• Capital outflow, collapsing currencies: is Asia headed back to 1997?
• Absolutely. It’s been headed there for five years
• But it’s not 1997 yet
• Most of Asia continues to run external surpluses. India and Indonesia are exceptions. Both have work to do
• Domestic leverage is at or below trend in most of Asia. China isn’t the furthest above trend, Singapore is
• Asia’s reserves are at an all-time high; external debt is at an all-time low
• Asia-vu is five years away at least. Recent outflows are cyclical, related to the Fed/QE. Structural inflows are larger and will continue for a long time. Whether 1997 comes again will depend on policy

Current account deficits, capital outflow, collapsing currencies – is Asia headed for 1997 all over again?

Absolutely. We’ve been charting Asia’s progress toward 1997 for five years and it’s closer than ever [1]. The good news is, we’re not there yet – 1997 is five years away, maybe more. There are some problems – mostly in India and, to a lesser extent, Indonesia – but recent outflows reflect jitters over Fed/QE tapering, not structural problems in the region more broadly. QE was never going to last; the inflows it spawned were never going to stay. Longer-term structural inflows – always the bigger if less sexy force than QE – will stay, and grow. Asia will continue to move forward to the past.

David Carbon • (65) 6878-9548 • davidcarbon@dbs.com
If that sounds ominous, it shouldn't. A few years ago, everyone said global rebalancing was necessary – Asia needed to stop running surpluses and the West needed to cut its deficits. That is now happening and, with the important exception of India, that's pretty much all that's happening – it's a benign and welcome development. Asia, as a developing region, is supposed to be running deficits, not surpluses. It's supposed to be borrowing from the rich countries, not lending to them.

And for those international investors who wish emerging market countries didn't run deficits, they need to realize this is a contradiction in terms. The only reason emerging markets need foreign money in the first place is to run a deficit. No deficit; no need for foreign cash; no opportunity for the EM investor to earn ‘above average’ returns. It’s that straightforward.

How Asia's march back to 1997 ends remains an open question. A crisis isn't predestined – it depends on policy and on not letting things – leverage mainly – get out of hand. If leverage and other policies remain appropriate, the cycle doesn’t have to be a cycle – one could run north forever. Asia might not see 1997 until 2027, if then.

But first things first. We're already talking about the end game when we should be charting the progression towards it. Only when the points are plotted can one declare ‘here is where Asia sits today’.

**What made 1997?**

We’ve used the stylized chart below to help us lay the groundwork before [2]. It’s a thirty year picture divided into three parts: the decade leading up to 1997; the decade between 1997 and 2007 and the decade following 2007, which may or may not lead back to 1997 in 2017.

**Decade 1: 1987-1997**

The ten years leading up to the 1997 financial crisis were archetypical of excess. Most countries ran large current account deficits that sometimes rose as high as 10% of GDP (Malaysia in 1995). Capital inflows into the region were strong, however – they more than financed the external deficits and put a lot of upward pressure on currencies and downward pressure on interest rates. Domestic leverage rose sharply (see chart on page 1) along with all the foreign borrowing. Gross fixed capital formation soared and GDP growth averaged 8% per year between 1987 and 1996. In Thailand, Indonesia and Malaysia – three of the ‘Crisis-4’ countries – growth averaged 9% per year for 9 years.
Decade 2: 1997-2007

It was a great run but, as most are aware, it all came to an end in the summer of 1997. Most of Asia – with the notable exceptions of Singapore and China – spent the next 10 years unwinding the excesses of the previous 10 years. Capital left the region. Currencies dropped. Interest rates rose. Current accounts soared from deficit and, for the most part, stayed there. Asia used its surpluses to pay back the foreign debt (and other liabilities) it had built up over the previous 10 years.

Of course the downside to paying off old debt is that you don’t have money left over to buy new things, like capital equipment. Investment in the post-97 decade dropped to a shadow of its former self (chart below left). In the Asean-5, for example, investment growth that averaged 12% per year between 1987 and 1996 dropped to less than 2% between 1997 and 2007.

Low investment means low growth, full stop. More than anything else, this is what kept Asia’s GDP growth between 4-5% in the post-crisis decade when it had been twice as high in the pre-97 decade (chart below right).

Referring back to the stylized Asia-vu chart on p2, it is clear that the post-97 decade was in most regards the equal-and-opposite reaction to the pre-crisis decade – an unwinding of all that came before. Ten years up, ten years down. What now?

Decade 3: Asia-vu

We have argued for some time that the ten years following the global financial crisis would, for Asia, look a lot like the ten years leading up to the 97 crisis – that is, the regional landscape would once again be characterized by capital inflow, a move toward external deficit from surplus, rising leverage, rising investment and faster GDP growth.

Are we there yet? Is it 1997 all over again? The short answer is no, Asia is not on the cusp of another 1997. Most of the region, in fact, remains far away. If one plots the relevant points – the deficits, the leverage, the reserves, the debt, the investment, the inflows and outflows – the picture that emerges is clear: Asia has several years to go before it’s 1997 again. Several countries have moved closer to 1997 than others, however, in important ways. Let’s consider the data.
Current accounts

Current account deficits are surely the most emblematic feature of Asia’s pre-crisis period. Deficits in the Crisis-4 countries (TH, MY, ID, KR) averaged 4-5% of GDP for nearly a decade. In 1995, Malaysia ran a full year deficit of 9% of GDP; Thailand ran 8% deficits in 1995 and 1996. That changed overnight, however, when the bottom fell out in 1997. Deficits became surpluses instantly and they were maintained for the next 10 years (chart below).

How is Asia faring today? Except for India and Indonesia, not very differently (chart below). Surpluses have fallen from 8% of GDP in 2007 to about 4% today. That’s a significant decline – and it owes more to strong growth in Asia than to weak growth in the G3 [3]. But a 4% surplus is still a substantial one and, from this perspective, Asia overall remains far away from 1997. (See Appendix I for country detail).

That said, India and Indonesia need to be monitored. External balances of both countries have trended south for the past 10 years, with India running deficits in most of them (chart below). India’s current account deficit has averaged nearly 5% of GDP for the past two years and officials have some serious structural work to do (see “IN: short-term focus, longer-term perils”, 19Aug).
Indonesia's deficit is more cyclical. It has fallen to 3% of GDP but only recently and we reckon some modest adjustments in policy would be enough to put it on a sustainable footing (see “TH, ID, PH: Roadmap to 2020”, 18Jun). As discussed above, there's no reason to pursue an outright surplus – a deficit of 1.5-2.5% of GDP is probably in both Indonesia's and foreign investors' interests.

**External debt**

Sixteen years of surpluses either gets you a pretty big foreign bank account or pays down a lot of old debt. In China's case, it's the former. In the rest of Asia – the part that got into trouble in 1997 – it's the latter. Net external debt (total less holdings of foreign exchange reserves) fell sharply in the decade following the 97 crisis. By 2009, most Asian countries had become net creditors to the outside world rather than net debtors (charts below and Appendix II).

Thailand, for example, had a net external debt equivalent to 67% of GDP in 1997; today it's a net creditor to the tune of 9% of GDP. Malaysia's net debt was 27% of GDP in 1997; today it's a 4% of GDP creditor. Even the Philippines is a net creditor today (1% of GDP) compared red ink equal to 45% of GDP back in 1997.

Countries that remain net debtors have made much progress too. Indonesia's 14 years of surpluses have lowered its net debt from 57% of GDP in 1997 to 20% today. Korea's surpluses have cut its net external debt to 7% of GDP from 29% back in 1997.

Sixteen years of surpluses add up. From an external debt / country risk perspective, Asia is miles away from 1997 [4]. If one had to put a marker on it, the region looks more like 1988 today than 1997 – it's reflating but slowly and the road to Asia-vu is a long one.

---

**Gross fixed capital formation**

Rapid and/or 'over' investment is a big part of most economic crises, including Asia's in 1997. Capital floods in, buildings (most notably) go up, some can't be rented, investors can't be repaid, everyone runs for the exit, hoping not to be the last out the door. Asia's 10 year investment boom ended abruptly in 1997 (charts below). How have things fared since? Is Asia 'over-investing' again?
Except for China, decidedly not. Between 1997 and 2007, investment ratios ran flat as a pancake. Like external debt, investment has ticked up modestly since 2007 but, as the charts below make plain, most of Asia remains as far away from 1997 from an investment perspective as it does from an external debt perspective.

China of course is the exception. Investment as a share of GDP has continued to rise from 35% of GDP in 1980 to 48% today. Does this put China on the cusp of 1997 moment?

It might were it not for a couple of mitigating factors. The first is that while 48% is high, how one gets there surely matters as much as the height itself. Thailand, Malaysia and Korea all jumped to 44% in the early 90s but they did it almost overnight. China’s ratio is higher than this but the rise occurred over a 35 year period, not a 2 year period. Indigestion must depend in large part on how fast dinner is consumed.

Second, the authorities in China are aware of the risks and are undertaking reforms to address them. Property development has been restrained. Industries where overcapacity is most acute – steel, aluminum, cement, paper – have been ordered to scale back. The GDP growth target has been lowered to 7.5% and for the first time in a long time it appears to be a real target rather than a lower bound. If China has been approaching 1997, the authorities have been pursuing structural changes to ensure it doesn’t get there [5].

**Domestic credit relatives**

Leverage and domestic credit doesn’t have to come from foreign inflows. That’s what drove Asia’s bubble in the early-90s but domestic monetary authorities can inflate economies just as easily as inflows can. Whatever the source, how does the overall credit / leverage picture in Asia look relative to 1997?

Like the other variables mentioned above, pretty muted. Domestic credit [6] relative to GDP is running on or below trend throughout most of the region (table at top of next page). Back in 1997, leverage in most Asian countries in the region had risen two standard deviations or more above trend (see Appendix IV).

Interestingly, given all the hoopla surrounding loan growth there, China’s leverage isn’t far above trend (chart bottom left of next page). Even including the so-called shadow banking sector, outstanding credit relative to GDP lies only 1.2 standard deviations above trend [7]. Stolid, safe Singapore, by contrast, is where leverage has run furthest amuck. Loans extended by domestic banking units now stand 2.1
Asia 10 domestic credit / leverage
Financial sector loans as a percentage of GDP

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<td>1.3</td>
<td>6.3</td>
<td>3.7</td>
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</table>

standard deviations above trend, a 4-unit swing since 2006 (chart below right). Singapore in 1997 looks almost sleepy by comparison.

Of course no single statistic (like standard deviations from trend) can fully describe the leverage situation and associated risks. Singapore’s leverage lies the most number of standard deviations above trend; Taiwan’s ratio is the second highest in absolute terms. China’s ratio has risen by the most number of percentage points since 1986 (95 points) but India’s leverage ratio has grown the fastest in percentage terms (and Singapore’s the slowest). Pick your poison, there’s something for everyone.

This kind of mixed picture shows why it is so difficult to gauge whether a bubble exists and / or when it might blow. We have always regarded standard deviations from trend as the most useful indicator but anyone who has ever drawn a trend line knows how subjective that exercise can be and, at the same time, how useless an ‘objective’ computer-generated trend line can be. The best any investor or regulator can do is look at everything and err on the side of caution. The good news is, most in Asia have done so since 1997.
A final point here is worth noting. To the extent that China’s leverage has run too high and financial stress were to lead to capital flight, the direction would likely be the opposite of what occurred in 1997. Back then, Asia’s precrisis borrowing turned to outward flight when foreign investors realized that not everyone would get out whole. China, by contrast, hasn’t been borrowing from the rest of the world for the past ten years, it has been lending to it. Were China to run into trouble, the ‘sucking sound’ of capital flows would likely be inward, not outward, as companies and officials pulled home foreign funds to patch local holes.

**Capital inflow and outflow** [8]

If Asia isn’t on the verge of another 1997, why then is capital leaving the region? The answer is, most of it isn’t. Most of the inflows into Asia over the past decade have been long-term / structural flows coming from investors and businesses seeking to capitalize on Asia’s strong growth – and they have stayed put. Since 2001, some US$2.4 trn of capital has flowed into Asia. About $500bn flowed out temporarily in 2008 and another $300bn has flowed out since September 2011. That leaves net inflows of $1.6trn since 2001, or about 2% of GDP, on average, during the period. That’s not chump change.

Some of the inflows since 2008 of course have been short-term in nature, arbitraging the difference between local rates and returns and those of Western countries where growth was weak and where central banks had cut interest rates to zero. These cyclical inflows are now reversing course. The world is once again in ‘risk-off’ mode, this time over fears of Fed tapering of its third quantitative easing program and the fallout it could potentially bring to asset prices.

Two points to make here. First, as the chart below clearly shows, outflows aren’t only, or even mainly about the Fed and QE3. Asia’s outflows (and slower growth) began a full two years ago – way back in September 2011 when the EU debt crisis erupted in earnest. In the second half of 2011, outflows averaged 8% of GDP, comparable to that which followed the collapse of Lehman Brothers in Sep 2008. Even after QE3 began, nine months later in Sep12, capital continued to flow out of Asia, not in. Outflows have recently reaccelerated but worries about Fed tapering are simply the latest in a string of ‘risk-off’ events that includes the EU debt crisis and concerns about a hard landing in China.

The bigger point to make is that the short-term money that flowed into Asia on the back of low interest rates in the West was always going to be just that: short-term. The US was always going to recover, its monetary policy was always going to return to normal. Inflows borne of cyclical weakness in the G3 were always going to reverse at some point. That point appears increasingly to be now.
**Longer-term inflows**

The biggest point of all to make is that long-term inflows will remain. And grow. If there is one thing that the global financial crisis has made clear, it is that Asia is where the world’s growth – its new demand – is being generated. In the four years following the collapse of Lehman Brothers, the US grew not one iota. Ditto for Japan. Ditto for Europe. Asia, meanwhile, continued to grow at almost its long-run average pace, ‘adding’ an entire Germany to the Asian economic map in the process. Even at today’s slower growth pace for China (7.5%) and the region more generally (6%), Asia will continue to add a new Germany to the region every four years. Five years from now, with even slower growth (but a larger base), it will take Asia only 3.5 years to put a new Germany on the map.

This kind of demand growth is what makes businesses want to invest in Asia. This kind of demand growth is what has brought long-term capital into the region and what will keep it flowing in in the years ahead. It’s not rocket science – businesses want to go where the growth is. And increasingly that is Asia.

Is Asia headed for 1997 again? Yes. Is it there yet? No. China and Singapore have some work to do on financial sector leverage. Indonesia has some work to do on the current account. India has work to do on many fronts. But the region as a whole remains far away from 1997 in 2013. Capital inflows will continue to push it forward to the past for several more years, if not for considerably longer.

**Notes:**


[2] Ibid.

Moreover, it is clear that most of the criticism Asia used to receive from Western countries for running surpluses and contributing to ‘global imbalances’ was unwarranted. Asia wasn’t creating new imbalances, it was addressing / unwinding old ones.


Domestic credit is defined as financial sector loans to the local private sector. In the case of shadow banking in China, it includes estimates of loans made by trust companies, brokerage firms and other small lenders and financial guarantors. Estimates are taken from the US Federal Reserve (“Shadow Banking in China“ Expanding Scale, Evolving Structure“, Federal Reserve Bank of San Francisco, April 2013.)


Capital inflows here are defined / calculated simply as the difference between an increase in foreign reserves and the current account surplus – e.g., a $1 rise in foreign reserves accompanied by $1 current account deficit implies capital inflows of $2.

**Sources:**

Except where noted, data for all charts and tables are from CEIC Data, Bloomberg, IIF (external debt) and DBS Group Research (forecasts and transformations).
Appendix I: Current account balances

Asia – current account balance
% of GDP

Asia – current account balance
% of GDP

Asia – current account balance
% of GDP

Asia – current account balance
% of GDP
Appendix II: Net external debt

Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP

Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP

Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP

Asia – net foreign debt as % of GDP

ext debt less reserves as % of GDP
Appendix III: Gross fixed capital formation

Asia – investment to GDP
percent, GFCF

China

India

Asia – investment to GDP
percent, GFCF

HK

SG

Asia – investment to GDP
percent, GFCF

Korea

Taiwan

Asia – investment to GDP
percent, GFCF

Thailand

Malaysia

Asia – investment to GDP
percent, GFCF

Indonesia

Philippines
Appendix IV: Domestic credit relatives

CH – domestic credit as % of GDP
percent, formal sector

CH – domestic credit as % of GDP
percent, formal sector + shadow banking

HK – domestic credit as % of GDP
percent

SG – domestic credit as % of GDP
percent, Dom Banking Units

SG – domestic credit as % of GDP
percent, DBU + ACU

MY – domestic credit as % of GDP
percent
Appendix IV: Domestic credit relatives (cont’d)

KR – domestic credit as % of GDP
percent

TW – domestic credit as % of GDP
percent

ID – domestic credit as % of GDP
percent

TH – domestic credit as % of GDP
percent

PH – domestic credit as % of GDP
percent

IN – domestic credit as % of GDP
percent
Appendix V: Domestic credit growth summary

Asia 10 domestic credit / leverage
Financial sector loans as a percentage of GDP

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<th>Stdev from trend</th>
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</table>

Asia10 – financial sector leverage, std deviations above trend
loans as % of GDP, std deviations above/below trend

Asia10 – financial sector leverage growth
loans as % of GDP, avg growth per year, 2000-2013
Appendix VI: Capital account balances

Asia – financial account balance
% of GDP

-15 -10 -5 0 5 10 15 20 25
88 90 92 94 96 98 00 02 04 06 08 10 12 14

China
HK

Asia – financial account balance
% of GDP

-8 -6 -4 -2 0 2 4 6 8
88 90 92 94 96 98 00 02 04 06 08 10 12 14

Taiwan
Korea

Asia – financial account balance
% of GDP

-30 -25 -20 -15 -10 -5 0 5 10
89 91 93 95 97 99 01 03 05 07 09 11 13

Spore
Malay

Asia – financial account balance
% of GDP

-8 -6 -4 -2 0 2 4 6 8
88 90 92 94 96 98 00 02 04 06 08 10 12 14

Indon
Thailand

Asia – financial account balance
% of GDP

-8 -6 -4 -2 0 2 4 6 8
89 91 93 95 97 99 01 03 05 07 09 11 13

Phils
India
### GDP & inflation forecasts

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* India data & forecasts refer to fiscal years beginning April; inflation is WPI

Source: CEIC and DBS Research

### Policy & exchange rate forecasts

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<td>Singapore</td>
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<tr>
<td>Thailand</td>
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<tr>
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<td>7.00</td>
</tr>
<tr>
<td>China*</td>
<td>6.00</td>
<td>6.00</td>
</tr>
<tr>
<td>Hong Kong</td>
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<tr>
<td>Taiwan</td>
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<td>1.88</td>
</tr>
<tr>
<td>Korea</td>
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<td>2.50</td>
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<tr>
<td>India</td>
<td>7.25</td>
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^ prime rate; * 1-yr lending rate

### Market prices

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<tr>
<th>Country</th>
<th>Policy rate</th>
<th>10Y bond yield</th>
<th>1wk chg</th>
<th>Current</th>
<th>FX Current</th>
<th>1wk chg</th>
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<th>Equities</th>
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Source: Bloomberg
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