Sailing through this Storm? Capital Flows in Asia during the Crisis

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July 2011

Summary

The financial crisis that started in 2007 led to a massive collapse of international capital flows, with a magnitude far exceeding that of the extensively discussed contraction in international trade. As Asian economies were at the center of the financial crisis of the late 1990s, one may expect them to have been particularly affected by the contraction in capital flows in the recent episode.

We find that this is not the case, and instead Asian economies fared relatively well. While they did suffer from a contraction in capital flows following the collapse of Lehman Brothers in September 2008, this contraction was less acute and of shorter duration than in other regions. Specifically, capital flows to and from Asian economies, both developed and emerging, remained robust in the first stage of the crisis from August 2007 to August 2008, in sharp contrast to the experience of the United States and Europe where flows fell substantially. In addition, capital flows in Asia rebounded quickly following the most acute stage of the crisis, which encompasses the six months following the fall of Lehman Brothers, again in contrast to other regions where flows remained at levels well short of the pre-crisis ones.

The relatively limited incidence of the crisis on Asian capital flows primarily reflects the limited exposure of the region to international banking, relative to other countries. Asian economies were thus less affected by the global deleveraging of banks engaging in cross-border lending. We also find that the experience of Asian economies was better than what one would expect based on their international banking exposure, possibly reflecting a limited exposure to specific problematic assets such as mortgage-linked securities.

The large holdings of foreign exchange reserves by Asian economies before the crisis impacted capital flows during the turmoil. They did not cushion the countries from a retrenchment by foreign investors, but instead allowed these economies to offset that retrenchment without having to curtail the accumulation of foreign assets by private domestic investors to a similar extent.