33rd Asian Shadow Financial Regulatory Committee Statement

January 21, 2019 – Kuala Lumpur

Rising Debt and the Risk of a Financial Crisis in Asia

Global debt levels continue to rise, currently standing at approximately US$244 trillion, up US$27 trillion since 2016. These levels have significant implications for financial market stability and the likelihood of a crisis.

Relative to GDP, global debt exceeded 318% today, though this ratio was higher in 2016 at 320%. In 2008 this ratio was 290%. The biggest borrowers are the US (125% of GDP), China (300% of GDP), Eurozone (close to 100% of GDP) and Japan (237% of GDP) – which together account for 67% of the world's household debt, 75% of global corporate debt and nearly 80% of government debt.

Comparing Q3 2018 with 2008 globally, non-financial corporate debt has risen from 26% of GDP to 30%; government debt has risen from 21% of GDP to 26%; financial sector debt has dropped from 32% to 25%; and household debt has dropped from 21% to 19%. The shifts in government debt and financial sector debt since 2008 are consistent with quantitative easing where central banks buy back bonds held by the financial sector. One stand-out change in recent times has been China where their percentage of total global debt rose from 4% in 2007 to 15% by 2016.[1]

The continuing rise in the level of debt against a backdrop of tightening financial conditions, is a cause for concern. At a joint meeting of the

[1] Global Debt Hits All-Time High: To Panic or Not to Panic? Andrew Boyle, CEO of LGB & Co Oct. 2018.

ASEAN +3 and European Central Bank Governors in Frankfurt in October 2016, central bankers expressed concerns about corporate debt and the need to be "watchful of corporate leverage in the region."[2] Also in a recent speech, the Head of the Monetary and Economic Department at the Bank for International Settlements, said that the continued growth in aggregate debt levels in relation to global GDP are a cause of real concern. This was a problem that triggered the 2008 global financial crisis but today the room to react to a similar event is more restricted from both a monetary policy and fiscal perspective. Further, the IMF has expressed concern over the evolution of fiscal positions and rising levels of government debt in less developed countries driven by the decline in commodity prices, natural disasters and internal conflict.

Rising debt levels are reflected in international balance sheets. From a financial market perspective, the latest information from the Bank for International Settlements on the international asset and liability positions of the banking sector also provides evidence of increasing systemic fragility. The net international bank balance sheet positions once again show evidence of the refinancing risks, in addition to existing foreign exchange and interest rate risks that emerged prior to the Global Financial Crisis (GFC).

While foreign exchange positions and interest rate gaps can be hedged using derivatives, such as cross-currency or interest rate swaps, refinancing may become problematic were interest rates to rise suddenly, or if financial markets are subject to external shocks. Any flight to quality will see corporate credit spreads increase that in turn will put pressure on corporate profitability as well as financing.

It is difficult to say what level of debt is too high. In practice, growing debt correlates with growing economies, however excessive debt can be a significant drag on economies if borrowers cannot service the debt.

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[2] Statement of Central Bank Governor Tetangco of the Philippines.

Since the 2008 financial crisis, borrowing has increased substantially and this overhang of global debt is starting to be stressed. The Federal Reserve has been moving interest rates up, albeit slowly, and while the US economy continues to grow strongly, others such as the Eurozone, Japan and China are starting to see signs of weakening growth. This is leading to calls for countries to pay and pare down debt levels, such as the ECB for Eurozone government debt. Unlike a decade ago, when the next economic and financial downturn occurs, the policy tools available to reverse it will be less effective.

Drivers of rising debt include the lingering fiscal response to the GFC. Corporations and households have responded to the low global interest rate environment leading to asset bubbles, the encouragement of share buybacks and buoyant consumer spending. One concern is the propensity for some developing economies to finance domestic debt in offshore markets leading to sensitivity to offshore market volatility and domestic currency depreciation. Collectively, these factors increase financial vulnerability leading to debt default, the bursting of financial asset bubbles and contagion, possibly to Asian economies.

Apart from rising debt as noted above, contagion could also happen due to other factors such as an increase of interest rates by the US Federal Reserve, a trade war between the US and China, an increase in inflation, or a crisis in the Eurozone linked to Italy.

Many countries in Asia implemented measures to reduce vulnerability after the GFC. For example South Korea introduced strict loan to value rules and household income requirements on housing loans and strengthened prudential regulations on commercial banks. Our concern is that these measures may not be enough should some of the factors mentioned above start to play out.

In particular, in order to preserve financial stability and to reduce the likelihood of a crisis in the near future, we are of the opinion that the following features of Asian financial systems could be improved:

1 Macro-prudential policies, which were implemented after the GFC, have been strengthened in some Asian countries recently, but could be strengthened further. However, the limitations and shortcomings of these policies need to be clearly understood. For example, restrictions on real-estate lending ignore the source of bank financing, which may largely come from non-core deposits and external wholesale funding markets over which central banks have little control. Such funding sources are subject to the whims of investor risk appetites.

2 Bank regulators in Asia should look closely at increasing bank capital adequacy requirements beyond Basel 3 levels, as is currently being done in countries such as Switzerland and New Zealand.

3 Crisis management and resolution procedures within Asia should be enhanced and preferably delegated to the ASEAN +3 Macroeconomic Research Office (AMRO). AMRO needs to continue developing its own independent capability to conduct effective regional macroeconomic surveillance so that it can serve as **the** regional institution responsible for dealing adequately with a crisis. Regional surveillance through AMRO should be strengthened.

4 In addition, it is critical for financial market participants to better understand region-wide risk and to do so requires greater data sharing than currently is the case.

5 Looking forward, initiatives to reduce the dependence on the US dollar and promote regional financial market integration should be pursued, for example, the use of local currency or a currency basket for the issuance of corporate bonds.