

Maintaining financial stability in Asia and the Pacific

Most Asia-Pacific economies have maintained a largely accommodative monetary policy stance in the past decade. However, lower policy rates have not been fully translated into stronger growth, but contributed to financial instability in terms of higher private debt, which harms long-term economic growth. A prudent approach to monetary policy would be needed to focus on maintaining price and financial stability. Policy makers shall accompany traditional monetary policies with macroprudential policies and regulations to strike a balance between supporting short-term growth prospects while containing the build-up of financial risks.

Rising financial instability in the Asia-Pacific region

Most Asia-Pacific economies have maintained a largely accommodative monetary policy stance since the Global Financial Crisis in 2008, aiming to maintain growth or avoid a slowdown. Almost all the economies across the subregions have kept their central bank policy rates lower than those in a decade ago (figure 1). Loose monetary conditions in the major developed countries have created a favourable environment.

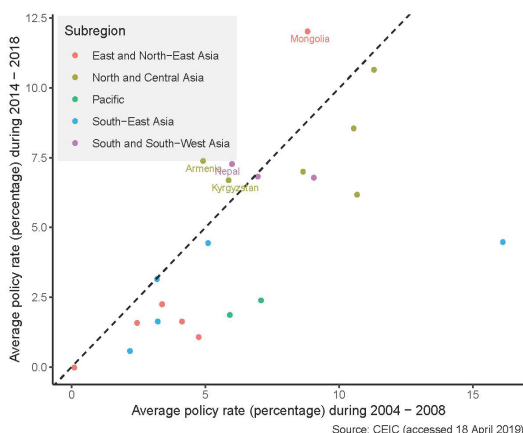
However, lower policy rates have not been fully translated into stronger growth. In 2018, for example, policy rate cuts were not associated with stronger growth in most countries (figure 2). Similar situation has been observed in the past few years.¹ Possible reasons why rate cuts did not boost economic activity could be relatively weak growth in real wages on the consumption side and uncertainty and excess capacity on the investment side; banking sector problems that fail to translate policy rate reductions into lower commercial

lending rates (such as high non-performing loans in India); or existing high financial leverage (ESCAP, 2017 & 2018). In addition, ageing populations and increasing inequality have the potential to reduce the demand to invest while increasing the propensity to save, thereby lowering the natural rate of interest and narrowing the scope for central banks to secure price stability and maintain output at its full potential (Summers, 2014; Arslanalp, Lee and Rawat, 2018).

Instead, lower policy rates have likely exacerbated financial instability. Although overall public debt sustainability is not a major concern for countries in the Asia-Pacific region, rising household and corporate debt calls for policy makers' attention. The private sector in emerging markets borrowed heavily during the post-Global Financial Crisis period, favoured by a low global interest rate environment. In the Asia-Pacific region, large and rising household debt is a growing concern in *Malaysia, the Republic of Korea, and Thailand*, as is fast-expanding corporate debt in *China* (figure 3).

Figure 1. Most Asia-Pacific economies have maintained an accommodative monetary policy environment in recent years...

Average policy rates during 2004-2008 and 2014-2018

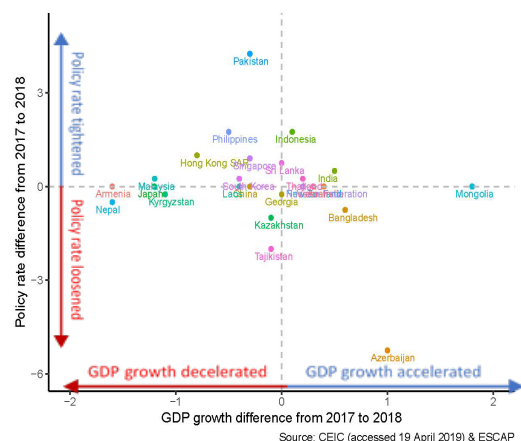


Source: CEIC (accessed 18 April 2019)

Note: The dotted line is a 45-degree line. If the dots are below the line, the related countries' average policy rates during the period 2014 – 2018 are lower than those during the period 2004-2008.

Figure 2. ...however, lower policy rates have not been translated into stronger growth

GDP growth difference vs. policy rate difference from 2017 to 2018

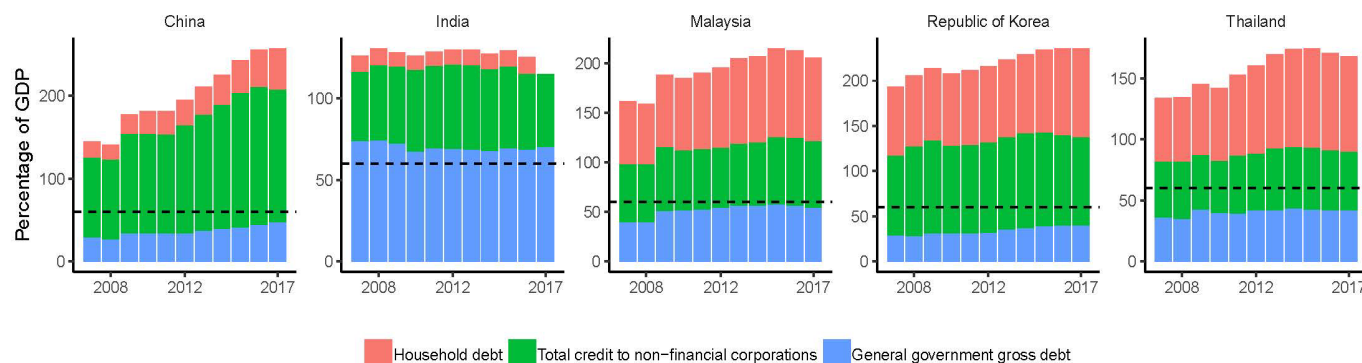


Source: CEIC (accessed 18 April 2019)

Note: The dotted line is a 45-degree line. If the dots are below the line, the related countries' average policy rates during the period 2014 – 2018 are lower than those during the period 2004-2008.

Figure 3. Upward trend for private debt in selected Asia-Pacific economies in past decade

Debt, by composition, for selected countries



Source: IMF and BIS (accessed 26 July 2018)
Note: the dotted line illustrates 60 percent of GDP.

Elevated levels of private debt have adverse implications for financial stability and may eventually harm economic growth. Debt expansion can boost economic growth in the short term as firms and households take on more debt to consume or invest. However, such positive effects on GDP is short-lived (IMF, 2017a). Highly indebted firms and households may need to cut back on spending to repay their loans. Moreover, excessive leverage can inflate, for example, asset prices. For example, in the *Republic of Korea*, rising household debt is highly skewed towards mortgage loans, which served as one of the major factors of property price dynamism (Kim, Son and Yie, 2017). However, if an abrupt correction of housing prices happens, firms and households need to further cut back on investment and consumption to repair their damaged balance sheets while banks and other financial institutions will suffer a surge of non-performing loans and thus lend less, hurting investment and consumption (Park, Shin and Tian, 2018). Non-performing loans in countries with higher private debt risks in the region have remained at a relatively low level, especially when compared with during the Global Financial Crisis (figure 4).

In addition, **financial fragility in several developing countries in the region has also been exacerbated by the rise in dollar-denominated debt.** The United States dollar-denominated debt to non-bank borrowers as share of GDP in *Indonesia*, the *Russian Federation* and *Turkey* doubled during 2011 and 2018 (figure 5). Further strengthening of the United States dollar and potential interest rate hikes could increase the burden to service debt as well as create additional financial vulnerability, given their high exposure to refinancing and currency mismatch risks (United Nations, 2019).

The emergence of nonbank online consumer loans brings new risks. Internet giants in *China* such as Alibaba leverage their successful e-commerce and online mutual fund platforms to attract investors. Big data technology is used to conduct due diligence on individual borrowers based on their transaction history. Small peer-to-peer (P2P) lending platforms grew rapidly by issuing small-amount open-end loans that are used to finance day-to-day consumption.

Such consumer loans are often uncollateralized and have higher default rates than mortgage loans on average. Research suggests that in *China* 3-6 percent of P2P loans were nonperforming in 2016, higher than the 1.2-2.7 percent for bank-originated consumer loans (Li, 2018).

Figure 4. Non-performing loans remain at a relatively low level

Bank non-performing loans to total gross loans

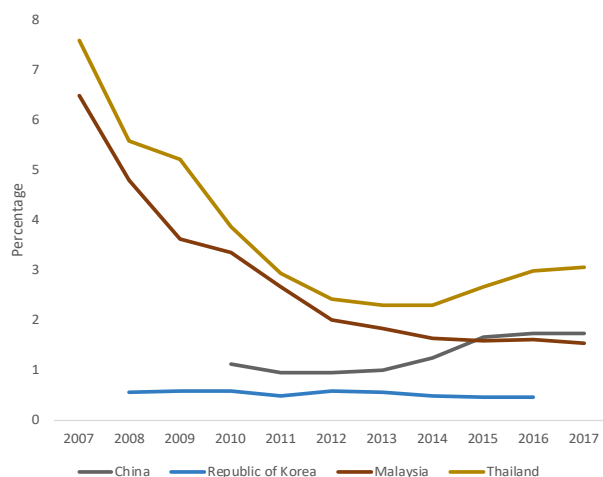
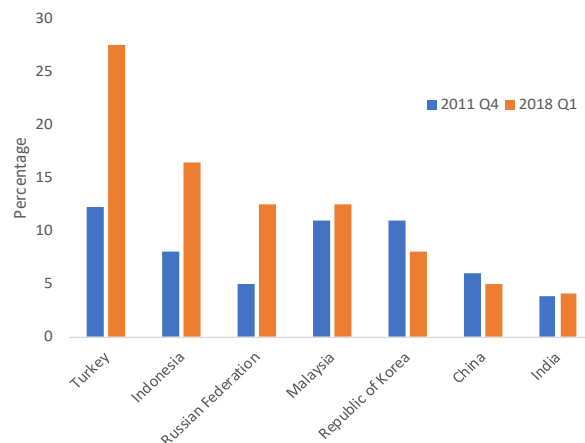


Figure 5. United States dollar-denominated credit to non-bank borrowers increased in several countries in the Asia-Pacific region

Dollar-denominated credit to non-bank borrowers as a share of GDP



Source: World Bank data (accessed 26 January 2019)

Source: United Nations, World Economic Situation Prospects 2019. Sales No. E.19.II.C.1.

Policy recommendation

A prudent approach to monetary policy would be needed to focus on maintaining price and financial stability. Such stability can help reduce uncertainty and thus indirectly facilitate investments that are critically needed to effectively pursue the 2030 Agenda. Central banks could consider the trade-offs and effectiveness of using different tools to ensure financial stability and address asset price booms and busts (Cerra and Saxena, 2017).

- **Interest rates:** With increasing downside risks and global uncertainties, many countries plan to ease monetary policy to support short-term macroeconomic stability. For example, China announced to cut its real interest rate levels and lower financing costs for the private sector in early 2019 (Reuters, 2019). Countries may now have greater monetary policy space to do so, given relatively low inflation in the region, the pause in monetary policy normalization in the developed world and relatively stable global oil prices compared with 2018.

However, such accommodative monetary policy - responding to low inflation risk - contributes to the boom and bust cycles that end in financial crises and output losses. **Policy makers shall strike a balance between supporting short-term growth prospects while containing the build-up of financial risks.** Loosening monetary policies could reverse the efforts to deleverage and induce further debt accumulation. In the *Republic of Korea* and *Thailand*, for example, low interest rates for an extended period have contributed to higher household debt (ESCAP, 2018a).

- **Macroprudential policies and regulation:** Given the limited impact of interest rate reductions on aggregate demand and the rising financial vulnerability (private debt and exchange rate volatility, as discussed above), traditional monetary policies should be accompanied by macroprudential measures.

Developing economies in Asia have been at the forefront of macroprudential policies. Since the early 2000s, these economies have adopted various tools to cope with different potential threats to financial stability (table 1). For example, *Hong Kong, China*; and *Singapore* have predominantly relied on housing-related loan-to-value (LTV) restrictions. The *Republic of Korea*, in addition to housing measures, imposed a levy on bank non-deposit foreign currency liabilities and a ceiling on banking foreign-exchange derivative positions. *China* and *India* have been heavy users of reserve requirements.

Macroprudential measures have helped curb housing-related credit growth, inflation and bank leverage in the region. Some effective instruments include LTV ratio caps, housing tax measures and foreign currency-related measures

Table 1. Macroprudential measures targeting demand for and supply of credit

Tools affecting the supply of credit	Tools affecting the demand for credit
<ul style="list-style-type: none"> • Loan-to-value ratios • Margin requirements • Loan maturities • Tax policy and incentives 	<ul style="list-style-type: none"> • Lending rate ceilings • Interest rate ceilings • Reserve requirements • Capital requirements • Portfolio restrictions • Supervisory pressure

Source: ESCAP, 2018a

(Zhang and Zoli, 2014). Countries in the region are developing macroprudential policies and frameworks to address household debt. For instance, in the *Republic of Korea*, LTV and debt-to-income ratios continued to be tightened in 2017 and 2018; and the country introduced a debt-service ratio to assess borrowers' ability to repay loans.

- **Regulating fintech to minimize financial risks:** Given the challenges arising from the fintech industry, the regulatory framework would need to be adjusted to manage the corresponding financial risks. Central banks could broaden the set of indicators in policy analyses to cover digital financial services. For example, they could incorporate information on money-holding of digital financial intermediaries and balance sheet data of digital financial institutions in the assessment of money and credit supply (Bernoth and Gebauer, 2017). An improved regulatory framework could enhance consumer protection and therefore foster financial inclusion. For example, the Bank of Thailand announced that it would set regulations for P2P lending platforms, a measure that is expected to improve the access of small businesses to financial sources.

Market infrastructure, such as clearing or settlement, can be provided to support regulatory efforts. For instance, in 2018 China mandated all online payment transactions to go through a central bank established online settlement platform. The platform monitors all capital flows of digital payment providers, therefore preventing money-laundering, bribery and other irregular financial activities.

- **Flexible exchange rate regimes should be maintained to act as shock absorbers, although more financial opening should be cautiously managed.** One of the lessons learned from the Asian financial crisis is that domestic financial reforms should precede financial globalisation. Certain prerequisites or initial conditions, taking into account individual country circumstances, have to be met before a country can be expected to benefit from further financial opening-up. A phased and sequenced domestic financial liberalisation and financial deepening, supported by appropriate financial stability safeguards, can help countries to benefit

from financial liberalisation while minimizing risks of excessive volatility, contagion from abroad and crisis (ESCAP, 2018b).

Many Asia-Pacific economies have intended to keep an accommodative monetary policy stance to maintain economic growth or avoid a slowdown. The current pause in monetary policy normalization in the developed world provides an enabling environment. However, low interest rates have contributed to the pile-up of private debt in some economies in the region, which can contain their long-term economic growth. Policy makers should continue strengthening macroprudential policy tools to curb financial instability. New regulatory framework needs to be explored to manage the financial risks emerging from new technologies. Countries should consider domestic financial deepening at a phased and sequenced pace to benefit from financial liberalization while minimizing risks of excessive volatility, contagion from abroad and crisis.

Endnotes

¹ This is also confirmed by simple regression analysis.

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The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue was prepared by Zhenqian Huang. It benefited from research assistance by Jittapat Sirison (intern) and overall guidance from Sweta Saxena and Hamza Ali Malik (Macroeconomic Policy and Financing for Development Division, ESCAP). For further information on this issue, please contact Hamza Ali Malik, Director, Macroeconomic Policy and Financing for Development Division, ESCAP (escap-mpdd@un.org).