systems and instruments.

Portfolio equity and FDI flows to the Asia have been on an uptick, but not necessarily to the same destination countries since the crisis. It is apparent that after reaching the lows in 2001 and 2002, net portfolio equity flows bounced back in 2003, their highest levels since 1998. Interest in the region has been partly induced by IPO issuances by many companies, particularly from the privatisation of state-owned enterprises in South Korea and China, while an increase in cross-border Mergers and Acquisition (M&A) activities have infused risk capital into companies in Asia following policy liberalisations in these countries. What the aggregate data do not highlight though is the shift in composition in FDI.

In particular, while ASEAN was the primary beneficiary of FDI inflows into East Asia prior to the crisis, China has absorbed some three quarters of the FDI inflows to the region post-crisis, buoyed in part by the country's WTO accession. Studies have however not been able to ascertain whether FDI into China has been diverted from China into ASEAN. If anything some studies suggest the reverse, i.e. complementarity between China and ASEAN as host destinations for FDI, partly due to China's increasing role in regional production networks. FDI flows to India have also been steadily rising albeit from a lower base.

Although the international capital inflows to Asia are on the rise, there has been a fundamental shift in the nature of the region's engagement with the rest of the world. In particular, the region has been running persistent current account surpluses (India, which runs a small current account deficit, is an exception in this regard). The region has consequently become a *net* exporter of capital to the rest of the world while still depending very heavily on *gross* financing from the rest of the world. Why has this been the case?

Motivated in large part by the financial crisis of 1997-98, Asian central banks and investors have systematically been transferring some balance sheet risks to the rest of the world by accumulating collateral

in the form of relatively risk free assets in the US, as well as comparable European and Japanese assets. Data on asset holdings by most central banks is shrouded in secrecy and makes careful analysis of flow of funds difficult.

Nonetheless, it is informative to note that the flows into US Treasuries have surged following the Asian crisis as regional central banks have rapidly built up their reserves. The increased demand for US corporate bonds from East Asia and elsewhere has been pushed by the relative scarcity of high-grade debt issuances, while also being pulled specifically into the US due to the deep and highly liquid nature of US capital markets. In other words, the US in the main but also other industrial countries have served as international financial intermediaries to East Asia.

Notwithstanding the mutual co-dependence between Asia and the US and the rest of the world, there are concerns that the costs of such self-insurance and international financial intermediation for China and the rest of Asia are escalating. As the search for high returns has been reinforced by the search for stability in the post-crisis environment, the savings surplus Asian region has been involved in an international exchange of risks with international capital markets. But there are two related concerns.

First, as the Asian economies continue to grow rapidly and become even more significant players in the global economy, it is important that the region pays greater attention to the implications of their actions on the global economy. Second, the rapid accumulation of reserves is proving to be increasingly costly, especially as some regional central banks are becoming less able to effectively sterilise their monetary effects. Excessive and rapid liquidity buildup is having adverse inflationary consequences in some countries. The monetary overhang could also be channeled inefficiently into certain non-tradable sectors such as real estate.

In response to this many regional central banks have been tightening monetary policy, liberalising capital outflows to ease the pressures on the balance of payments, and are also attempting to acquire a greater return on their reserve holdings by undertaking riskier investments overseas. The latter is epitomized by China's purchase of a US\$ 3 billion equity stake in the US Blackstone Group, which is in all likelihood the start of much more to come.

Going forward, the region must take steps to develop more effective and efficient financial intermediation within and between themselves if domestic surplus savings are to be rechannelled into domestic and regional investments.

Ramkishan S. Rajan is an Associate Professor at the School of Public Policy, George Mason University.

Copyright: OpinionAsia, 2006 - 2007.
www.opinionasia.org

Reprinting material from this website without written consent from OpinionAsia is a violation of international copyright law. To secure permission, please contact membership@opinionasia.org