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# Finance and instability in Asia

## External Financial liberalization

- Foreign presence in debt and equity markets. Does not necessaily increase competition.
- Residents permitted to hold assets abroad.
- Permission to hold and trade foreign currency assets in domestic markets.

## Internal Financial liberalization

- Removal or dilution of controls on the entry of new financial firms.
- The reduction or removal of controls on the interest rates.
- Liberalization of avenues and instruments for investment and mobilization of capital.
- Market mediated regulation and regulatary forbearance.
- Withdrawal of the state.

## Financial deregulation in Asia

- Japan:
  - Internationalization of Japanese business, especially after Plaza accord
  - Pressure from international finance/banks
  - Demand for level playing field
  - Demand for freedom to "innovate" when growth decelerated
- Influenced by US market dependence

## Crises as triggers

- A post-transition crisis such as the 1991 balance of payments crisis in India or the 1997 financial crisis in Korea often triggers an acceleration in financial liberalization.
- Liberalization as usual both external and internal, but intensity much greater.
- Financial liberalization central, though prior rounds of such liberalization may be responsible for the crisis.

## Consequences

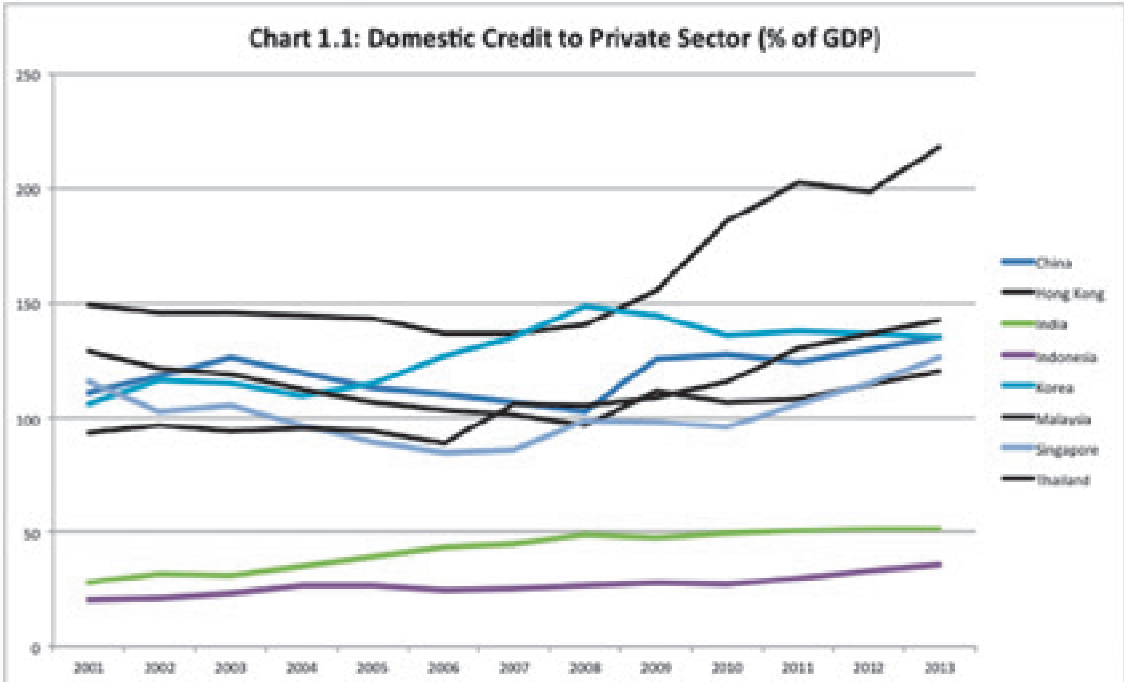
- Global financial integration with rising inflows
- Change in regulatory framework
- Huge expansion in domestic bank credit. Even by 2004, of domestic credit that banks had extended to private borrowers, consumer lending accounted for 53 per cent of total bank lending in Malaysia, 49 per cent in Korea, 30 per cent in Indonesia, 17 per cent in Thailand, 15 per cent in China, and 10 per cent in the Philippines

## Capital account liberalization

- Measures that allow foreign residents to hold domestic financial assets, either in the form of debt or equity. This can be associated with greater freedom for domestic firms to undertake external commercial borrowing, often without government guarantee or even supervision.
- Measures that allow domestic residents to hold foreign financial assets.
- Measures that allow foreign currency assets to be freely held and traded within the domestic economy ("dollarization" of accounts). This is the most extreme form of external financial liberalization. Not too common.

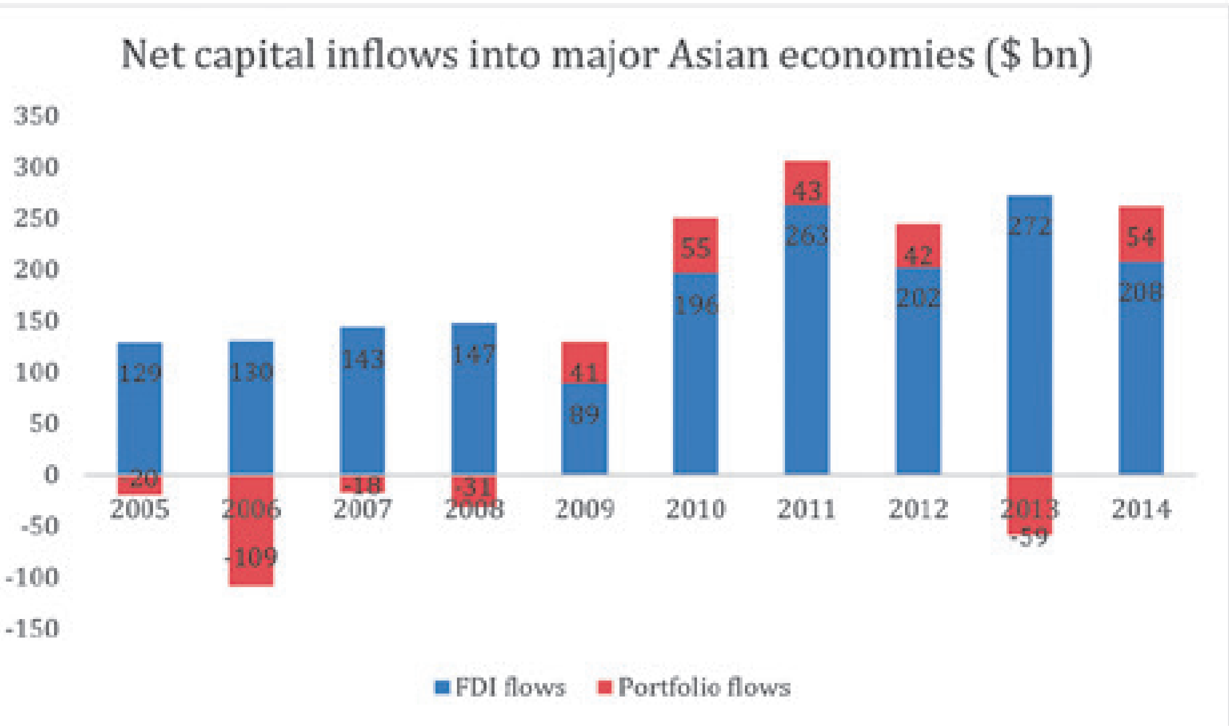
# Cross-border flows

- The global integration of the Asian region has been marked for some time now, but financial integration through capital flows evident only from the 1990s.
- The boom in capital inflows into some Asian economies in the 1990s came to a rather abrupt halt with the Asian financial crisis that drastically curtailed non-FDI flows especially to the crisis-hit countries.
- But global investor perceptions altered by the early 2000s, and over the last decade the region has once again become a significant recipient of net capital inflows. Flows determined not by demand side requirements but by supply side developments with regard to liquidity and interest rates.



# External financial liberalization

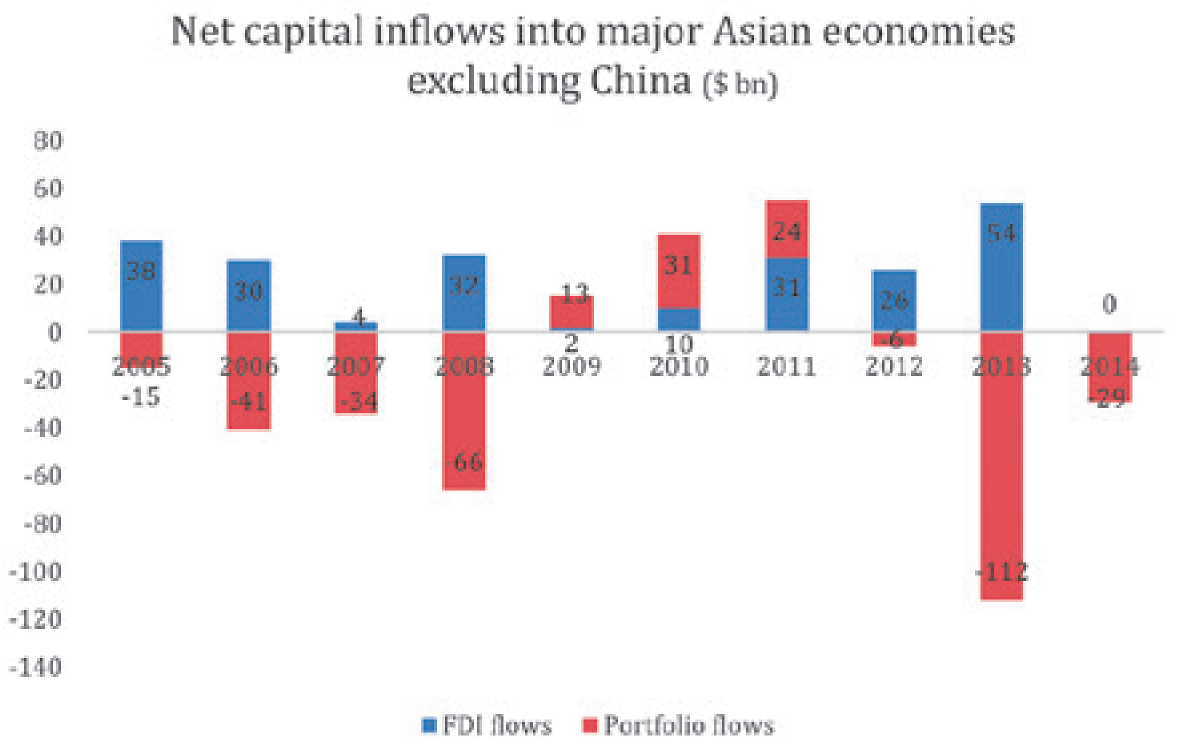
- External financial liberalization involves changes in the exchange control regime.
- Typically, full convertibility for current account transactions accompanying trade liberalization have been either prior or simultaneous reforms, which are then complemented with varying degrees of convertibility on the capital account.
- Often required to support trade liberalization.



# Recent trends

- Throughout the period since 2005, and even during the years of the Global Financial Crisis and its aftermath, net capital inflows into major Asian economies (China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea and Thailand) stayed positive.
- Dominantly because of FDI, as portfolio inflows were far more volatile and negative in some years, notably 2006 and 2013, when the "taper tantrum" occurred.

# China concentration



# After excluding China

- Once China is excluded net capital inflows into these countries were more often than not negative over this period, despite very large gross inflows for certain countries in particular years.
- Only in the four-year period immediately after the GFC that net capital flows to these Asian countries taken together were positive.
- While net FDI inflows were generally positive, they were also quite small, and indeed declined to near zero in 2014. Meanwhile net portfolio flows have been extremely volatile, but turned negative since 2012.
- Estimates suggest that the net outflow of portfolio capital from these countries would have been even larger in 2015.

# Forex Reserve accumulation

- Not only the result of current account surpluses –in most cases they reflected either a combination of current and capital account surpluses or reserve build-up based on borrowed finance which involved significant interest rate losses for the concerned country.
- By-product of the need to provide self-insurance against future crises by holding large amounts of foreign exchange reserves, which accentuated the attempt to manage exchange rates (so as to maintain external competitiveness) in the face of capital inflows.


# Implications

- The addition to reserves amounts to the *ex ante* excess of savings over investment, which in turn means that these countries – many of which are far from completing their development projects and some of which still have low per capita incomes – are not using these resources for investment that could be significant for their future economic expansion.
- What this indicates is that despite growing financialization, increased integration into global capital markets and associated fragilities, most of the important economies of the Asian region did not really benefit from significant and stable inflows of foreign capital even in the most recent period.

## The return of debt

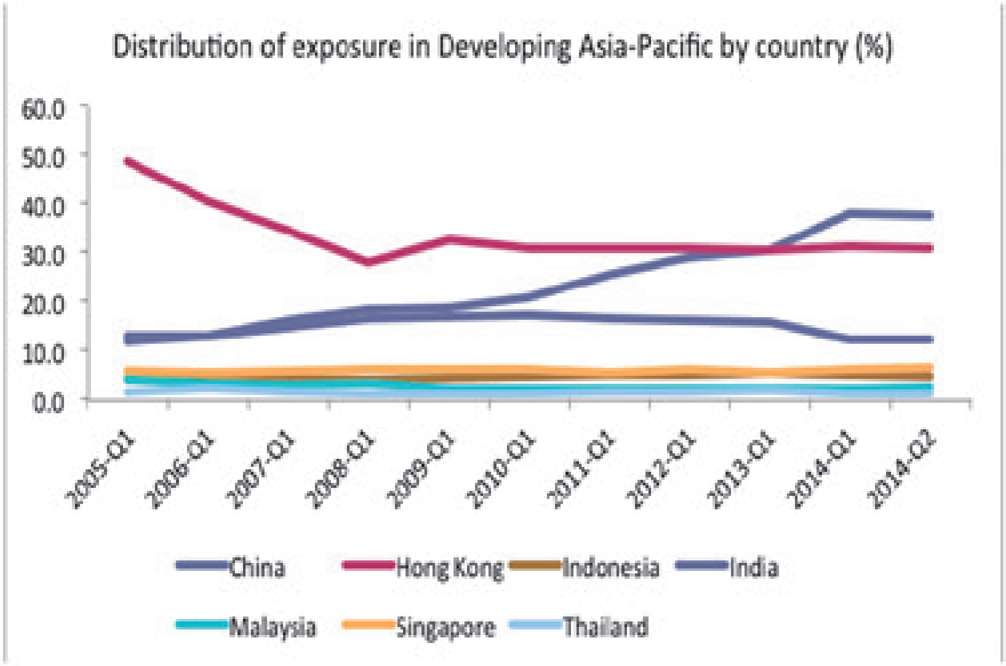
- Effects on Asian debt of the 1997 crisis (that struck a few countries in the Asia-Pacific region) and the 2008 crisis (affecting the centres of developed capitalism) have been very different.
- The former was followed by debt reduction, as a result of reduction of household and government debt and repair of balance sheets that began immediately after the crisis.
- By contrast, the latter was followed by significant increases rise in corporate leverage and other forms of internal and external borrowing in developing Asia.

## Magnitude

- Outstanding international bank claims rose fourfold in the developing Asia-Pacific region, from \$503.5 billion at the end of the first quarter of 2005 to \$2164 billion at the end of the second quarter of 2014.
- In four of the nine years, starting with the year ending the first quarter of 2005, the annual increase in international bank claims in eight leading Asian emerging markets exceeded the highest annual increment of \$212 billion in portfolio inflows to those countries, with the increase peaking at \$393 billion in 2010-11.

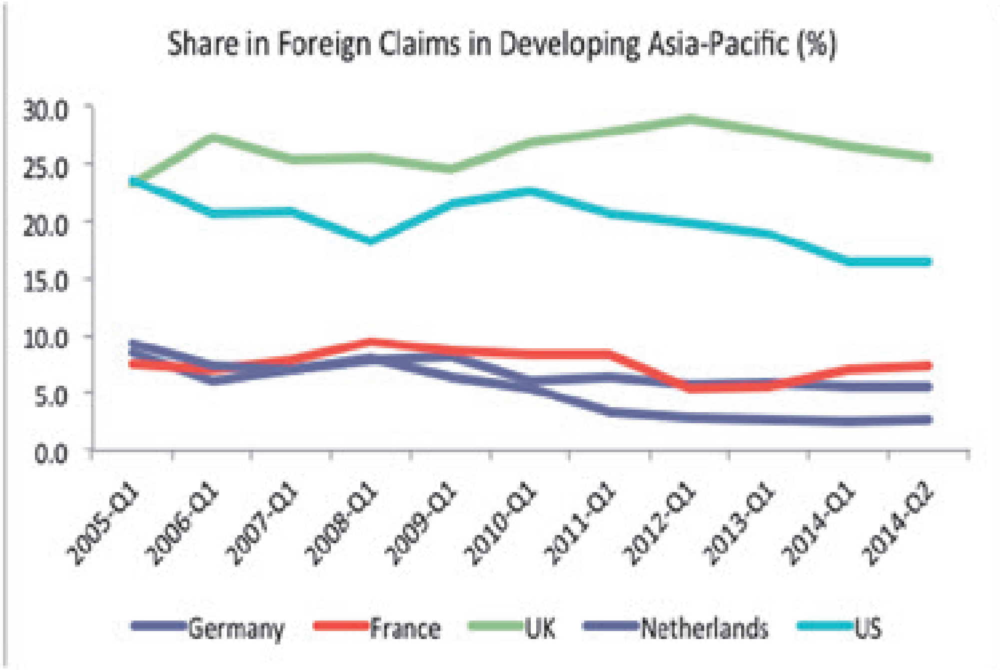

# Concentration of debt

- Over the decade until 2014, international bank claims in the Asia-Pacific were concentrated in Hong Kong (which serves as a financial hub), China and India in that order.
- Hong Kong and China together accounted for between 47 and 70 per cent of aggregate exposure in the developing Asia-Pacific, with the figure exceeding 50 per cent in all but one year.
- When India is added to these countries, the share of the three in developing Asia-Pacific exposure fluctuated between 66 and 82 per cent since 2005.



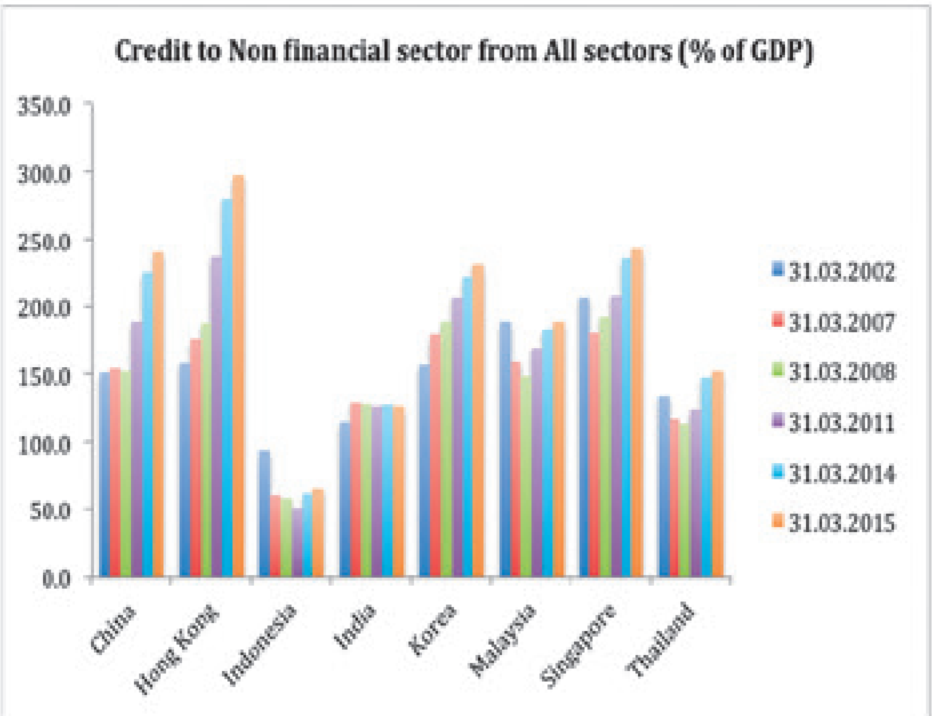

# Cause for concern

- Given the role that local developments in source countries of loans can have in inducing volatility and the danger of contagion signalled during the 1997 crisis, this concentration of debt exposure is disconcerting.
- Banks owned by residents in two countries, the US and the UK account for the bulk of the exposure, varying from 43 and 50 per cent of the total during this period.
- The volatility of bank financing experienced during the "taper tantrum" in 2013 and subsequently since the middle of 2014 as US Federal Reserve rate increases began vindicates of such concern.

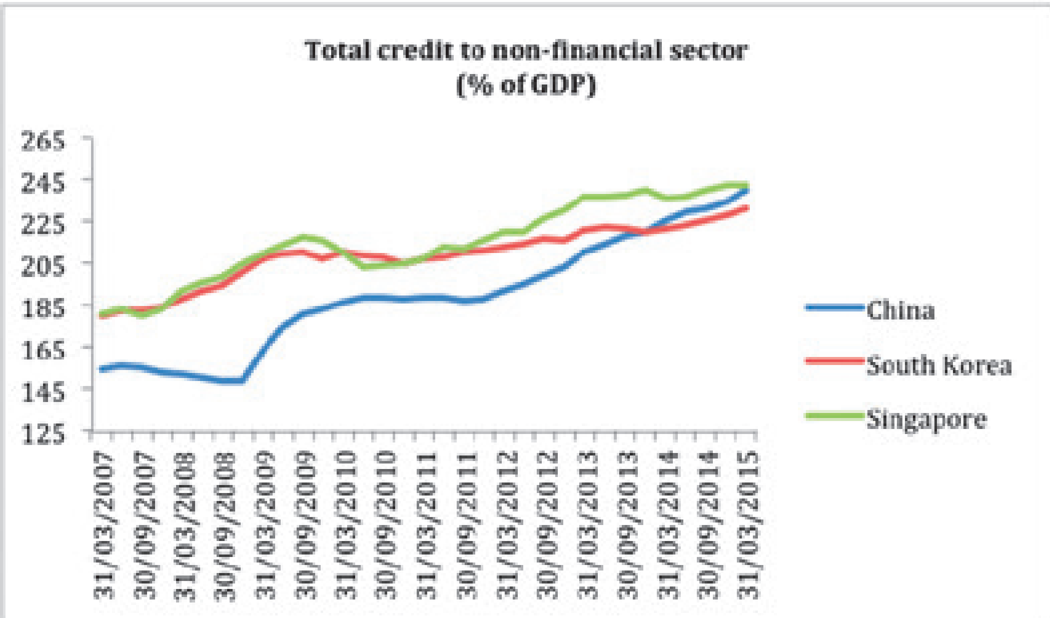


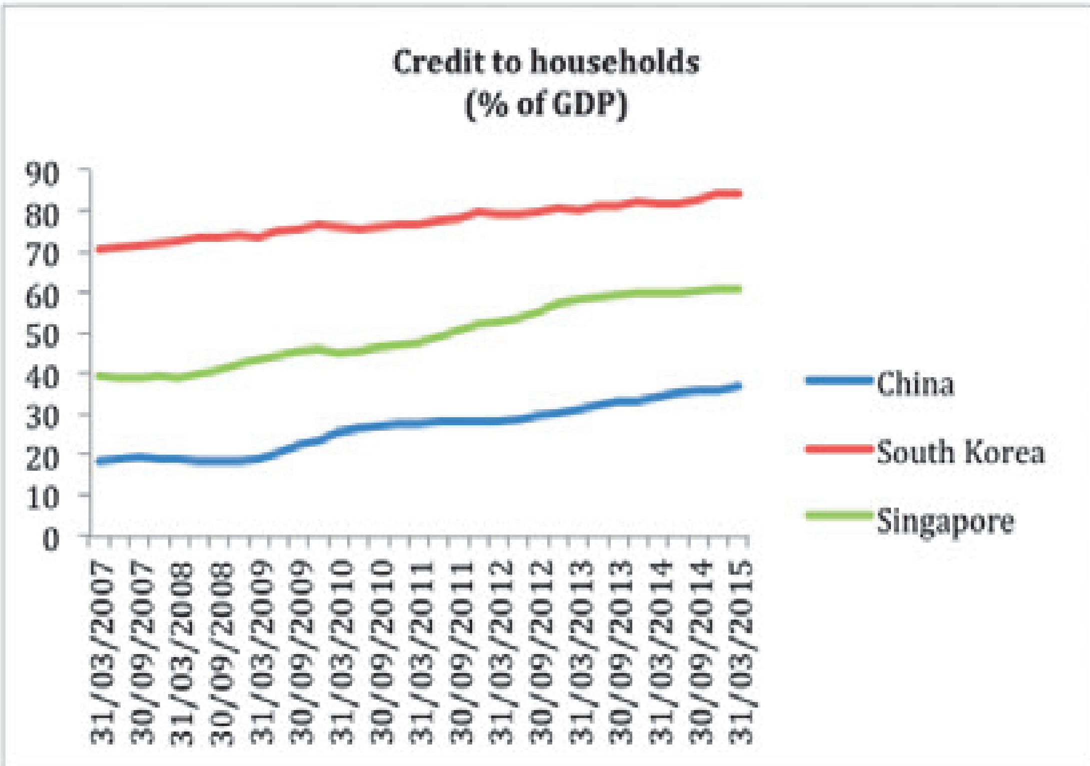

# Fall-out

- Parallel expansion of domestic debt.
- Banks awash with liquidity now need to lend more at a time when government borrowing is under control. The result is a change in financial sector behaviour and bank lending practices.
- Visible in countries with very different trajectories–South Korea, India, China, for example. In all cases rising overhang of private debt with rising stressed and non-performing assets with banks.
- Fragility due to excess debt and asset price inflation.




- All countries other than India and Indonesia registered sharp spikes in the aggregate debt of the non-financial sector in the period after the 2008 crisis. In most countries this was partly driven by the need to provide a countercyclical stimulus to the economy in the wake of the crisis. In the era when the stress is on holding down government fiscal deficits and on fiscal consolidation, this required relying on an increase in credit provision to spur investment and consumption demand. The Chinese post-crisis stimulus was a typical example of this. As noted above, this was also the period when the massive infusion of liquidity into the system by central banks resulted in a large flow of capital into equity and debt assets in the emerging markets. By 2015 bank credit to GDP ratios were close to 300 per cent in Hong Kong, above 240 per cent in China and Singapore, around 230 per cent in Korea. These were higher than levels that prevailed in the US (239 per cent) and UK (269 per cent) and significantly higher than that in more conservative Germany (192 per cent).


Total credit to non-financial sector
(% of GDP)
265
245
225
205
185
165
145
125
31/03/2007
30/09/2007
31/03/2008
30/09/2008
31/03/2009
30/09/2009
31/03/2010
30/09/2010
31/03/2011
30/09/2011
31/03/2012
30/09/2012
31/03/2013
30/09/2013
31/03/2014
30/09/2014
31/03/2015
China
South Korea
Singapore


Credit to households
(% of GDP)
90
80
70
60
50
40
30
20
10
0
31/03/2007
30/09/2007
31/03/2008
30/09/2008
31/03/2009
30/09/2009
31/03/2010
30/09/2010
31/03/2011
30/09/2011
31/03/2012
30/09/2012
31/03/2013
30/09/2013
31/03/2014
30/09/2014
31/03/2015
China
South Korea
Singapore

## Macroeconomic implications

- Accumulated, legacy foreign capital generates strong pressures for private sector-led growth, tax forbearance and fiscal consolidation.
- Ability to use the fiscal lever as a countercyclical investment undermined. Growing dependence on monetary policy.
- An ostensibly 'independent' central bank pursuing inflation targets sees reason to manipulate interest rates while allowing liquidity expansion a free reign. But transmission limited or absent.

## Growth in the age of finance

- Growth depends on debt financed private expenditure. Increases financial fragility and proves unsustainable.
- Volatile cross-border flows creates problems for macroeconomic management and increases external vulnerability.
- Susceptibility to boom-bust cycles driven by supply-side development increase.