HKMA-BIS Joint Conference on Asia-Pacific Economies
"The Resilience of the Regional Economies in a Turbulent Global Environment"
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Financial Imbalances in Asia

How worried should we be?

Cross-Border Financial Flows and Leverage in Asia

October 20, 2016

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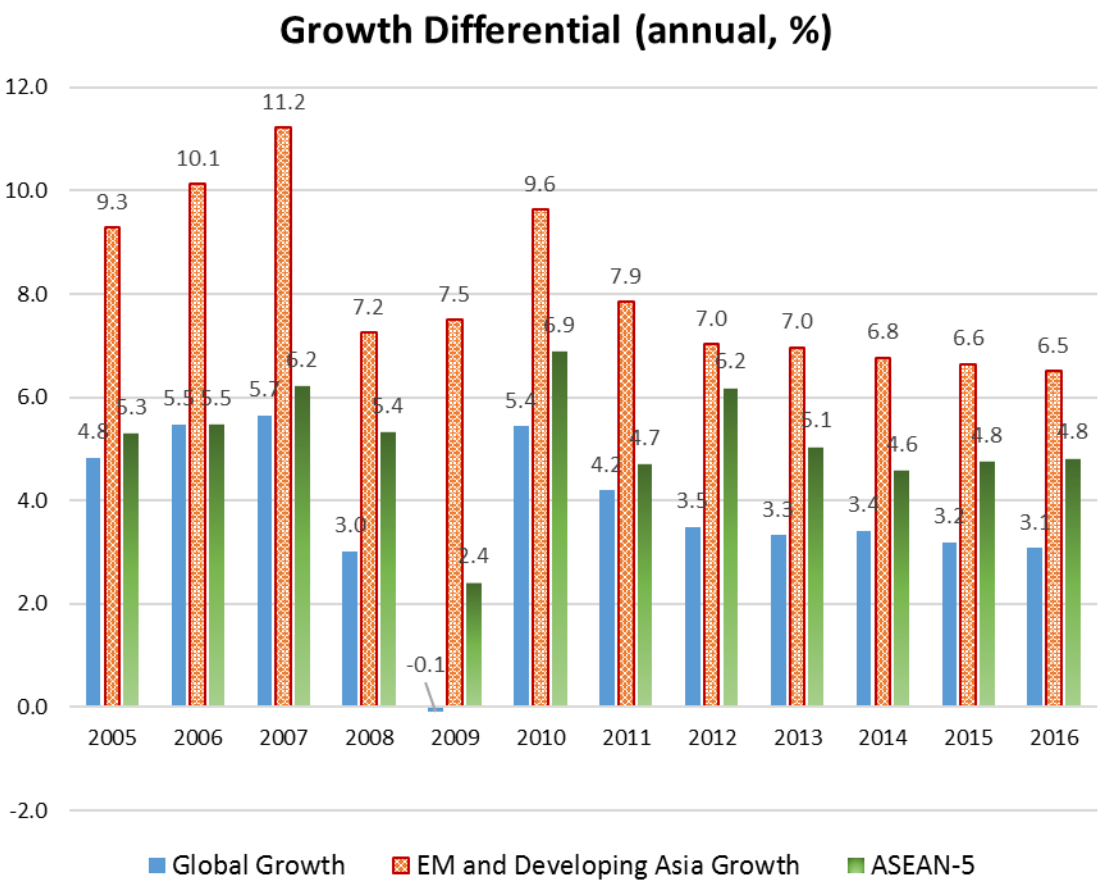
DISCLAIMER: The views expressed in this presentation represent those of the presenter and do not represent those of the IMF.

Cross-Border Financial Flows and Leverage in Asia

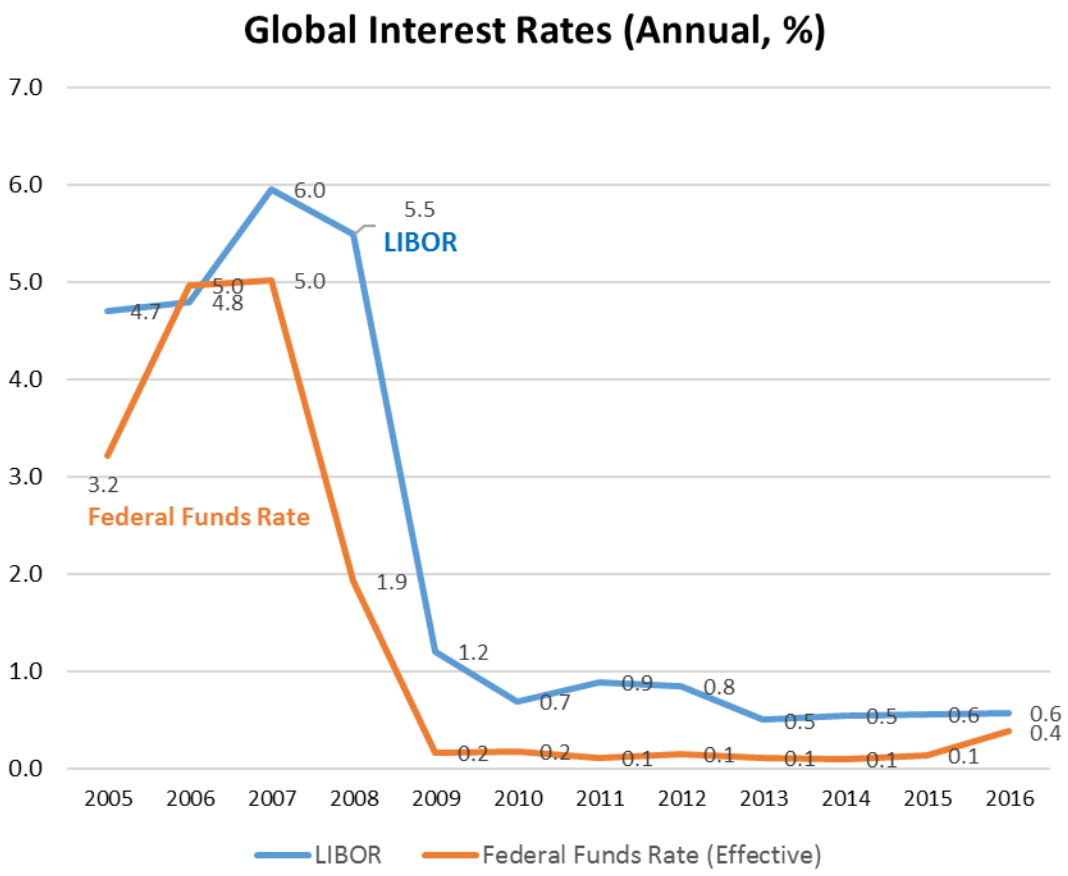
Patterns and Features

- Growth at Lower Interest Rates after the GFC
- Recent Asian Financial Landscape
  - Financial account evolutions (IFS BOP data)
  - Cross-border funds (EPFR data): flows and assets
- Evolving Capital flows, International Reserves, and Exchange Rates
- Domestic Financial Imbalance: Household Debt
- Implications for Financial Stability

Asia grows faster than the global economy amid lower external-funding costs…



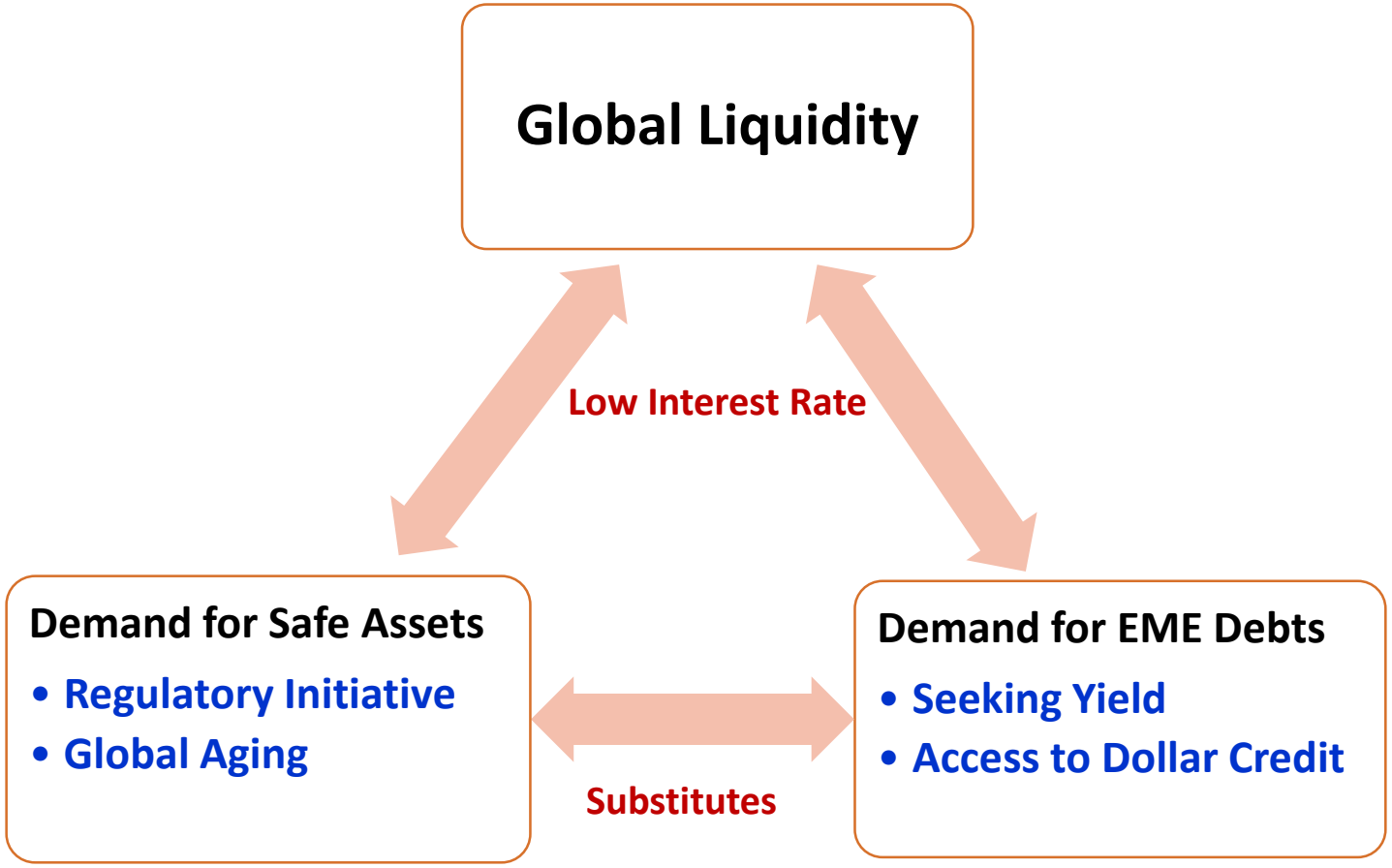
Data: IMF WEO



Data: FRED

Global liquidity (GL) has a self-reinforcing feedback loop …

GL reinforces itself at low interest rates, footing on increasing demand for safe assets and EME debts—substitutes to global investors.



Low Interest Rates: Double Edged Sword?

Lower funding costs facilitate investment & spending but are prone to escalate leverage…

- Lower costs of external financing help build up sovereign liquidity (Choi et al. 2009)
- Low interest rates reduce future debt-service burdens and thus empower government spending impacts on consumption and investment (Choi and Devereux 2006; Huidrom et al. 2016)
- Prompt leverage and balloon financial imbalances in Asia – increasing household debt as well as corporate debt and shadow banking (2015 BOK-IMF Conference)

Asian Financial Landscape: Patterns and Features

Cross-border liquidity flows print big waves in Asia

Asia unwinds financial derivatives (except for China and India), keeps up inward FDI (except for Japan), attracts portfolio investment (in Japan and Australia), and adjust other investment

Equity funds are concentrated on Japan, China, India, and Australia, while **bond funds** are built up in India, Australia, and Japan since 2013

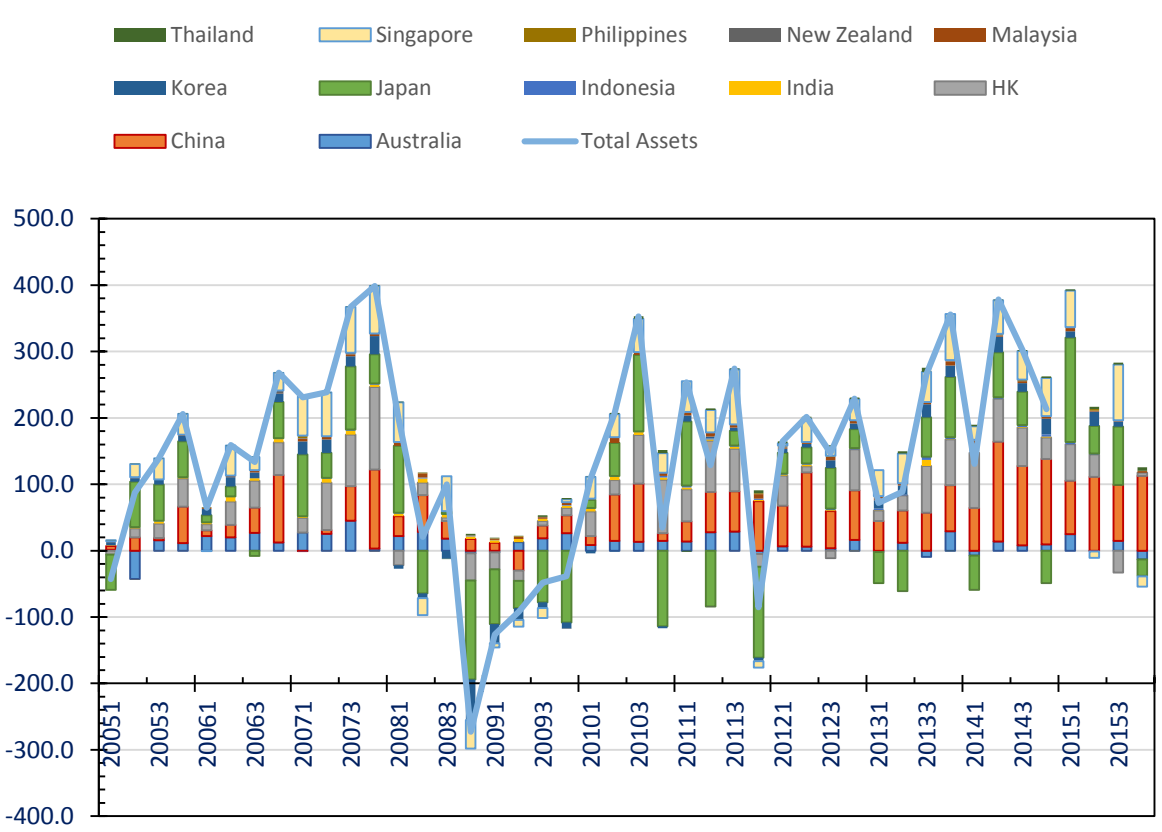
Recent capital flow reversals accompany exchange rate depreciations and reserve declines

Financial imbalances stem from **mounting HH debt**

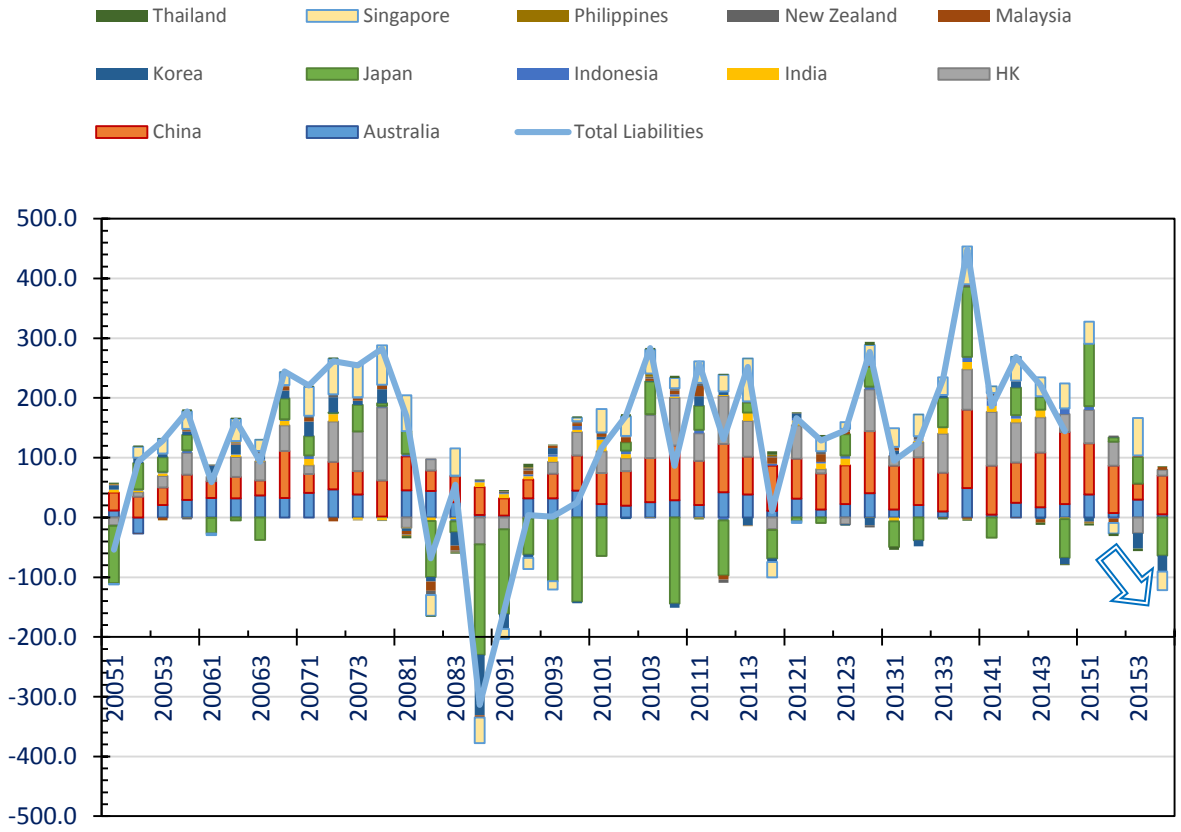
EM Asia would be prone to credit shortage upon large capital flow reversals

[IFS] While financial investment abroad (led by China, Japan, and Singapore) has remained vibrant since 2010, capital inflows in Asia have declined in recent quarters…

12 Countries: Gross Capital Outflows (Assets, Bil US$)

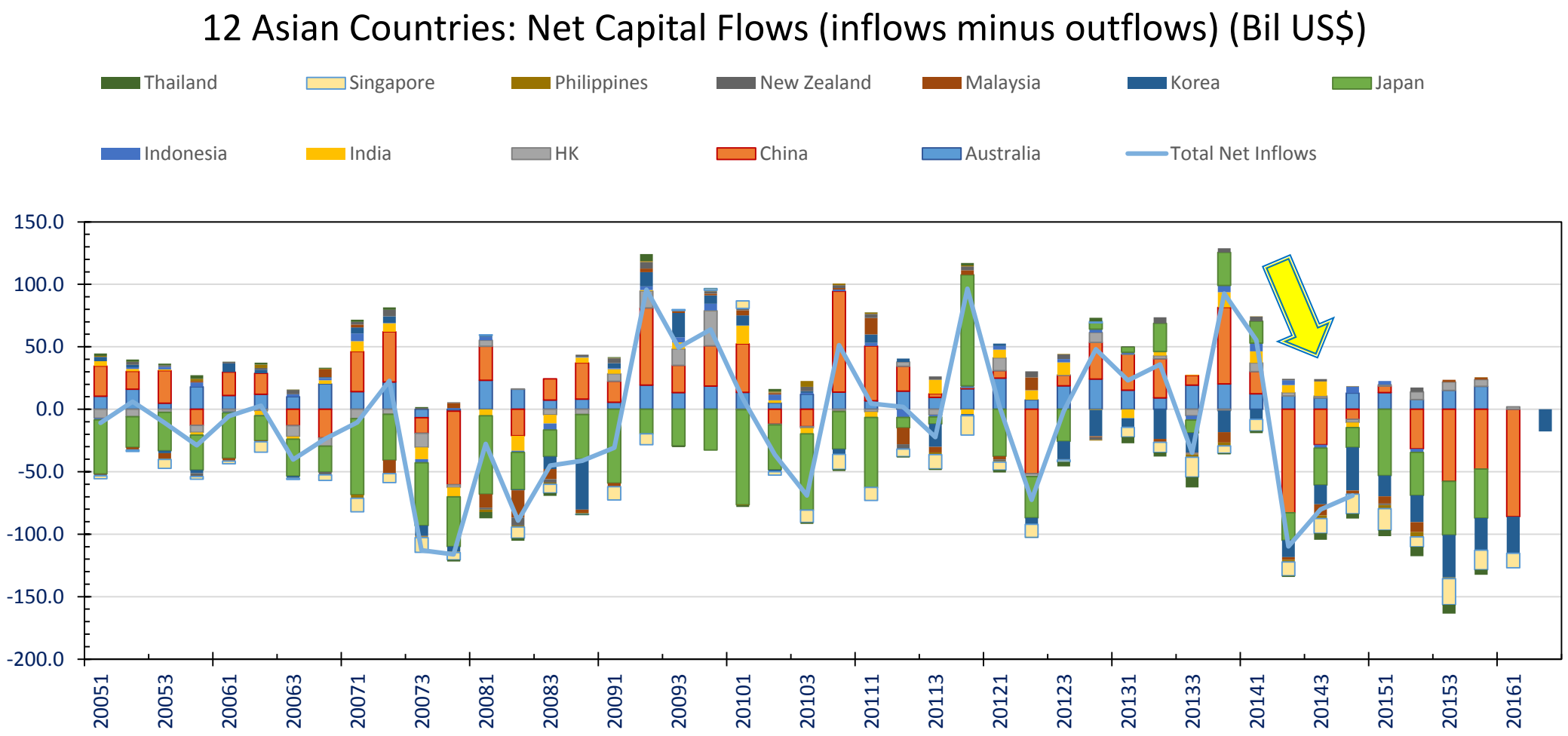


12 Asian Countries: Gross Capital Inflows (Liabilities, Bil US$)

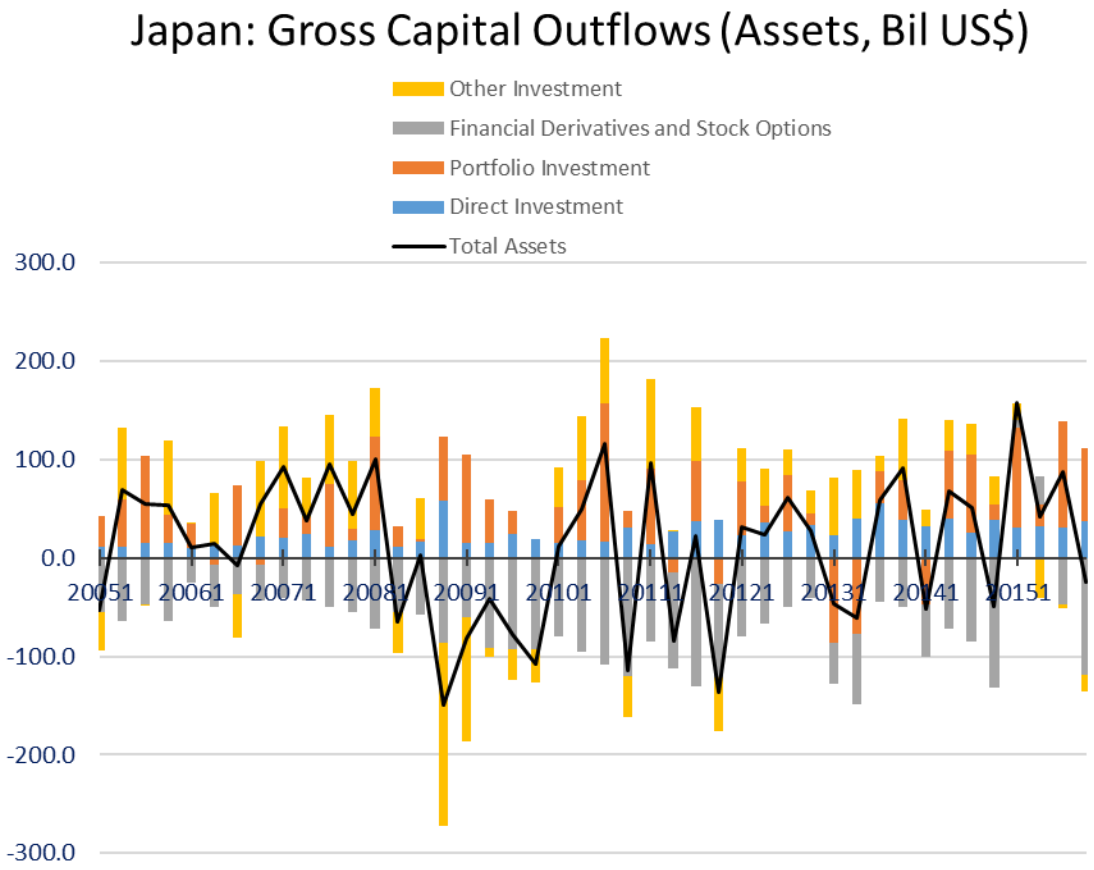


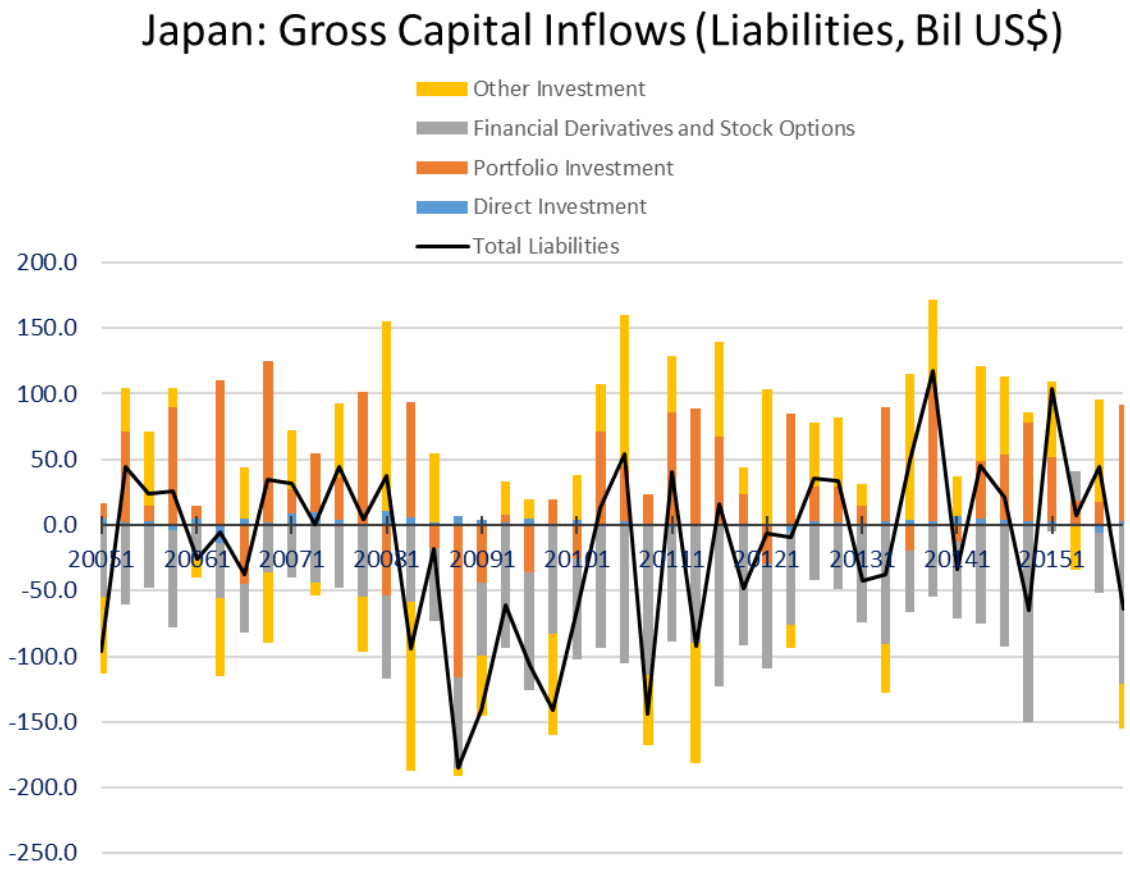
[IFS] Asia sees declines in net capital flows since 2014q2 against the prospective Fed's interest rate hikes.

More pronounced for China, Japan, and Korea…

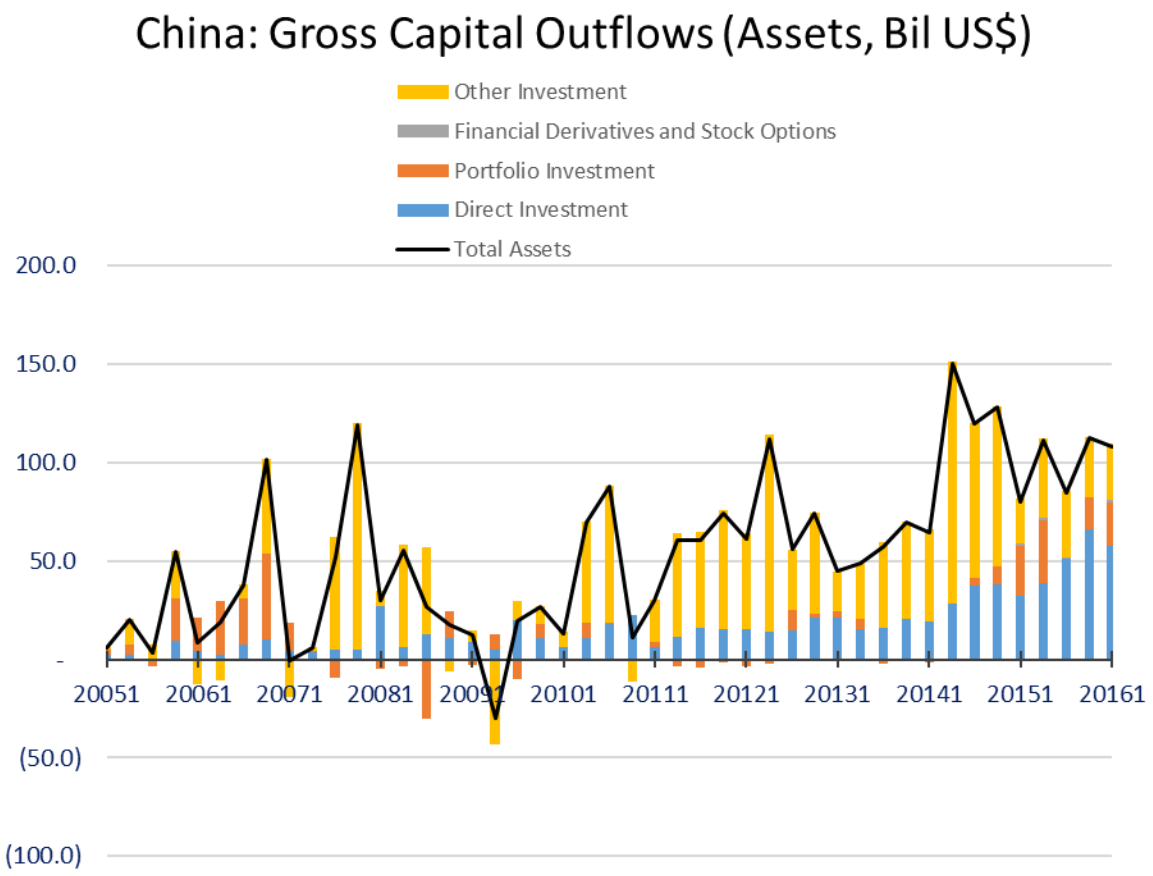


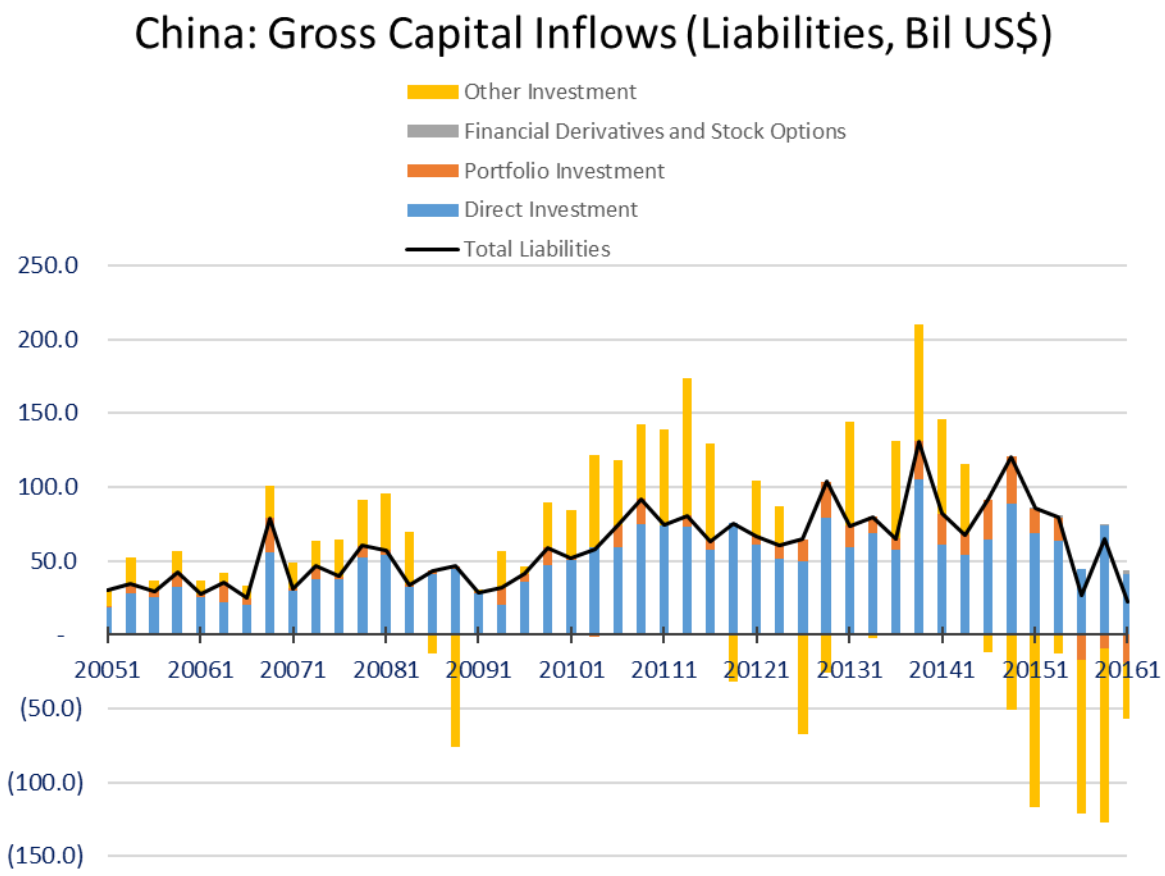
[IFS] **Japan**: Outflows are largely in line with inflows, outward FDI remains sturdy, and financial derivatives have been unwound in both assets and liabilities…



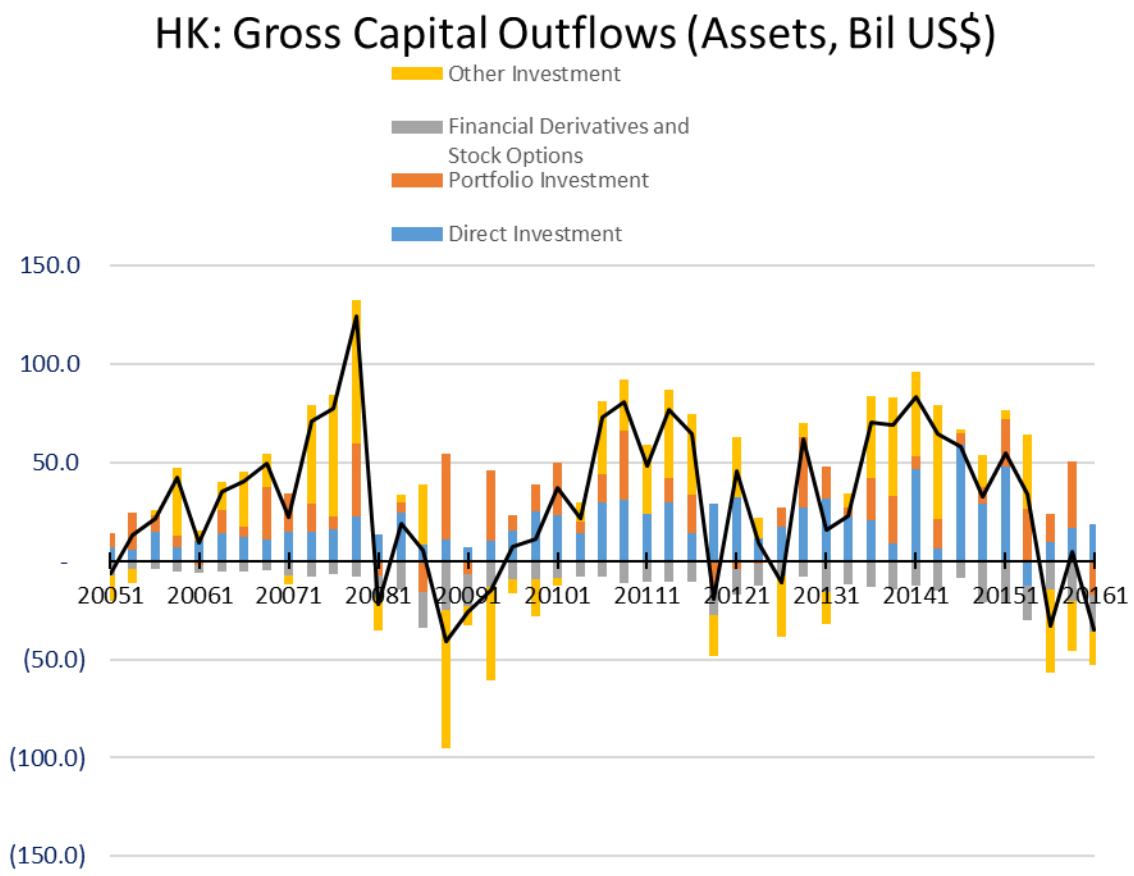


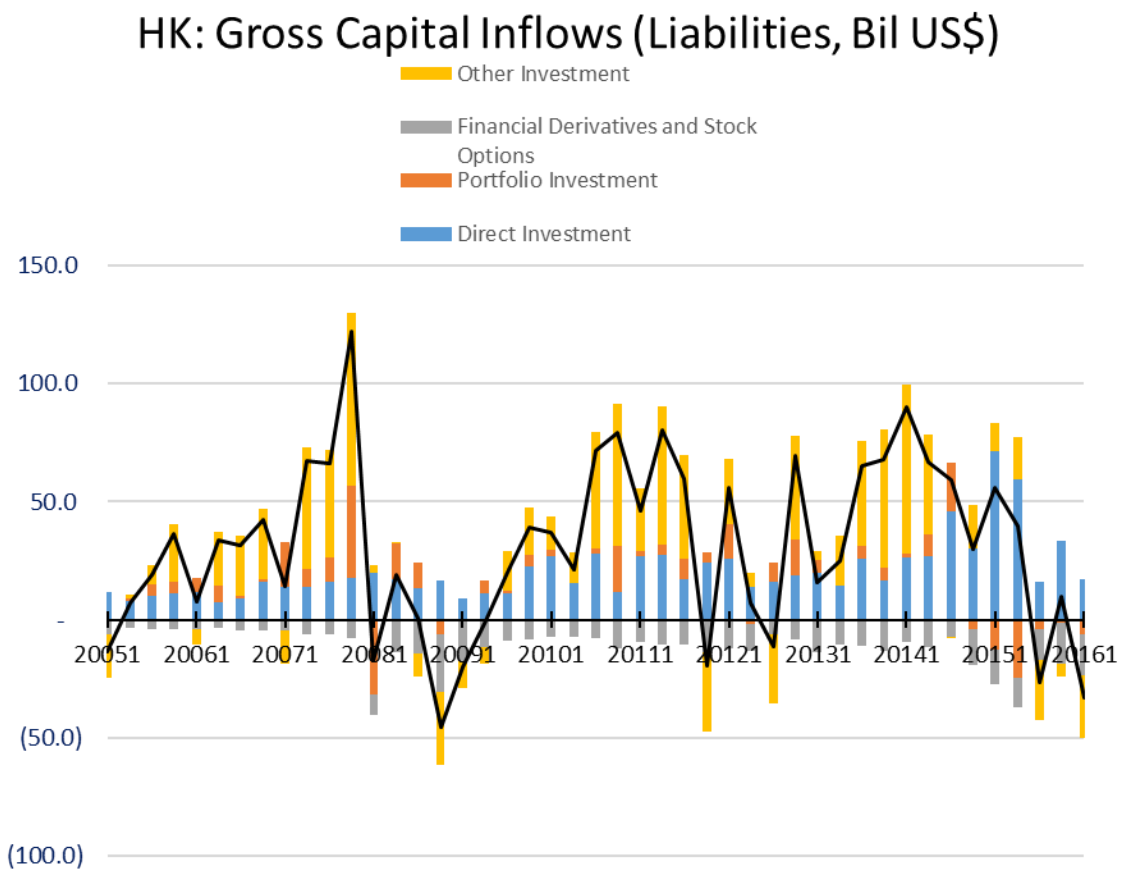
[IFS] **China**: Strong drives in outward FDI and other investment after the GFC. Inward FDI has been dominating, and portfolio investment and other investment have receded recently…



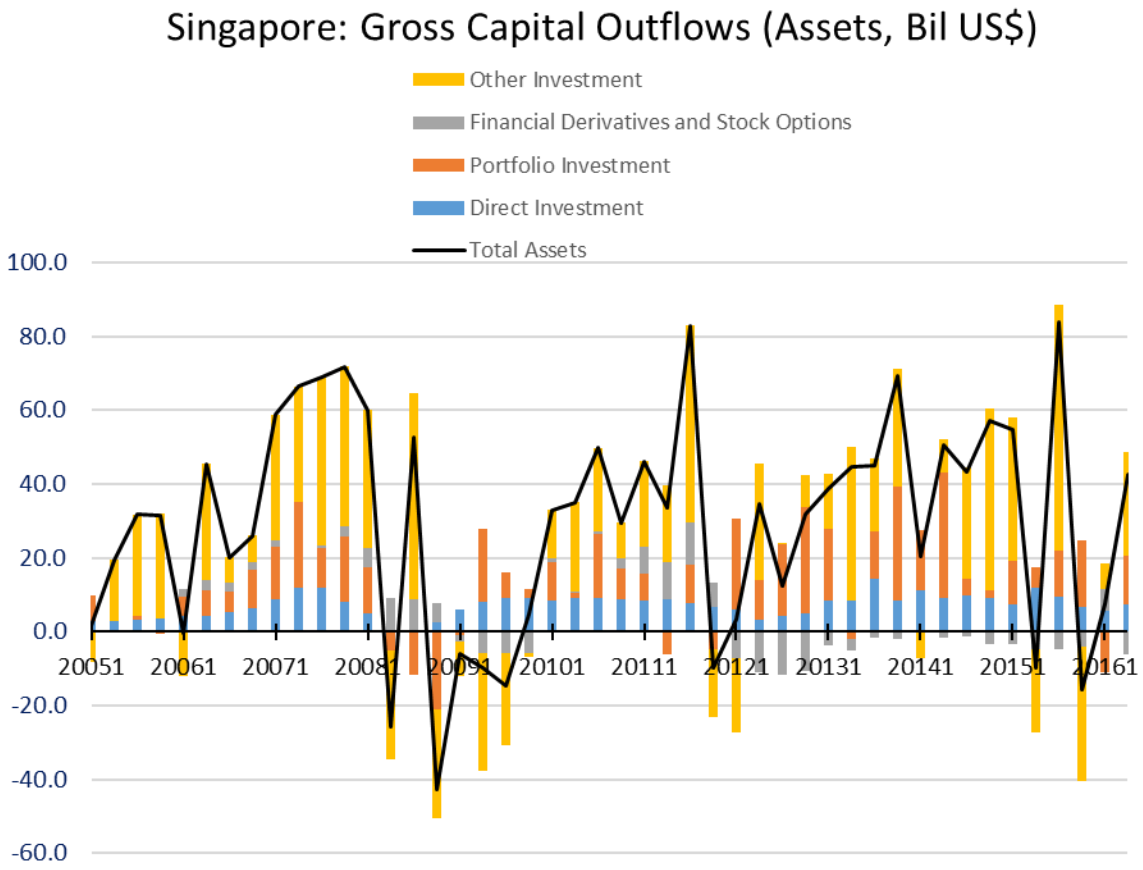


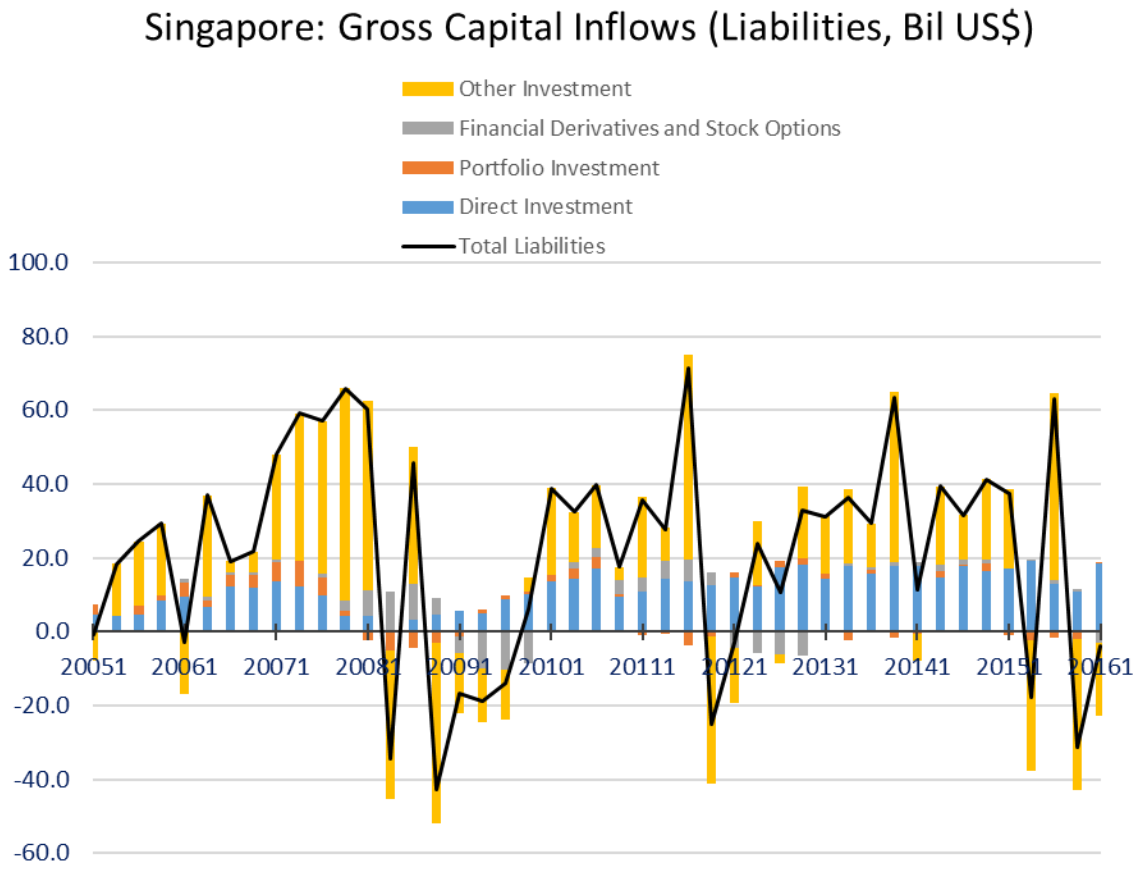
[IFS] **Hong Kong**: Keeps up outward FDI and attracts inward FDI, while unwinding financial derivatives over a decade, and from the mid-2015 reduces other investments on both sides.



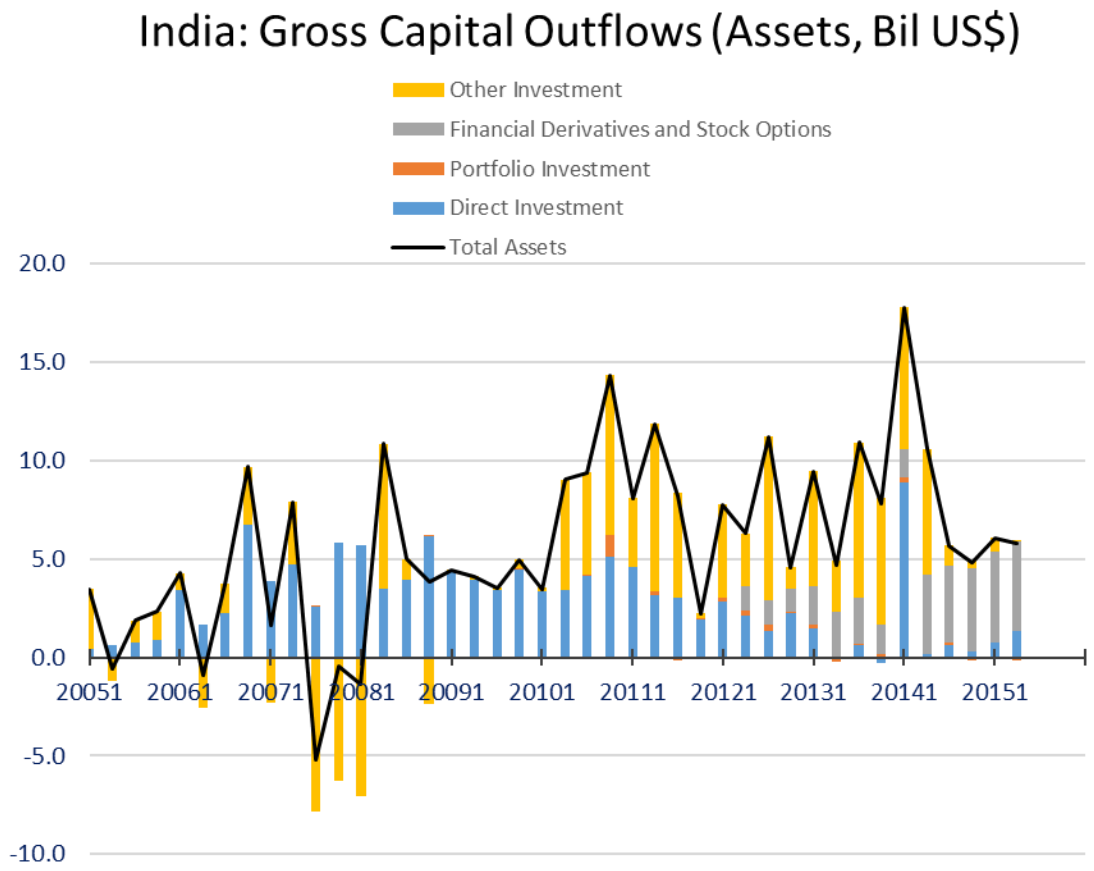


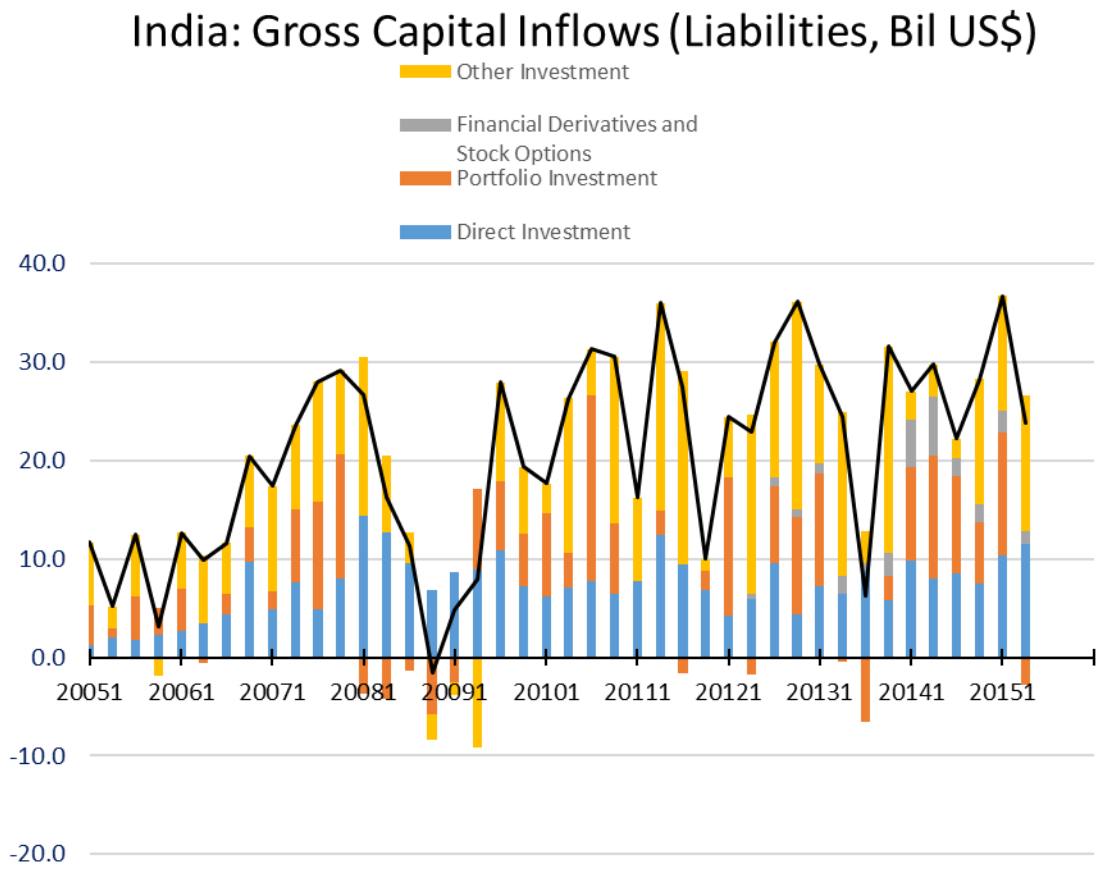
[IFS] **Singapore**: Mix outward FDI, portfolio investment, and other investment abroad, while attracting inward FDI and other investment. Other investment on both sides has become volatile recently.



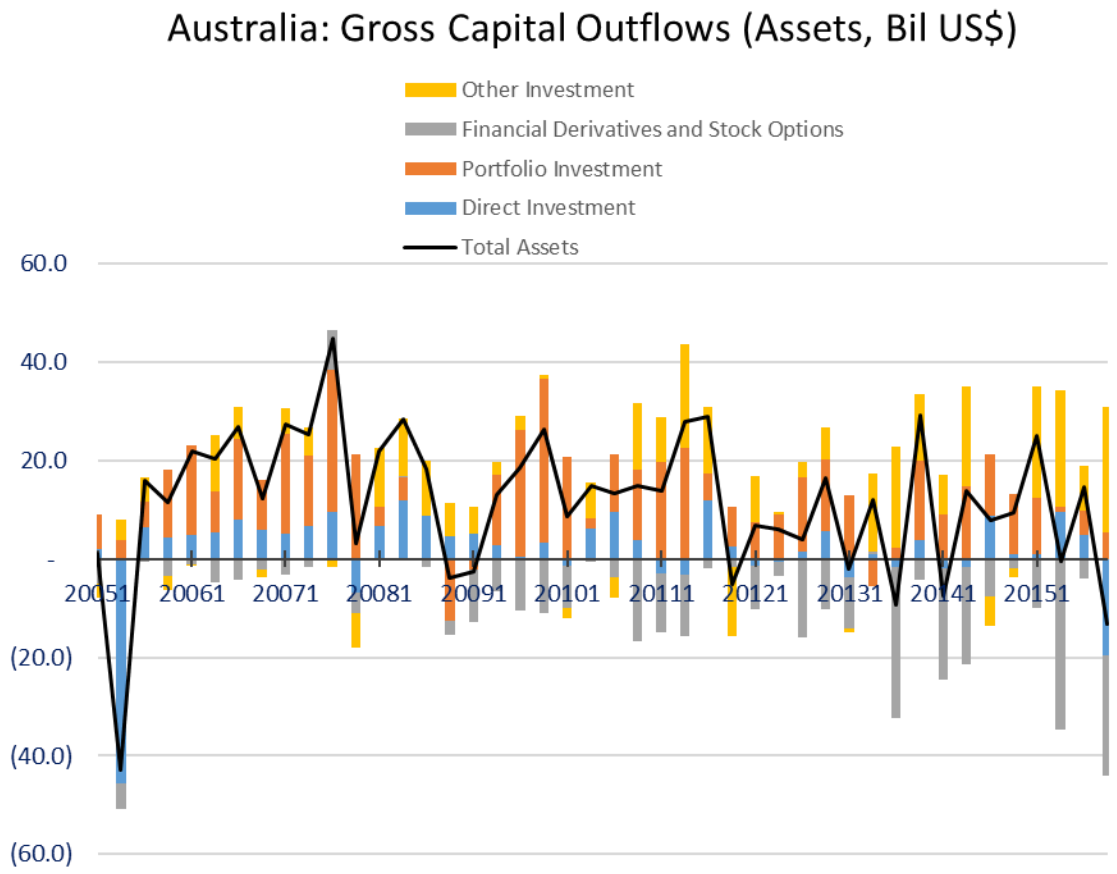


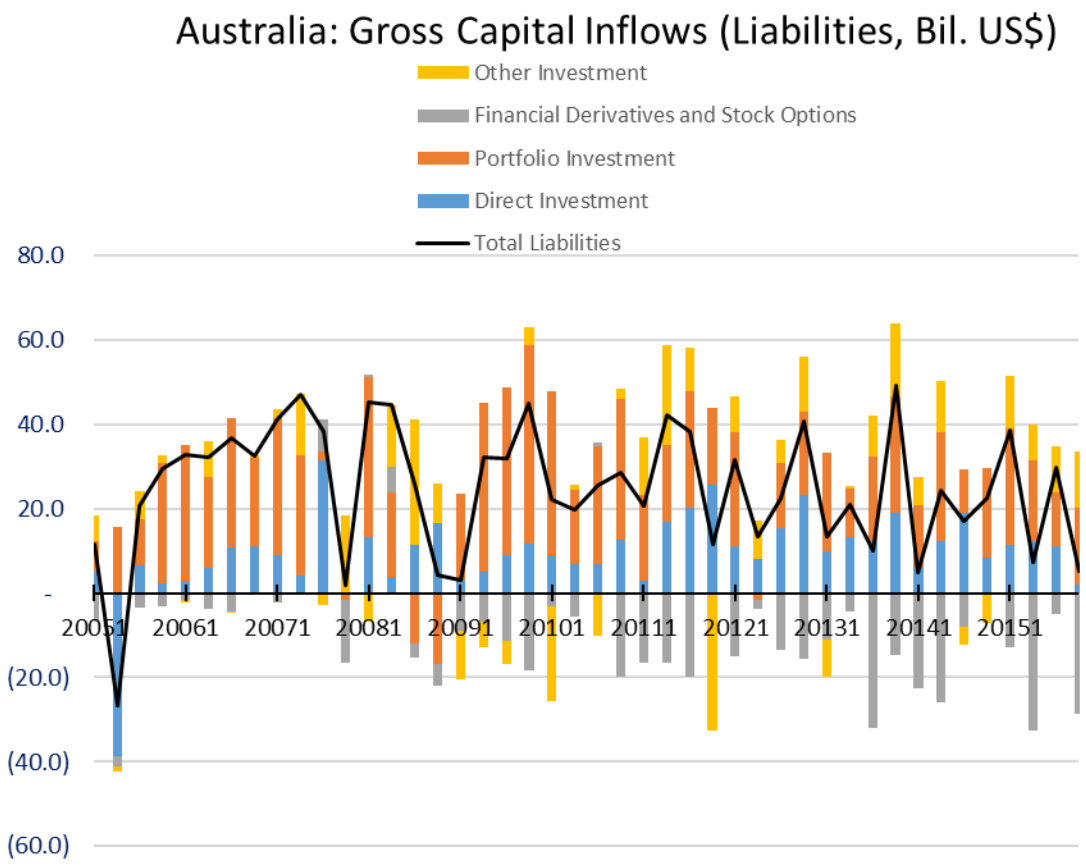
[IFS] **India:** Started to invest abroad recently in financial derivatives and other investment… Attract stronger inflows including FDI…





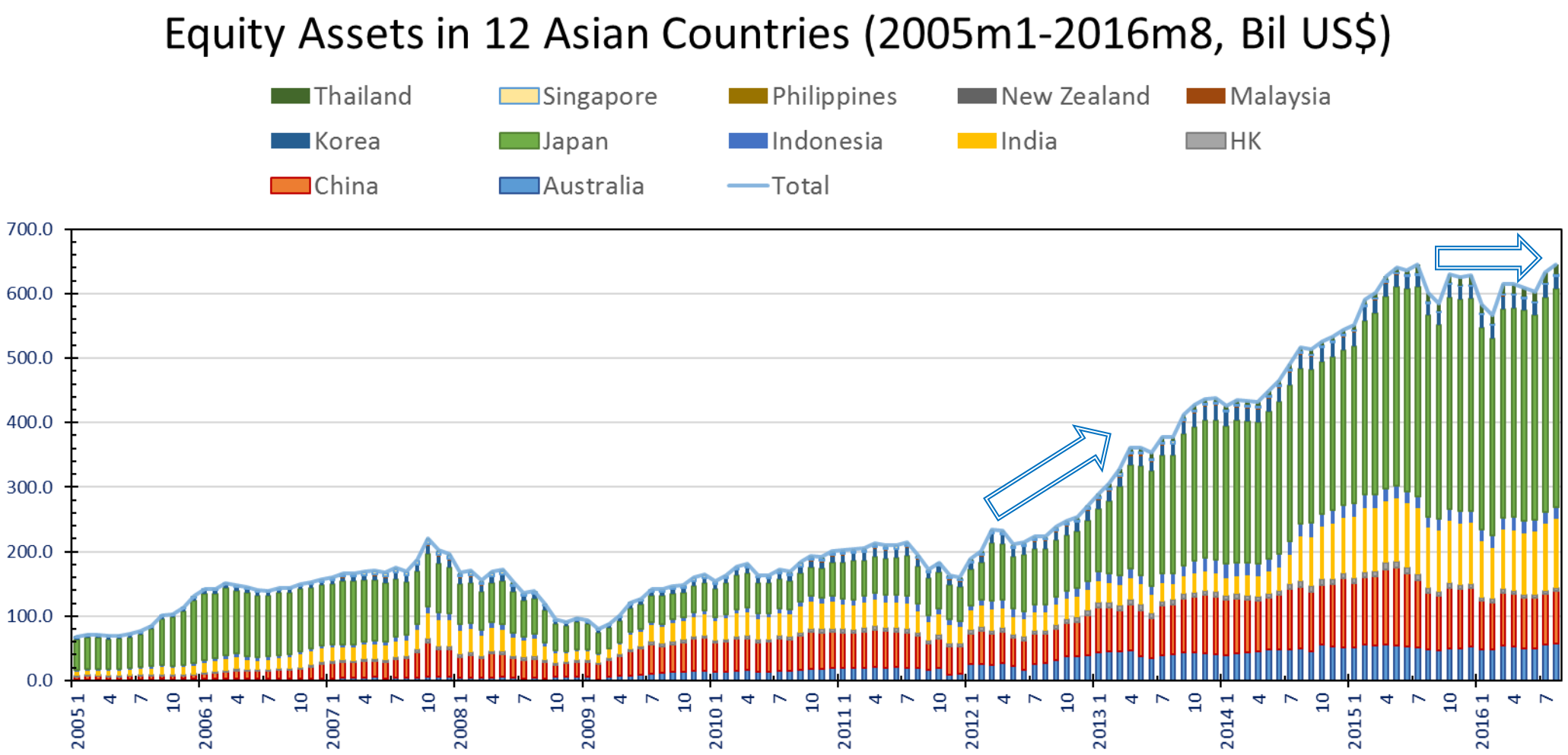
[IFS] **Australia**: Unwind financial derivatives on both sides. Increase portfolio and other investments abroad, while attracting inward FDI and portfolio investment…





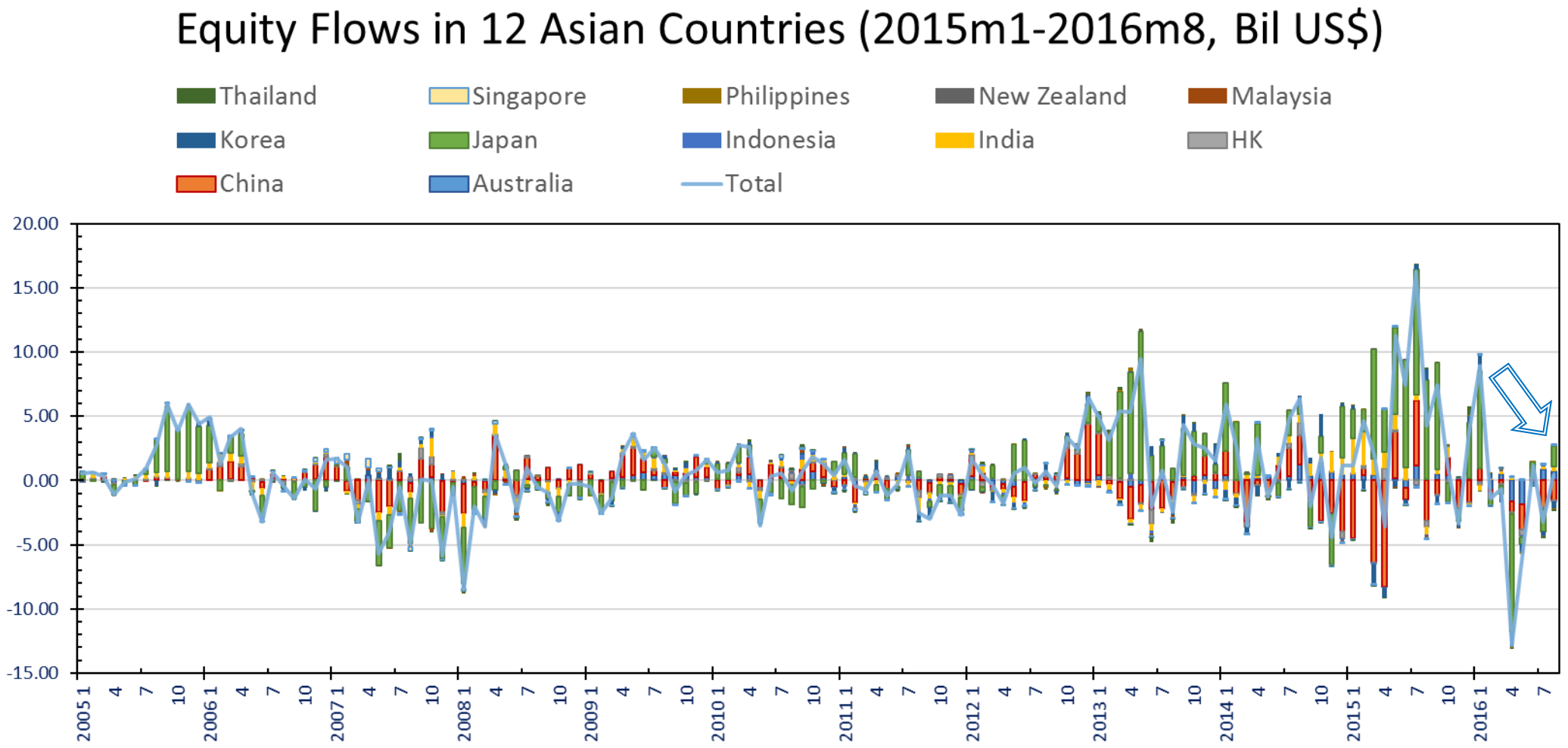
[EPFR] Equity Funds, ETFs & Mutual Funds Assets in Asia

Key recipients are Japan, India, China, and Australia… Since mid-2015, the total assets reached a plateau…



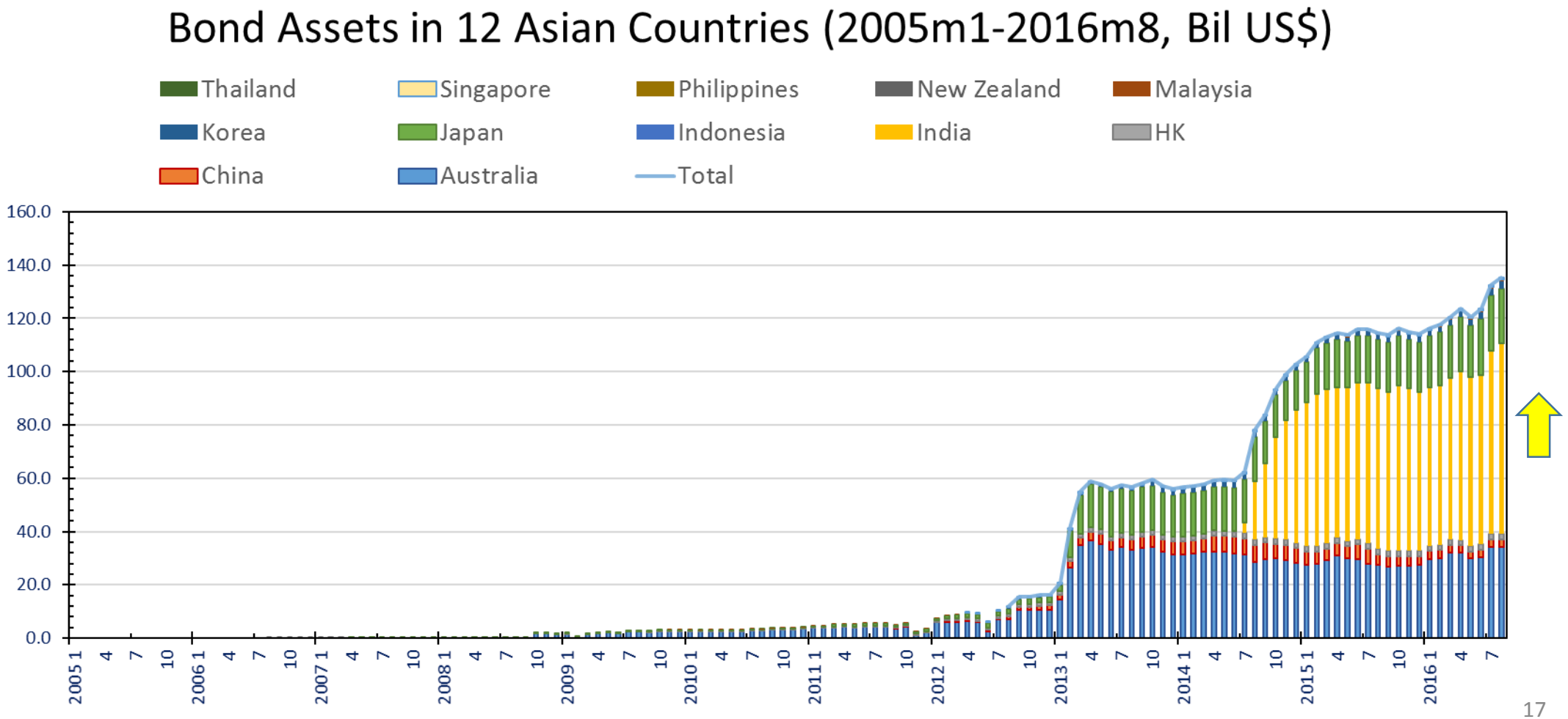
[EPFR] Equity Funds, ETFs & Mutual Funds Flows into Asia

Volatile movements since 2015…After mid-2015, Asia sees negative equity funds flows.



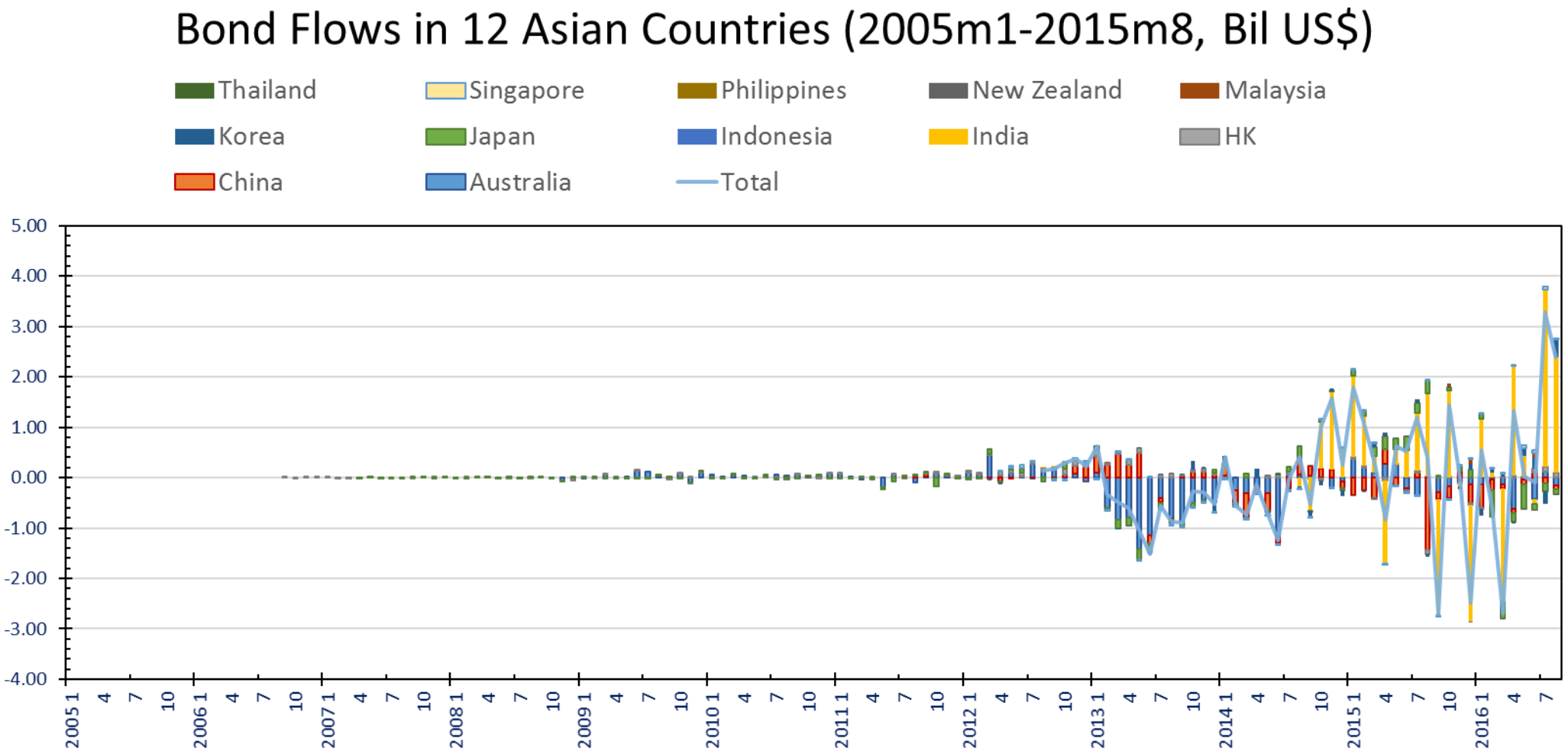
[EPFR] Bond Funds Assets in Asia:

Accumulating assets are concentrated on India as well as Australia and Japan in recent few years…



[EPFR] Bond Funds Flows into Asia:

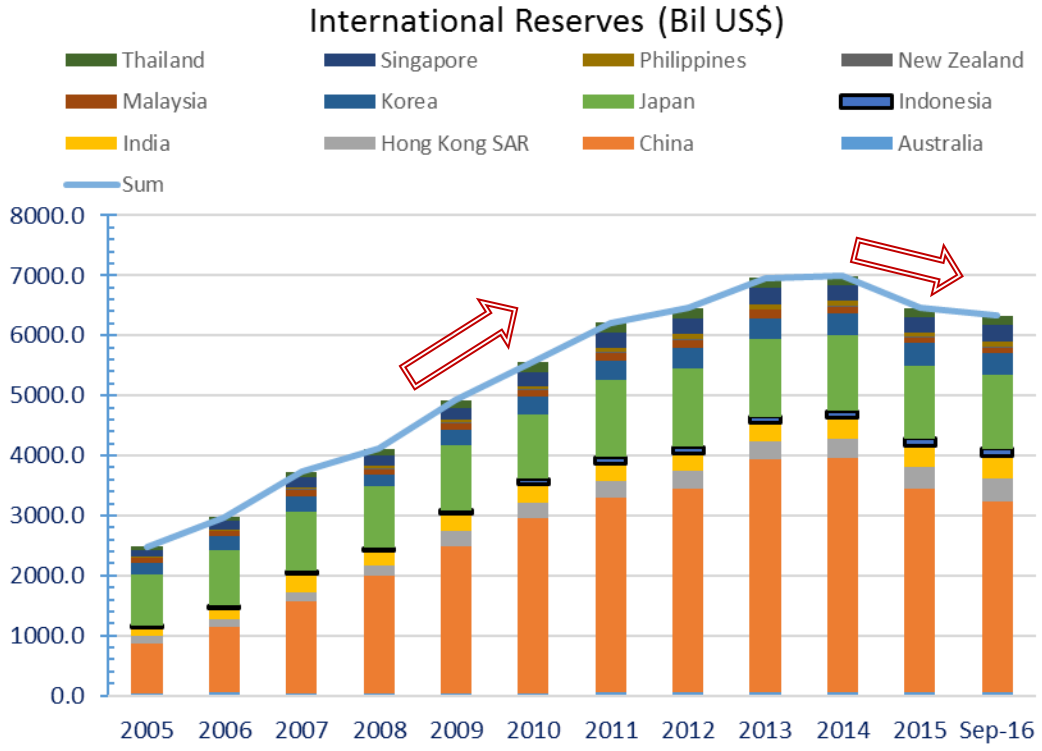
Bond flows have become larger, especially for India (+) and Australia (-), in recent few years.



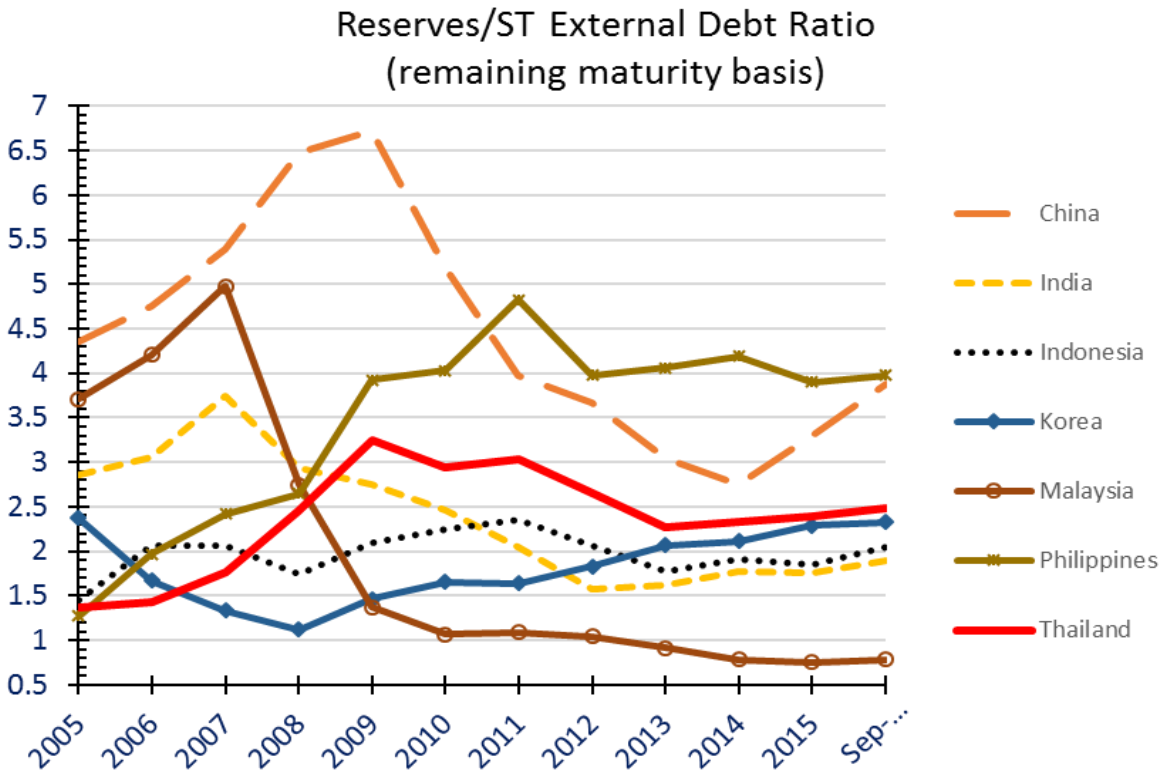
Sovereign Liquidity: International Reserves

Reserves kept accumulating till 2014—thanks to lower external funding cost (Choi et al. 2009)—but started to decline with the headwind of global liquidity ebbs…

Countries are keen to ensure that reserves sufficiently cover short-term external debt, being mindful of reserve adequacy.



Data: IMF WEO, IFS

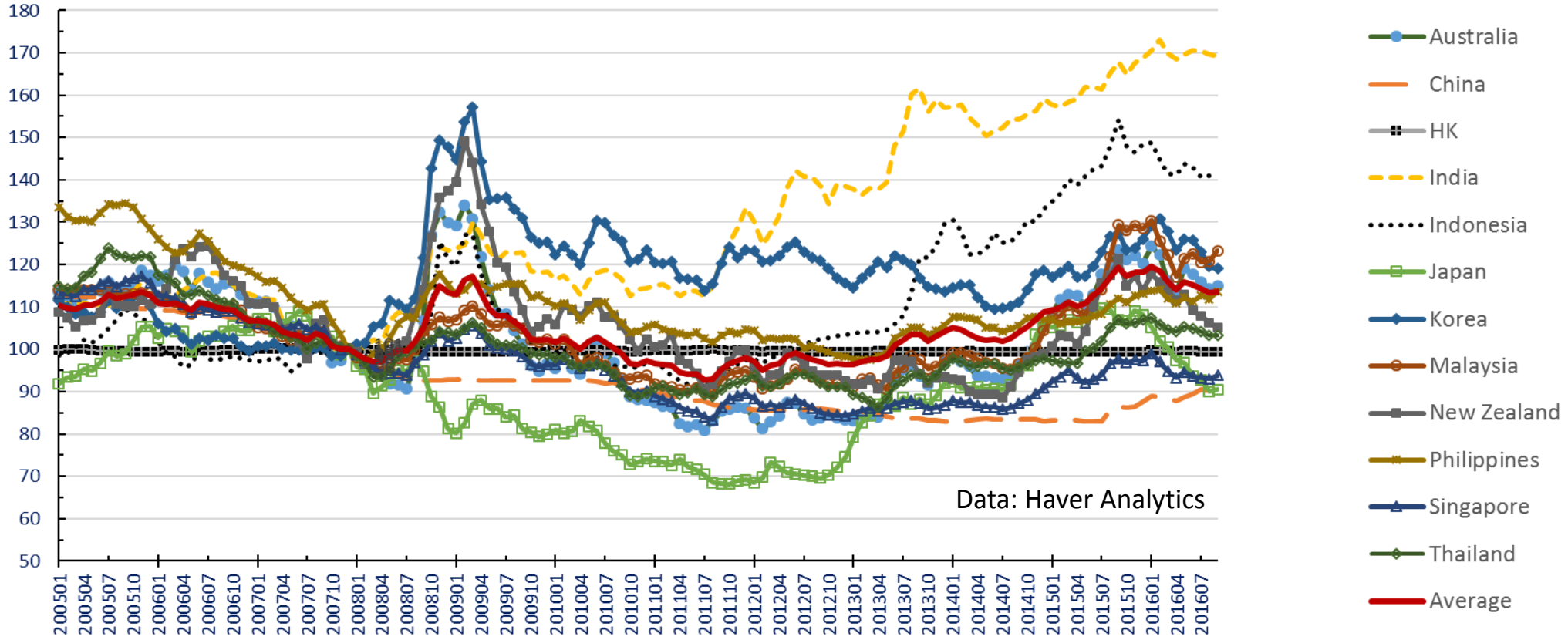


Data: IMF WEO

Exchange Rates Movements

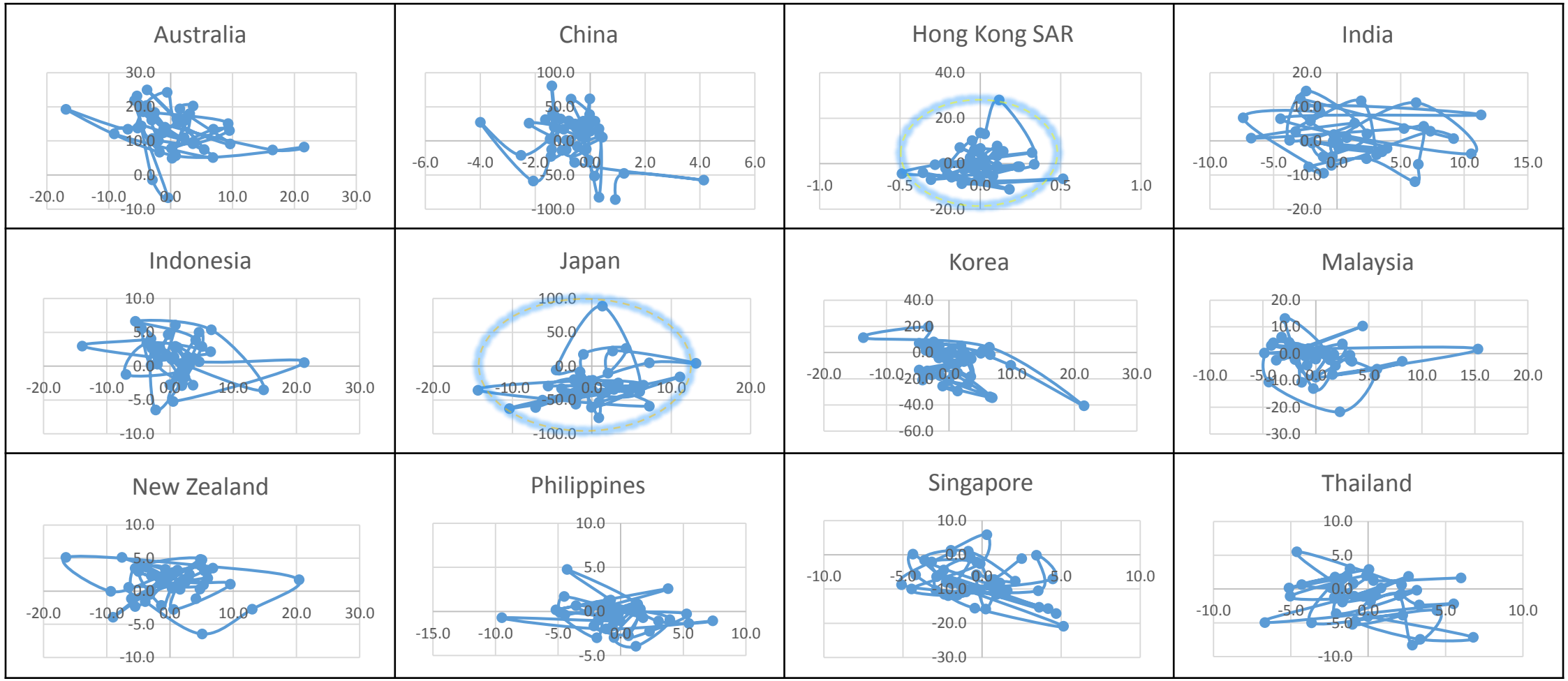
Reminder of sharp exchange rate depreciations upon the GFC… Recently many countries (except for Japan, China, HK) saw deprecation waves following the 2013 QE Taper Tantrum and the prospective normalization of global interest rates since mid-2014… while slowed their paces with prolonged global monetary easing…

Nominal Exchange Rates (Local Currency/US$, 2007m12=100)



Exchange rate depreciations *are mostly negatively associated with* ***net capital flows*** *(except for Hong Kong SAR with the currency board system and Japan with reserve currency)…*

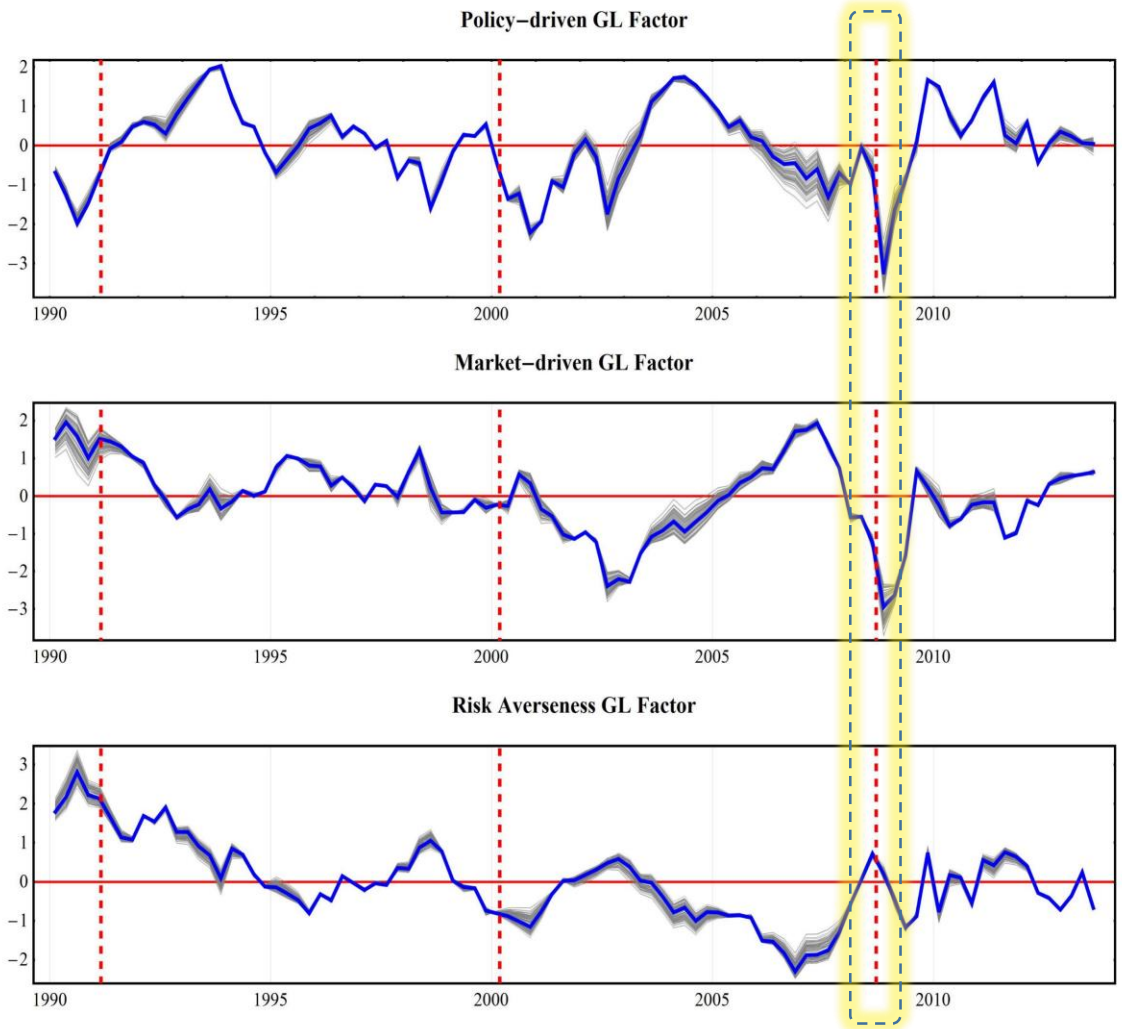
Data: Haver Analytics, IFS



Note: The figure shows how exchange rate depreciations (q-on-q nominal exchange rate growth, %: x-axis) are associated with net capital flows during a quarter (billion U.S. $: y-axis) from 2005q2 up to 2016q1 dictated by data availability.

Shocks to Endogenous GL and Risk Averseness

They also importantly affect capital flows and exchange rates…



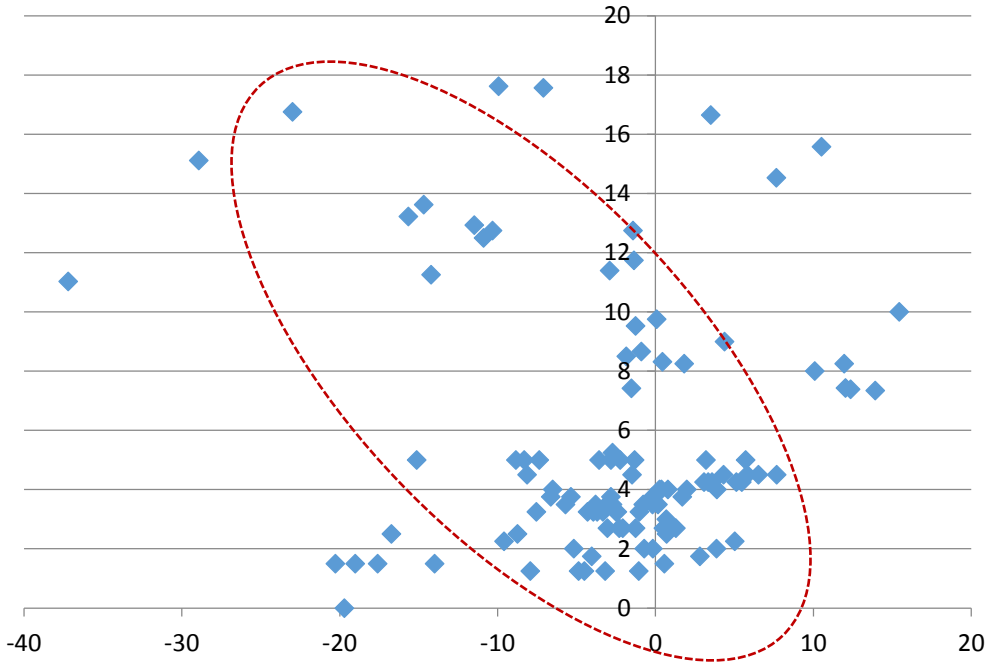
- The confluence of different global liquidity momenta could magnify global liquidity impacts on EME activities.

Source : **Choi, Kang, Kim, and Lee (BOKWP 2014)**
Notes: Three momenta (standardized) are derived from principal component analysis and identified by the sign restrictions. The blue-solid lines depict the medians of all candidates as the corresponding momenta, and the shaded areas represent all candidate factors that pass the sign restrictions. The three red-dashed (vertical) lines indicate the onset of the 1991 recession, the bust of the dot.com bubble, and the GFC.

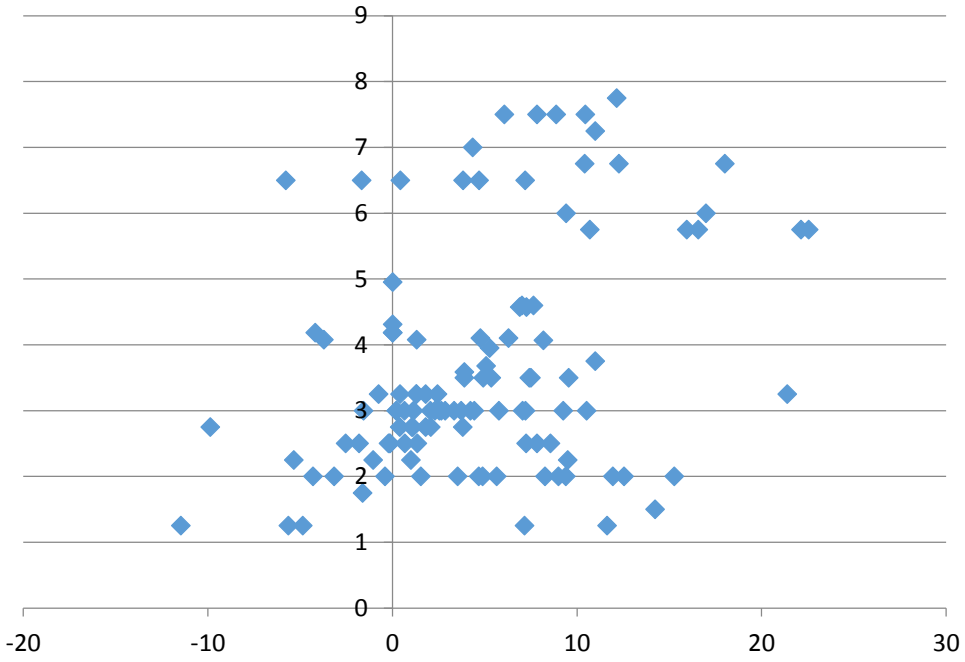
Domestic Financial Imbalances in EMEs Before/After the GFC:

Before the GFC high policy rates (along with high inflation) accompanied credit shortage, but after the GFC little link is drawn between policy rates and the credit gap … With interest rate normalization, credit to the private sector would shrink, and credit shortage may constrain growth in EMEs.

Policy rates and Credit Gaps
(2000~2007)



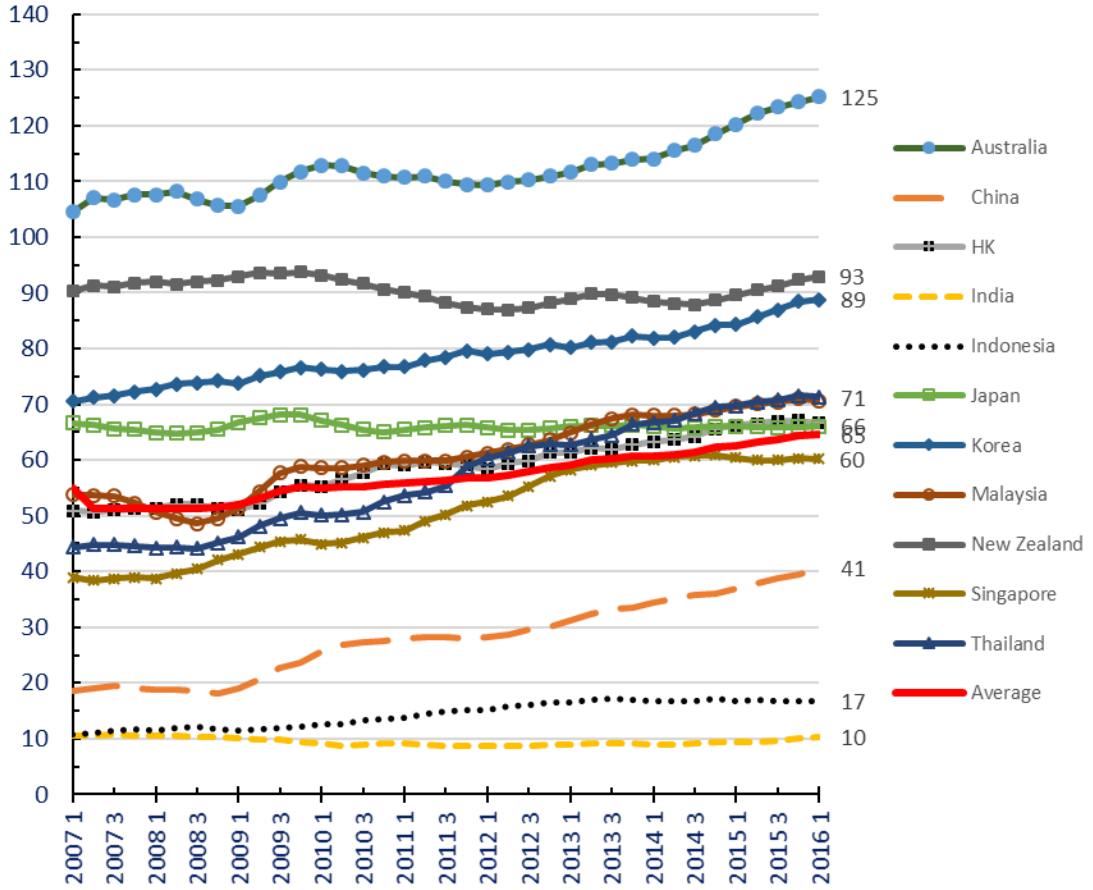
Policy rate and Credit Gaps
(2009~2014)



Credit Gap (%): Credit to the private sector growth minus GDP growth
Sample countries: Indonesia, Korea, Malaysia, Philippines, and Thailand

*After the GFC, **household (HH) debts** (relative to GDP) have grown rapidly in many countries with **credit expansions to HHs** … Interest rate normalization will increase **HH debt service burdens**…*

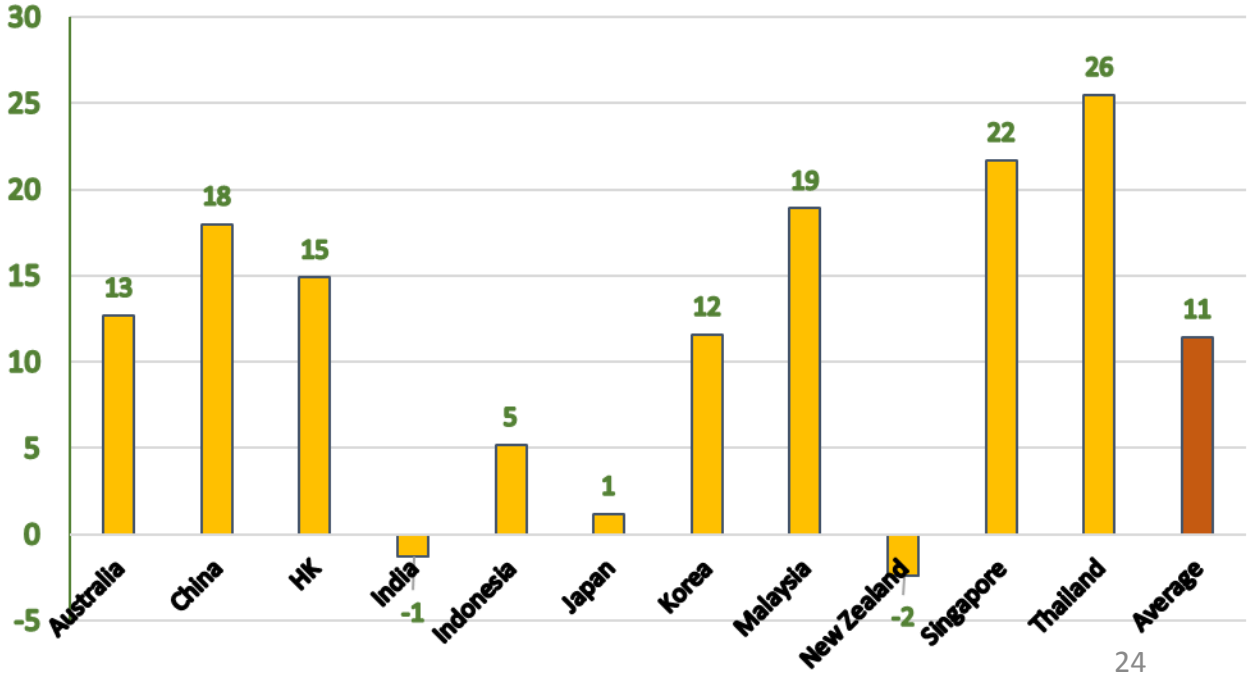
HH Debt as Percent of GDP
11 Asian Countries (2007q1-2016q1)



* Philippines: not included owing to data availability
Data: FRED

HH debts have grown fast after the GFC in Australia, China, HK, Korea, Malaysia, Singapore, and Thailand…

Changes in the HH Debt to GDP Percentage Ratio from 2007q1 to 2016q1: 11 Asian Countries



Strengths, Weaknesses, Opportunities, and Threats

...in Evolving Asian Financial Landscape

S

- ✓ Relatively strong growth opportunities
- ✓ Enhanced financial resilience to external shocks

W

- ✓ Mounting leverage
- ✓ Vulnerability to liquidity shortage

O

- ✓ Boosting regional financial integration
- ✓ Becoming the epicenter of shifts in the global financial landscape

T

- ✓ Heightened geopolitical and economic uncertainty
- ✓ Rising spillovers on the external and financial fronts

Concluding Notes

- Low interest rates over a decade open **more opportunities** for EM and developing economies with **lower external and domestic funding costs**.
- **Global liquidity waves** will be driven by geopolitical risks, global growth prospect changes, and reserve-currency countries' initiatives.
- Amid increased incentives to stockpile external liquidity ammunition, **GFSN and currency swaps** will help ensure buffering shocks. **Upon spillbacks**, CBs could proactively deploy tools to **shore up domestic liquidity**.
- It is time to **foster private and public-infrastructure investment at low funding costs** to restore growth potential in the region, conducive to boosting global demand. Resources and available funds need to be efficiently allocated with **the mix of monetary and macroprudential policies**, pending off excessive leverage.

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Thank you!