FEB 02.27.2015

ECONOMICS: ASIAN PERSPECTIVES

ASIA: ARE FINANCIAL IMBALANCES STILL A CONSTRAINT FOR MONETARY EASING?

+ Vincent Tsui, Economist—Global Economic Research, vincent.tsui@abglobal.com
+ Anthony Chan, Asian Sovereign Strategist—Global Economic Research, anthony.chan@abglobal.com

While some Asian central banks have embarked on a rate cut cycle, thanks to lower inflation resulting from falling oil prices, others remain cautious. The main concern among those hesitant central banks—the risk of causing over-leveraging and financial instability down the road—appears to be overdone, in our view.

Disinflation driven by a sharp decline in oil prices has resulted in a divergence in monetary policies across Asia over the past several months. India and Indonesia have been the front runners in the rate cut camp, followed by Singapore. The central banks of these countries have cited the increasing global economic uncertainty and the policy leeway created by low inflation as the bases of their policy actions. Meanwhile, central banks in Korea, Thailand, Malaysia and the Philippines remain reluctant to cut rates owning to concerns about causing financial instability.

However, the leverage cycle in most of the region has moderated noticeably over the past few quarters, and the instability concerns may be overdone, in our view. And in the countries where the balance of risk is unclear, we believe that policymakers should focus primarily on household leverage, as large corporations have become less dependent on debt financing in recent years.

Moderating Leverage Cycle

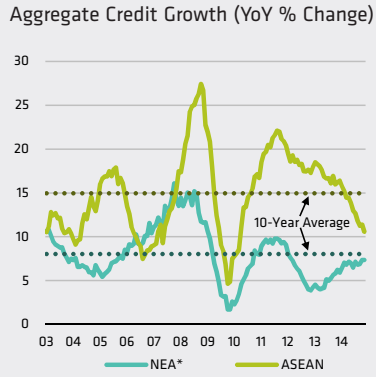
Even though most Asian central banks have maintained an easing bias since 2012, loan growth has been mediocre over the past three years, staying below the long-term average **(Display 1)**. Credit growth has continued to decelerate in 2014, particularly in the countries of ASEAN (the Association of Southeast Asian Nations).

Weak credit demand is the result of a number of factors: household debt is already elevated, governments are consolidating their fiscal positions, and manufacturers see little need to boost capital expenditure amid disappointing export trends. South Korea and Taiwan were the only countries in the region that registered a modest recovery in credit growth in recent months, but even in those countries the pace of growth has been slower than in previous cycles.

The increase in banks' leverage has been benign as well. The loan-to-deposit ratio has risen only modestly in most Asian economies since 2008 **(Display 2)**. Banks have generally remained prudent in extending loans.

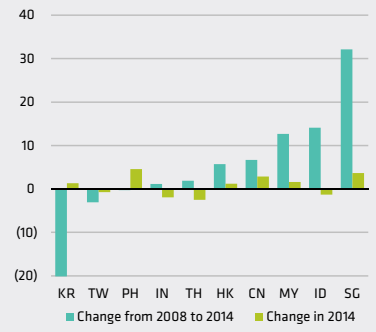
The only exceptions to this trend are Singapore, Malaysia and Indonesia. Even so, the credit cycle should not be too much of a concern in Indonesia, where credit penetration remains low and its 36% credit-to-GDP ratio is among the lowest in the region. In Malaysia and Singapore, the

Display 1
Credit Cycle Slackens Across Asia



As of February 26, 2015
*Includes Korea, Taiwan and Hong Kong
Source: CEIC Data and AB

Display 2
Leverage Not a Concern in Most Markets



As of February 26, 2015
Source: CEIC Data and AB

increase in the loan-to-deposit ratios has accompanied an increase in household debt for real estate purchases, and the credit cycle deserves more attention from policymakers. But even here, the momentum has already moderated noticeably.

The credit-to-GDP ratios in Taiwan, India, Thailand and Indonesia have even declined over the past year. This suggests that banks are opting to strengthen their capital base instead of expanding their loan books. So the multiplier effect of any monetary easing should be modest.

Even though credit growth has been decelerating over the past quarters, outstanding bank credit relative to GDP has continued to increase in China, South Korea, Singapore and Thailand **(Display 3)**. Except for China, the increase was due to weaker GDP growth, however. And even in China, the government's effort to improve the quality of credit in order to reduce excess capacity and local government debt is as important as—if not more important than—just the credit-to-GDP figures.

Policymakers in these countries are bound in a dilemma over whether to stimulate growth, or to refrain from easing to contain the risk of internal imbalances.

Household Debt Remains Key Concern

Sector-wise, leverage accumulation has been mainly confined to households, with most of the increase stemming from real estate activities. Still, in order to manage housing demand and curb speculative activities, targeted macroprudential measures, rather than monetary policy, should be more effective.

Large corporations in most of the region have reduced their reliance on debt financing over the past few years, despite the accommodative monetary conditions. The debt-to-equity ratio for listed companies across the region has fallen significantly **(Display 4)**.

These companies account for a major share of banks' corporate credit exposure, except in China, owning to the massive stimulus in 2009; the Philippines, where corporate leverage has increased only modestly; and South Korea, where the debt-to-equity ratio has already been declining for three years.

Monetary Policy Implications

The bottom line is, most of the region is already facing a credit downcycle, and sluggish credit demand, rather than excess liquidity conditions, should be the primarily consideration for policymakers, except in Singapore and Malaysia.

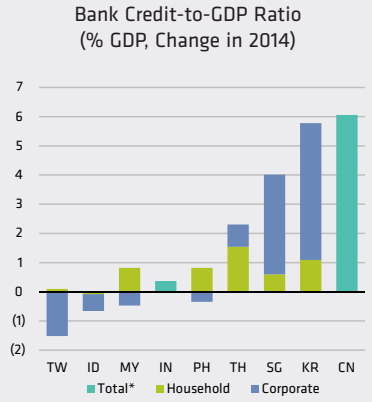
Singapore does not have an interest rate–based monetary policy, and its property prices have begun to consolidate anyway, but Bank Negara Malaysia should continue to refrain from easing because of the risk of a housing cycle overheating.

For other central banks that have yet to start on a monetary easing cycle, the prescription is less clear cut.

Thailand's debt has increased considerably in the past few years, but a lot of that is due to lending by state-owned institutions spurred by the government's fiscal incentives. So, there is only a limited risk of housing overheating. In fact, Thailand's commercial banking system has only seen a marginal increase in leverage, partly because corporations have been reducing their reliance on credit.

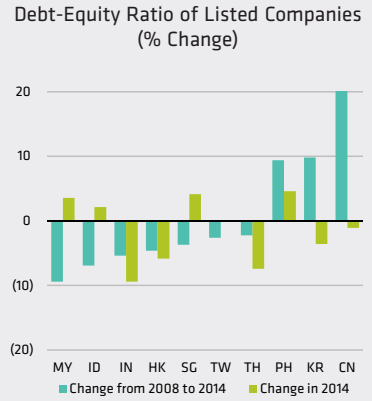
Likewise, the Philippines has also seen little increase in leverage, both in the private sector and the financial system. South Korea is now seeing a modest recovery in credit growth after some significant deleveraging in the financial system. But with a negative output gap, sluggish domestic demand and tepid nominal GDP growth, reflating growth should be the bigger priority for the South Korean authorities. In all these three countries—Thailand, the Philippines and South Korea—concerns about financial instability should not be a major constraint for monetary easing, and central banks have the flexibility if an easing is needed, in our view. ■

Display 3
Promoting Growth or Containing Leverage?



As of February 26, 2015
*Total change in bank credit-to-GDP ratio where breakdown is not available
Source: CEIC Data and AB

Display 4
Corporations Have Generally Reduced Reliance on Debt



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Source: Bloomberg and AB