



Session 2: Managing Imbalances and Rising Indebtedness Under a Low Interest Rate Environment

What would extended period of aggressive monetary easing
by major central banks mean for financial stability in Asia?

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Presentation at Bank Negara Malaysia Monetary Policy Conference

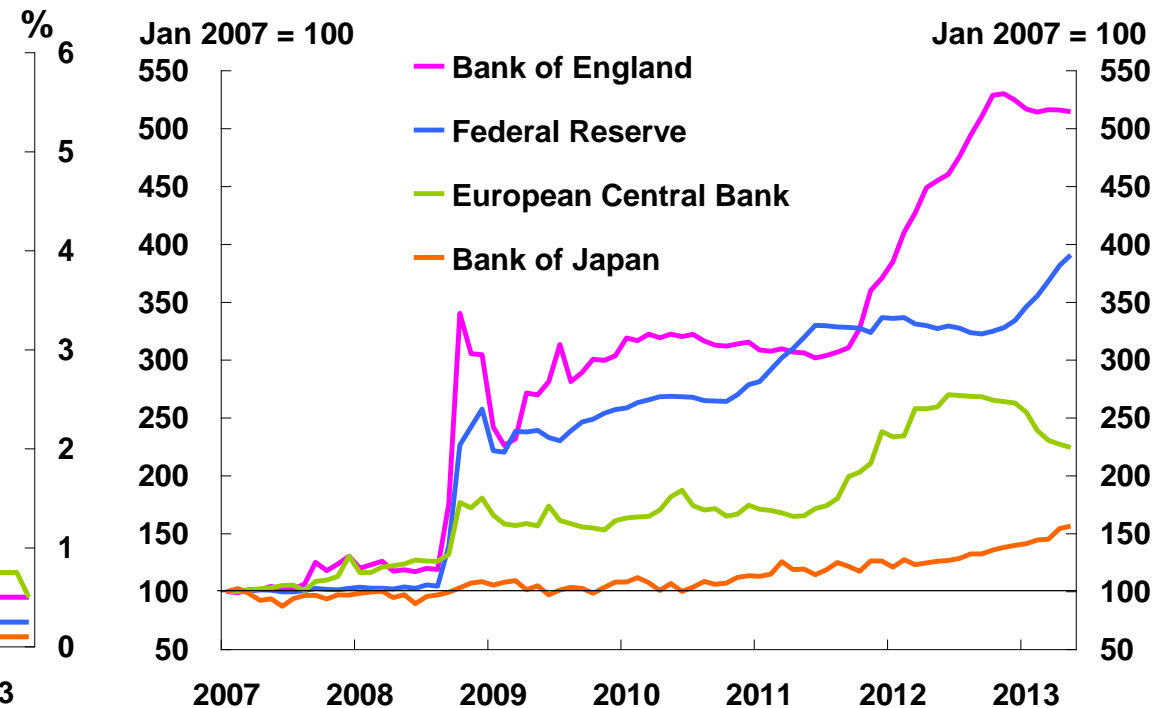
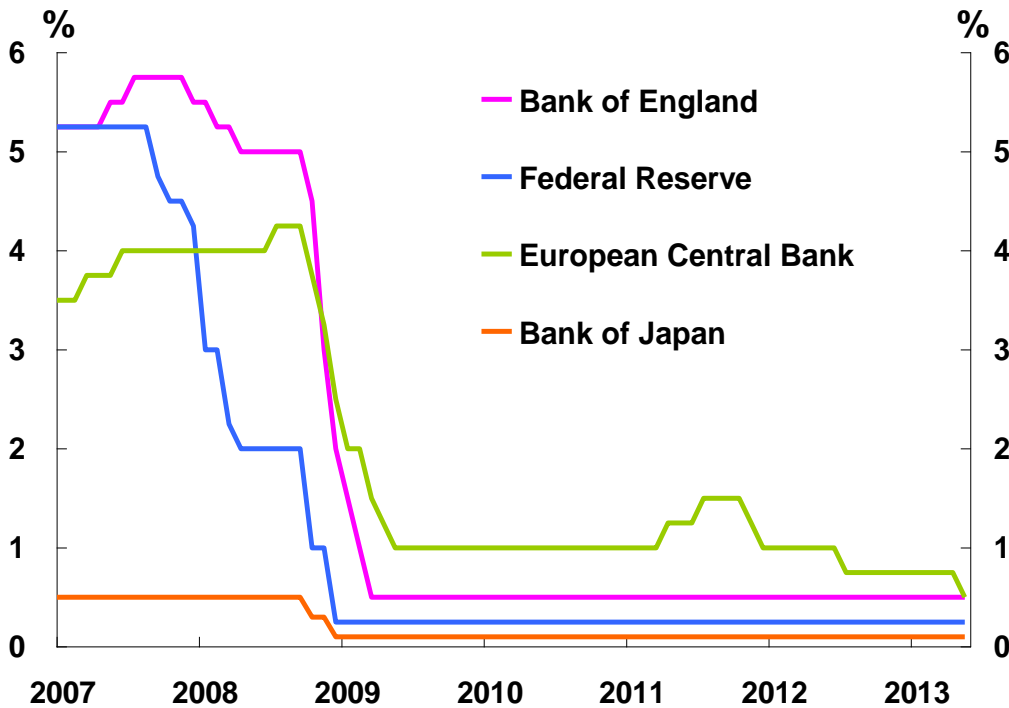
10 June 2013

Concurrent unconventional monetary policy easing and zero bound interest rates...



Near zero policy interest rates

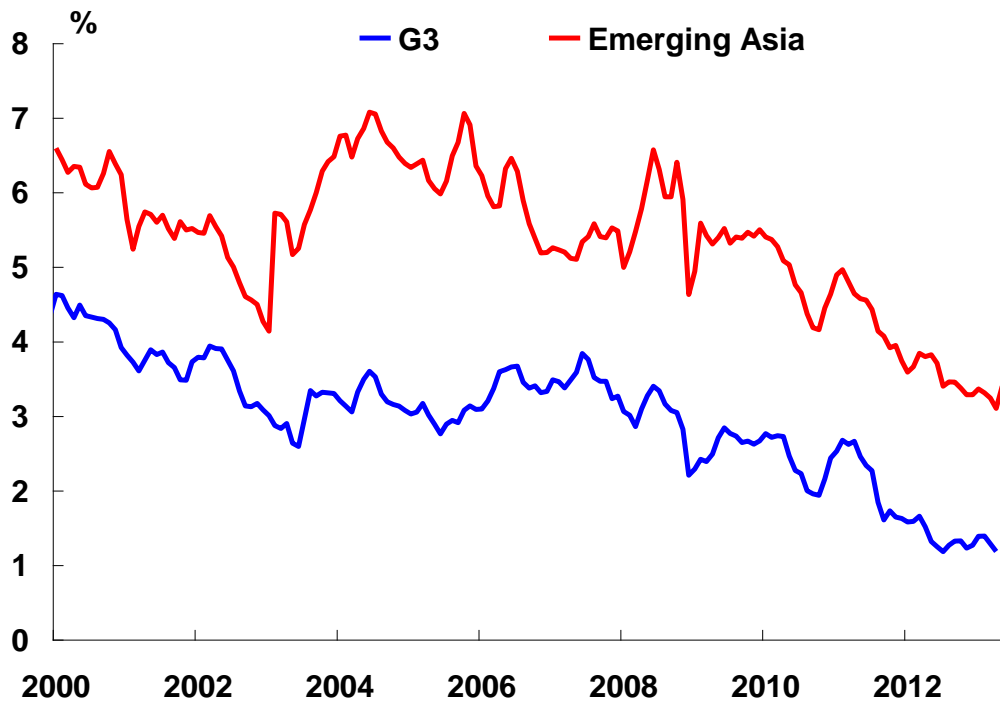
Rapid expansion of major central banks' balance sheets since the global financial crisis



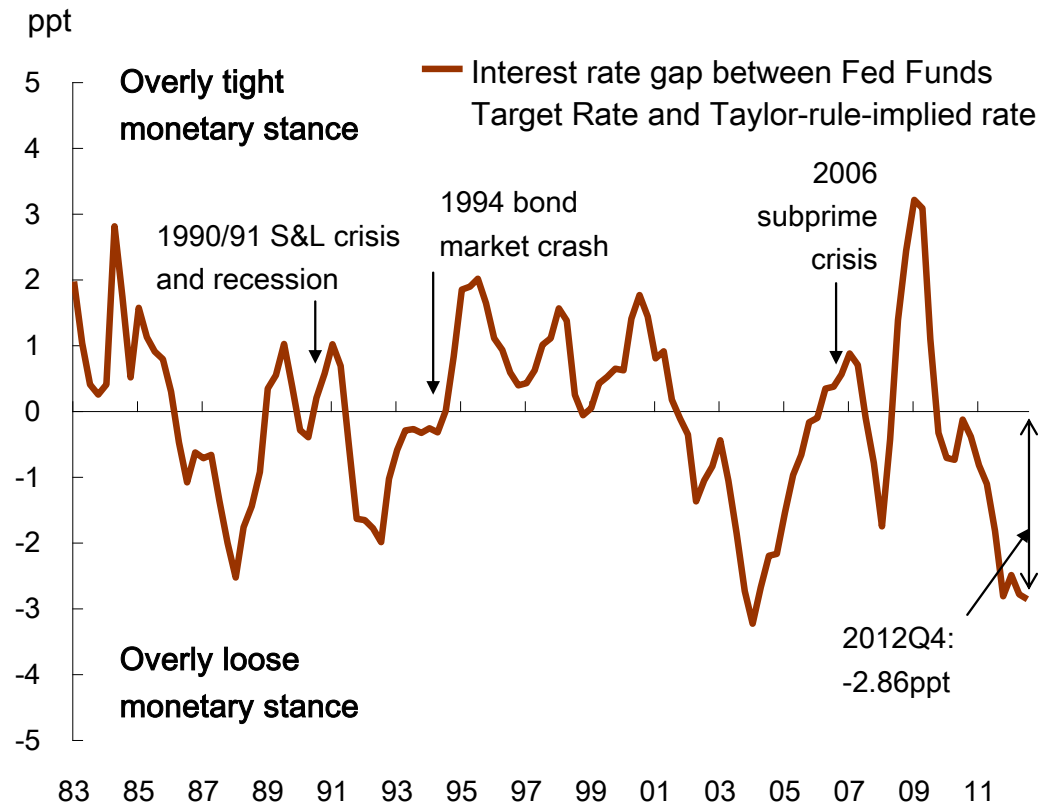
... could build up imbalances in the global financial markets, sowing the seeds for future financial crises



10-year government bond yields falling to their historical low levels globally



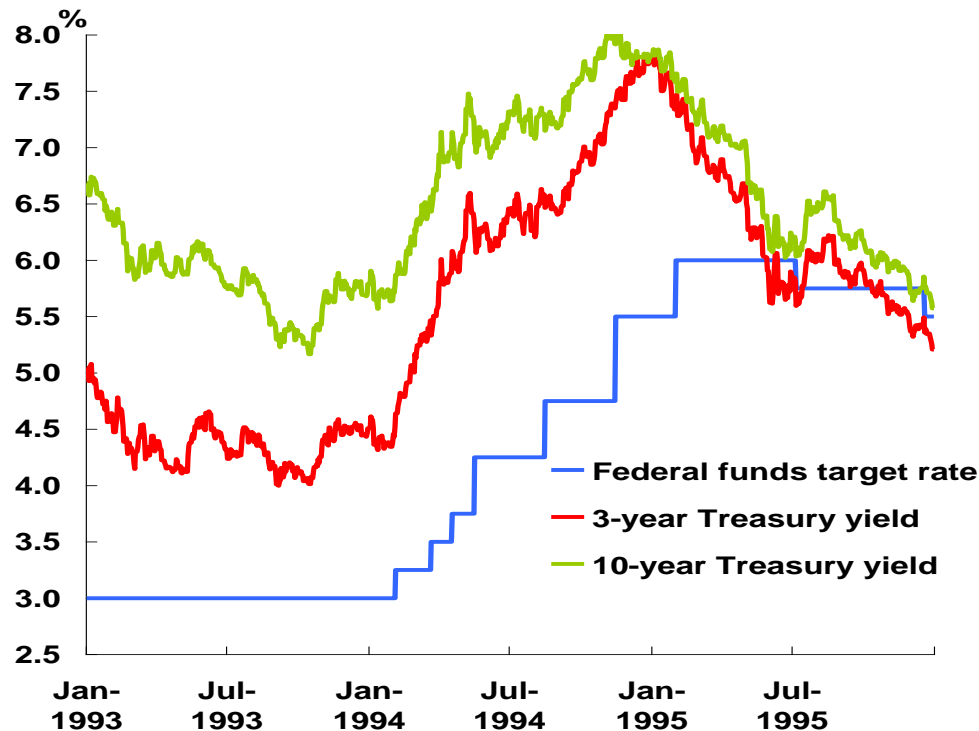
Financial cycles were often amplified by overly-loose monetary policy in the US



Financial imbalances in the major economies: A repeat of the 1994 bond market rout?



A repeat of the 1994 bond market rout?



Differences and similarities between now and 1994

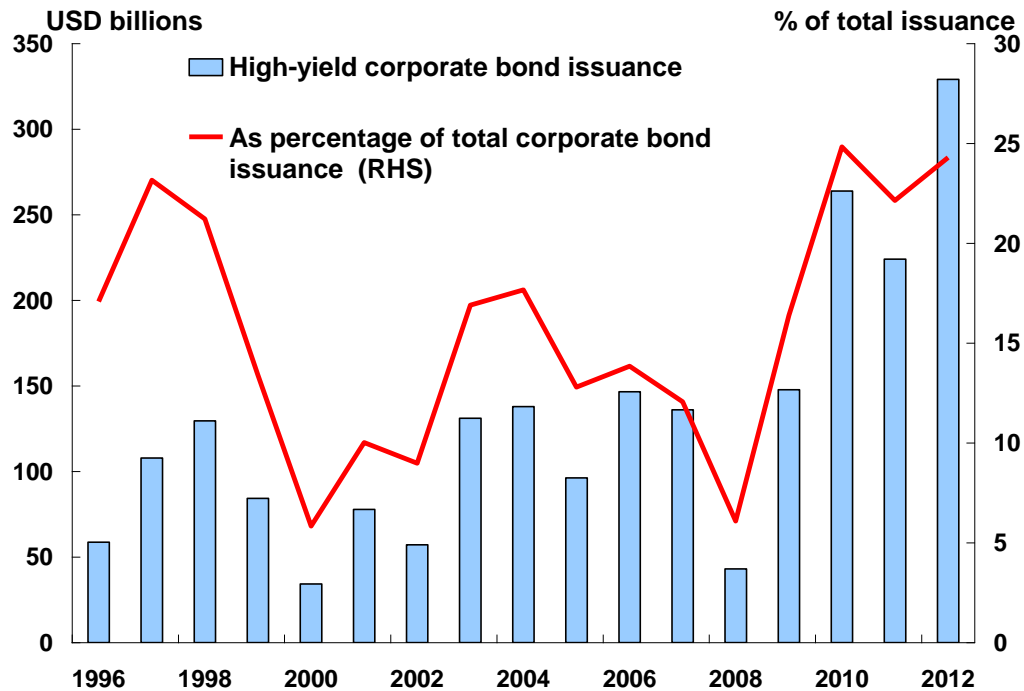
- Differences:
 - ❖ Much-improved Fed's communication policy
 - ❖ Much-reduced risks of fire-sale by hedge funds
- Similarities:
 - ❖ Prolonged period of overly-loose monetary policy
 - ❖ Steep yield curve

But history could repeat itself in a different form...



Widespread risk taking behaviour in the US high-yield bond market

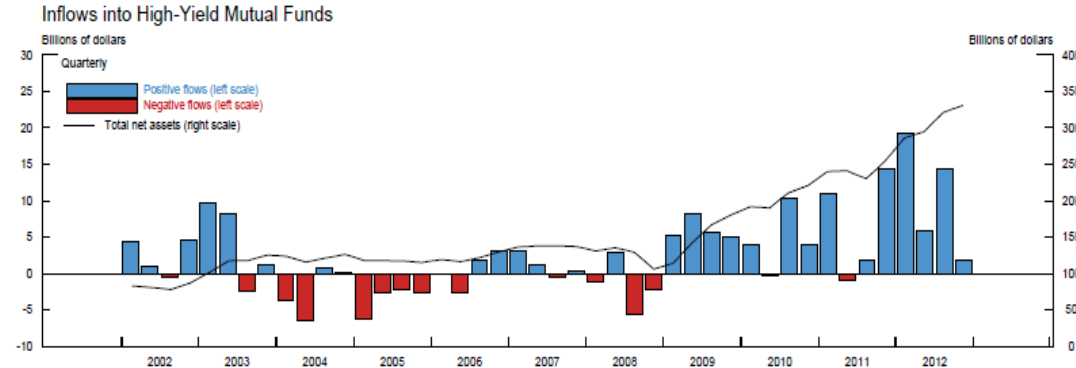
US: High-yield corporate bond issuance



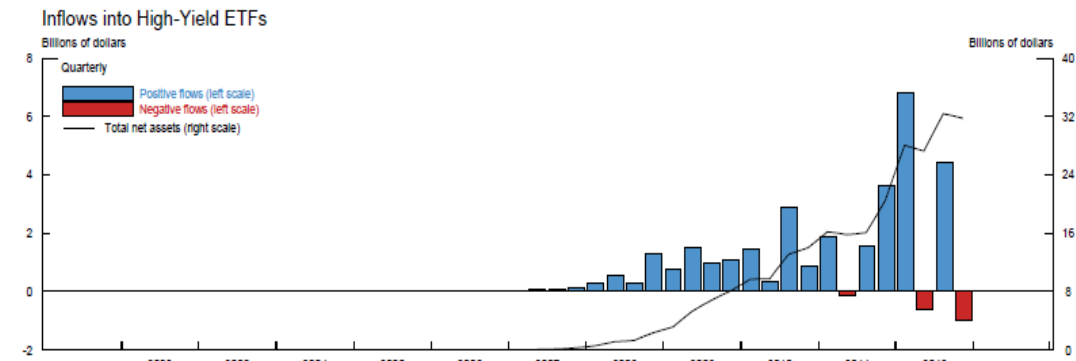
Source: SIFMA and HKMA staff estimates.

Inflows into high-yielding mutual funds and ETFs have increased sharply

US: Inflows into high-yield funds



Source: Morningstar.



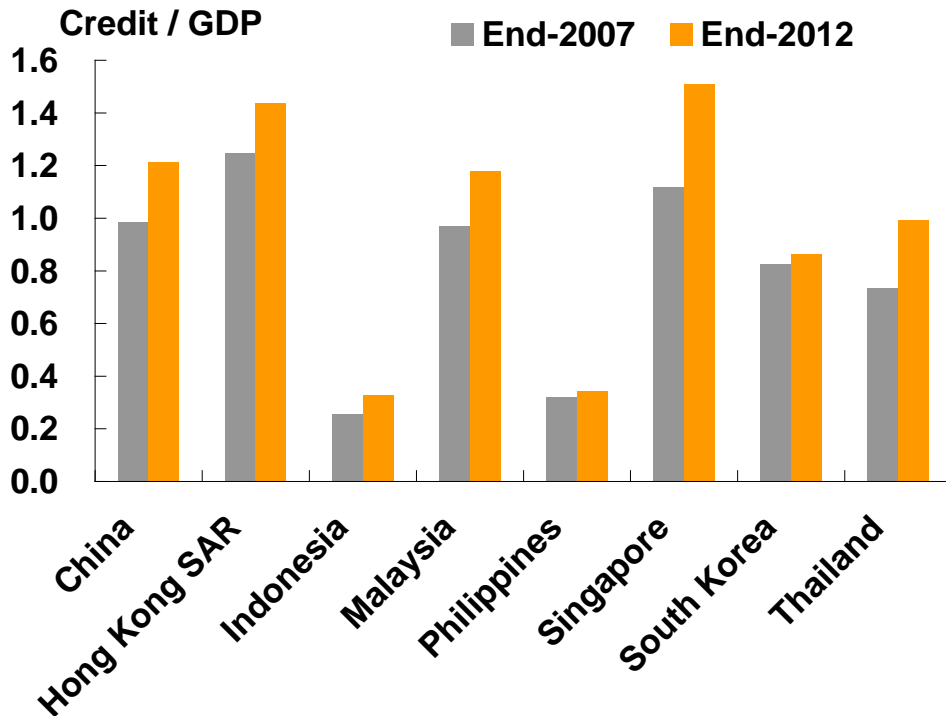
Source: Stein (2013) quoting figures from Morningstar.

Financial imbalances in Asia: Large cumulated inflows since 2009 and ultra-low interest rates have been supporting fast credit growth



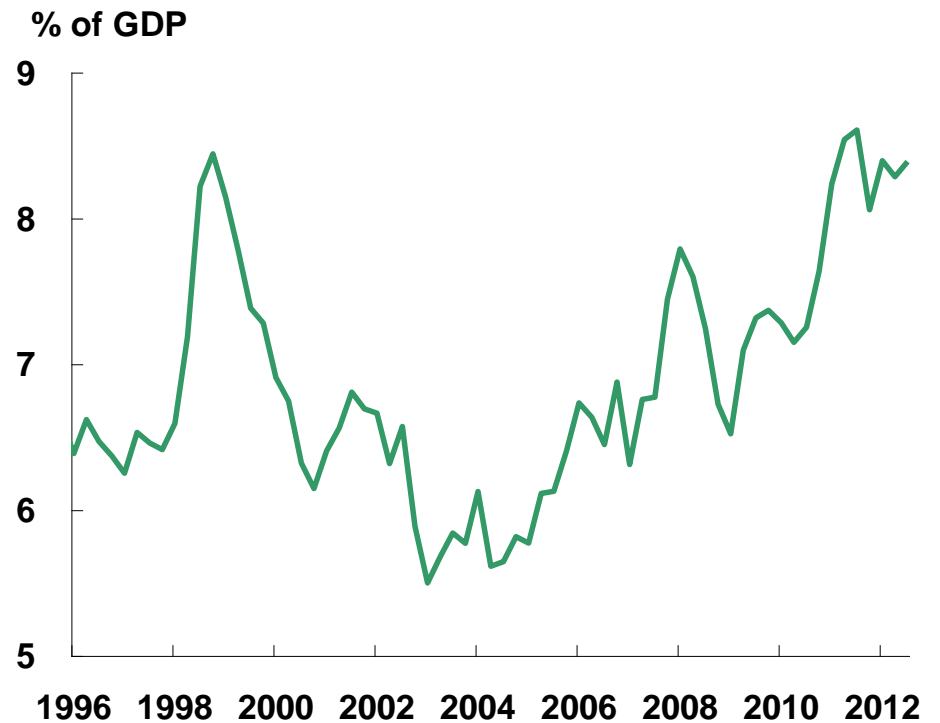
Strong credit growth is a common sign of imbalances in the region

Credit to GDP ratio



Increasing reliance on external financing

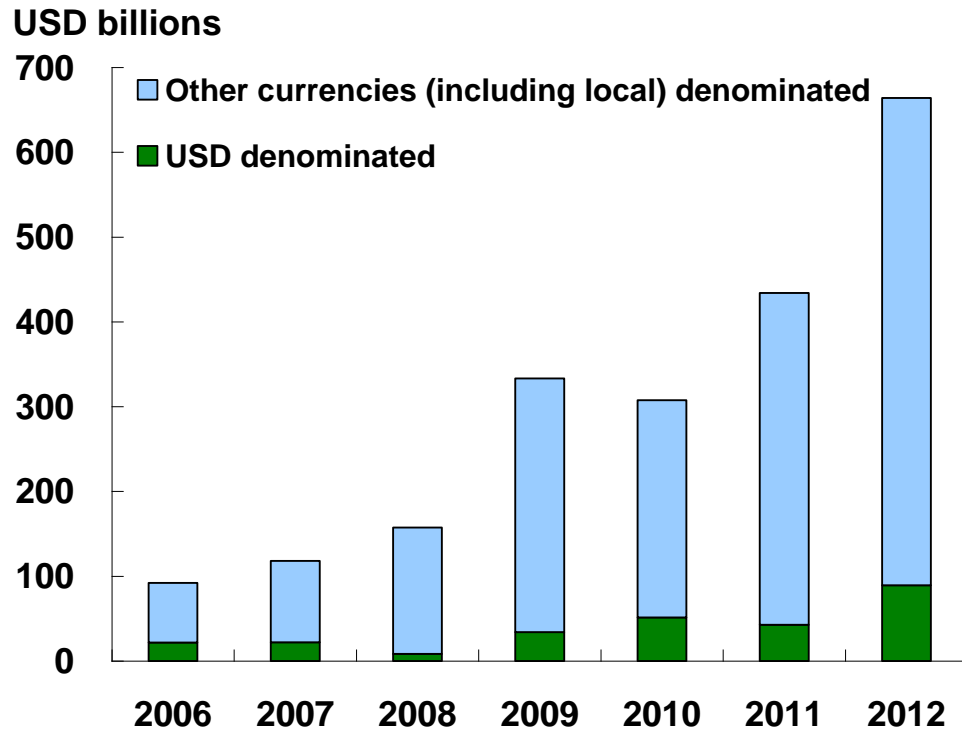
External bank claims on the region's non-bank sector



Financial imbalances in Asia: Strong demand for Asian bonds - cyclical or structural?



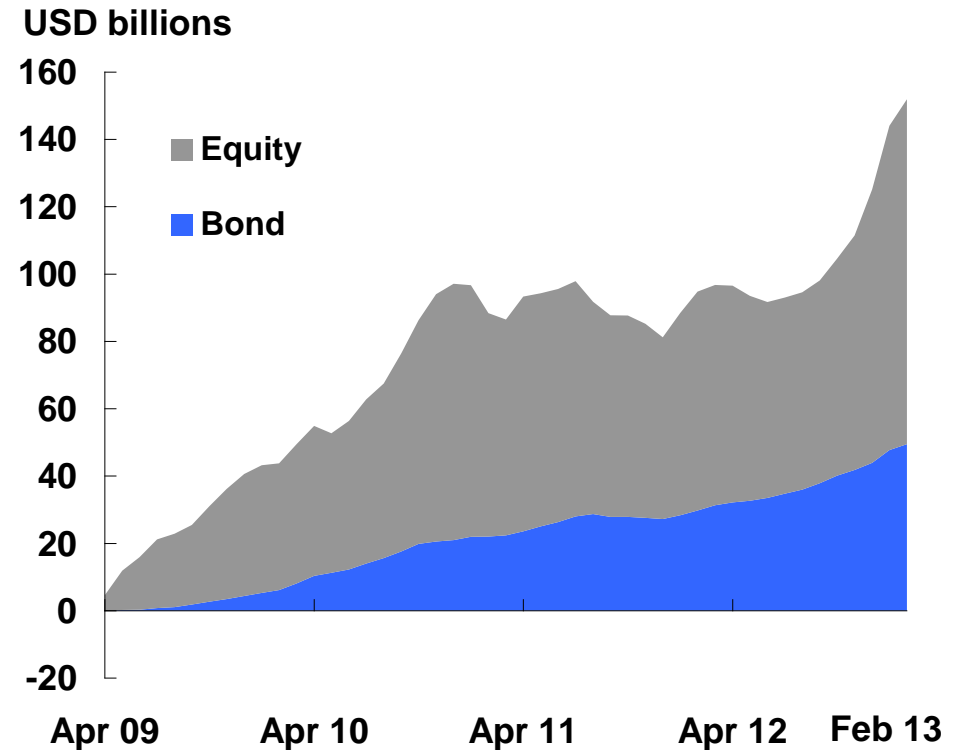
Bond issuance of emerging Asian economies



Note: Economies included: China, Hong Kong SAR, Indonesia, Malaysia, Philippines, Singapore, South Korea, Thailand, Macau, Mongolia, Taiwan Province of China and Vietnam.

Sources: Dealogic and HKMA staff calculations.

Cumulative equity and bond inflows to emerging Asia



Note: Economies included: China, Hong Kong SAR, Indonesia, Malaysia, Philippines, Singapore, South Korea and Thailand

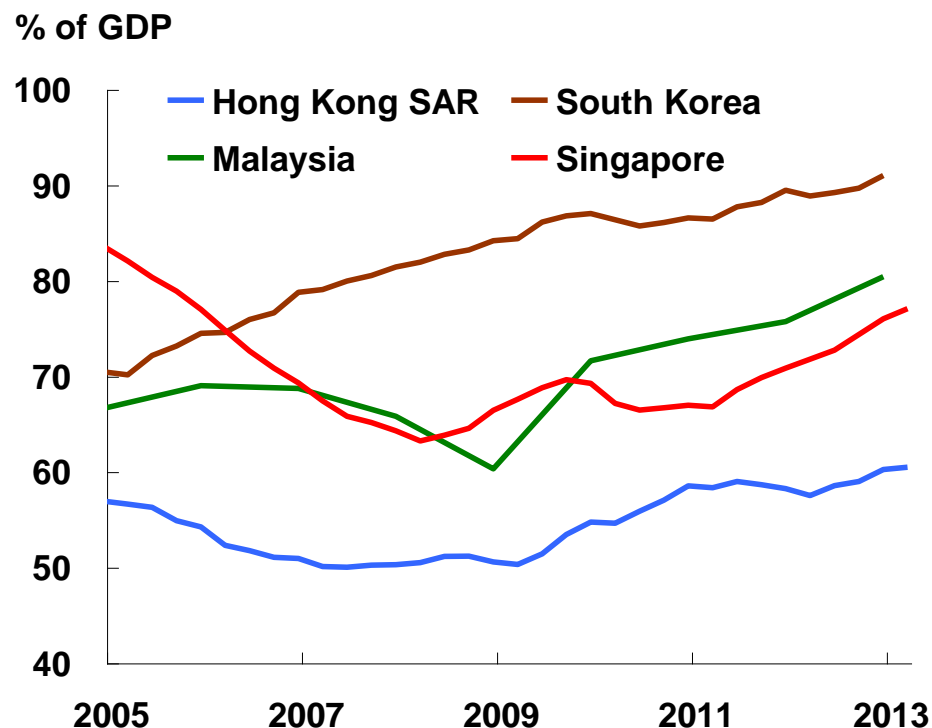
Sources: EPFR and HKMA staff calculations.

Financial imbalances in Asia: Domestic vulnerabilities also built up in various forms in different economies



Rising household debt in many economies

Household debt in selected Asian economies



Sources: CEIC, SingStat and HKMA staff calculations.

Overheating risk in the property market in some economies

Housing prices

	Percentage change since 2008
China	15.6
Hong Kong SAR	109.4
Indonesia	27.1
Malaysia	40.3
Singapore	24.8
South Korea	24.9

Note: China: Simple average of property price indexes of 70 major cities; Hong Kong SAR: Property price index of domestic premises; Indonesia: 14-city residential property price index; Malaysia: House price index of Kuala Lumpur; Singapore: Property price index of private residential; South Korea: Housing price index of 6 large cities

Sources: CEIC and Staff calculations.

... together with uncertainty in the timing and pace of interest rate normalisation, could lead to higher risk of a boom-bust



- Despite increase in transparency, there are still a high degree of uncertainty surrounding the timing and pace of the Fed's policy exit:
 - ❖ Relationship between inflation and unemployment subject to a lot of uncertainties
 - ❖ Risk of under-estimation of NAIRU and over-estimation of output gap
- The longer major economies delay policy exit, the higher the risk of a boom-bust in the financial markets



- More aggressive-than-expected interest rate hike by the Fed
 - ❖ Repricing of cost of credit, asset prices and/or exchange rates
 - Higher local currency risk-free rates along with US benchmark yields
 - Rise in risk premium on Asian risk assets due to reduction in overall liquidity and search-for-yield incentives
 - Possible capital outflows
- A global bond market crash
 - ❖ Global risk aversion leading to rise in risk premium on Asian assets
 - ❖ Rise in funding costs and reduced credit access
 - Foreign banks with liquidity problem cutting back on credit supply
 - Surge in counterparty risks
 - ❖ Likely much sharper capital outflows

Hong Kong's experience:

What was the impact of the 1994 bond market crash?

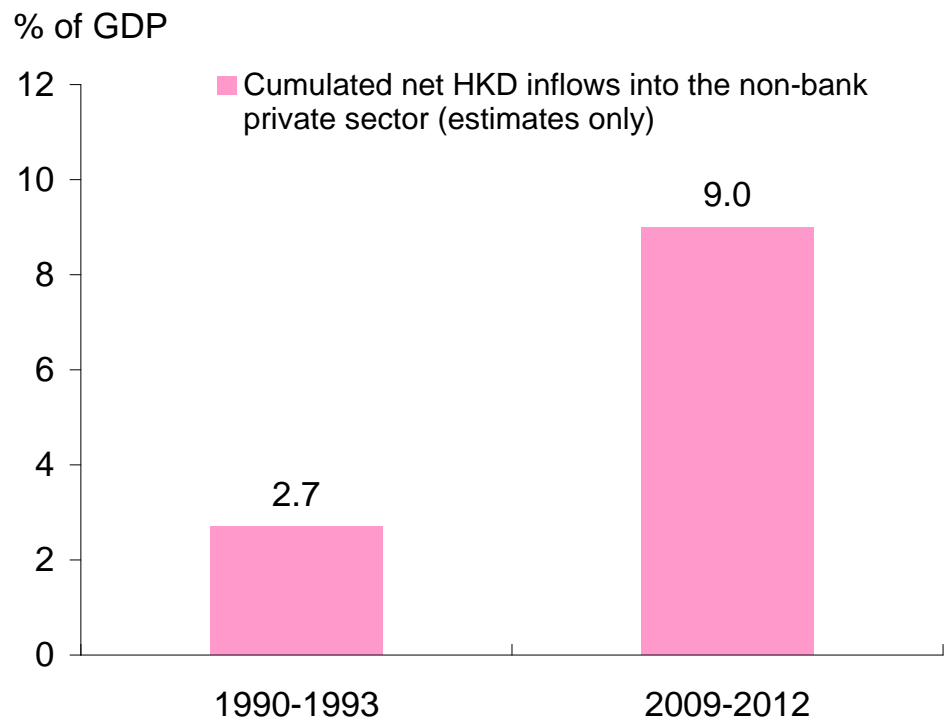


- US Fed Funds Target Rate: +300 bps (from 3% to 6% in 13 months)
- Impact on Hong Kong:
 - 3-month HIBOR: +325 bps
 - Best Lending/mortgage interest rate: +250 bps
 - HKD outflows: HK\$24 billion (2% of GDP)
 - Residential property price: -16%
 - Hang Seng Index: -43%
 - Real GDP: below-trend growth for six quarters
 - Unemployment rate: +2 percentage points

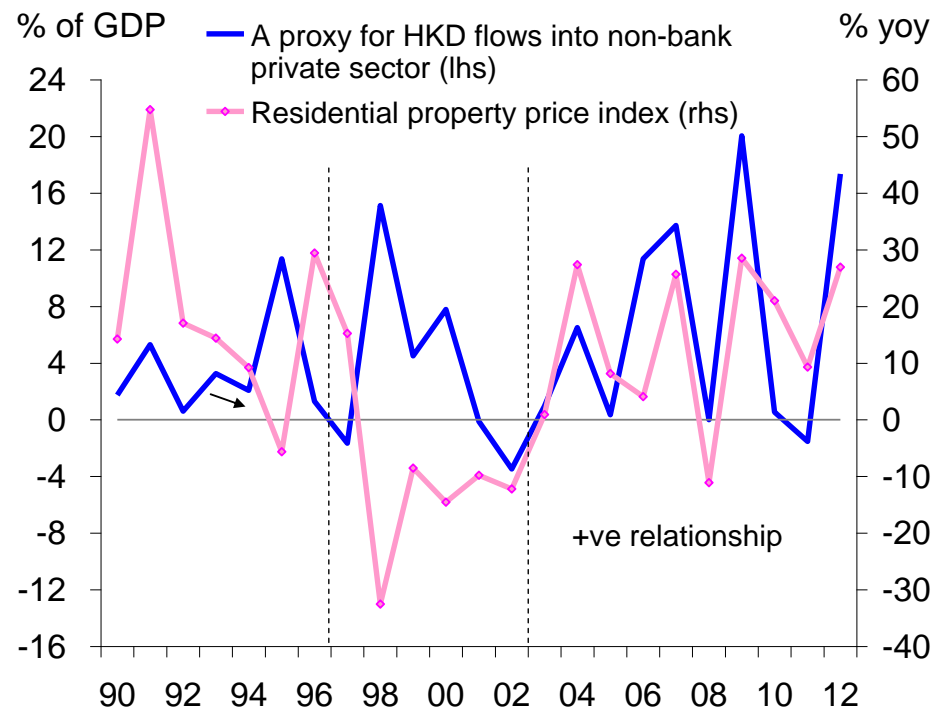
The potential impact could be bigger than during the 1994 bond market crash: cumulated fund inflows larger and volatility higher



More massive fund inflows than on the eve of the 1994 episode



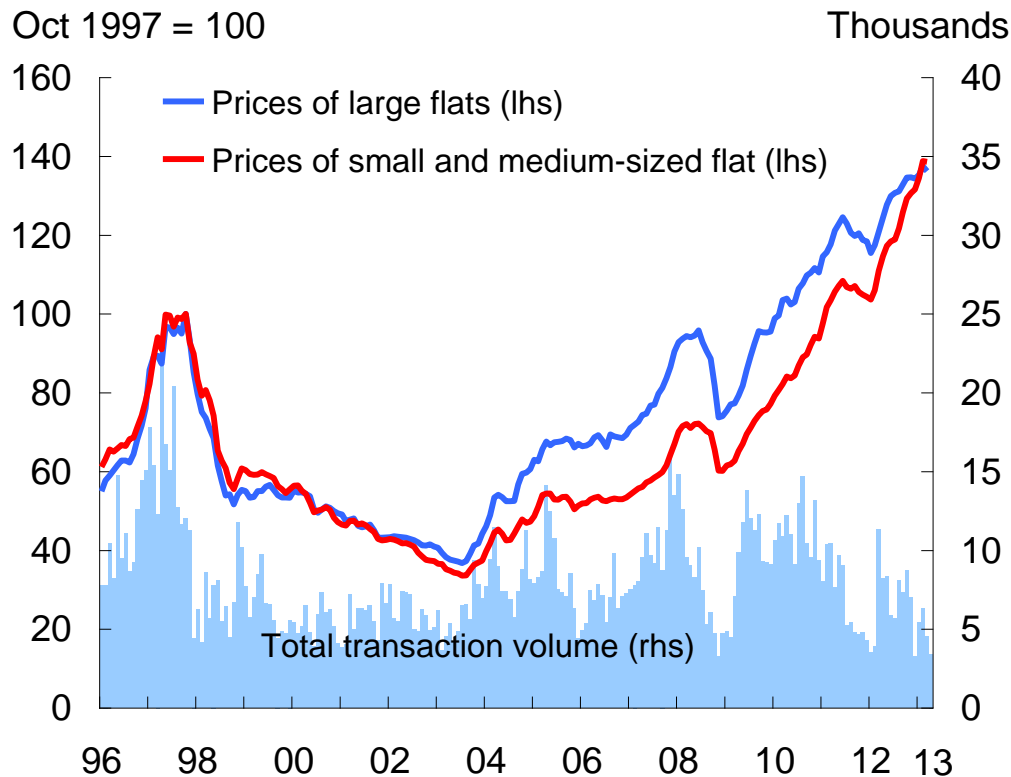
Fund flows more volatile and correlated with property prices



The potential impact could be bigger than during the 1994 bond market crash: property market being the key risk to financial stability

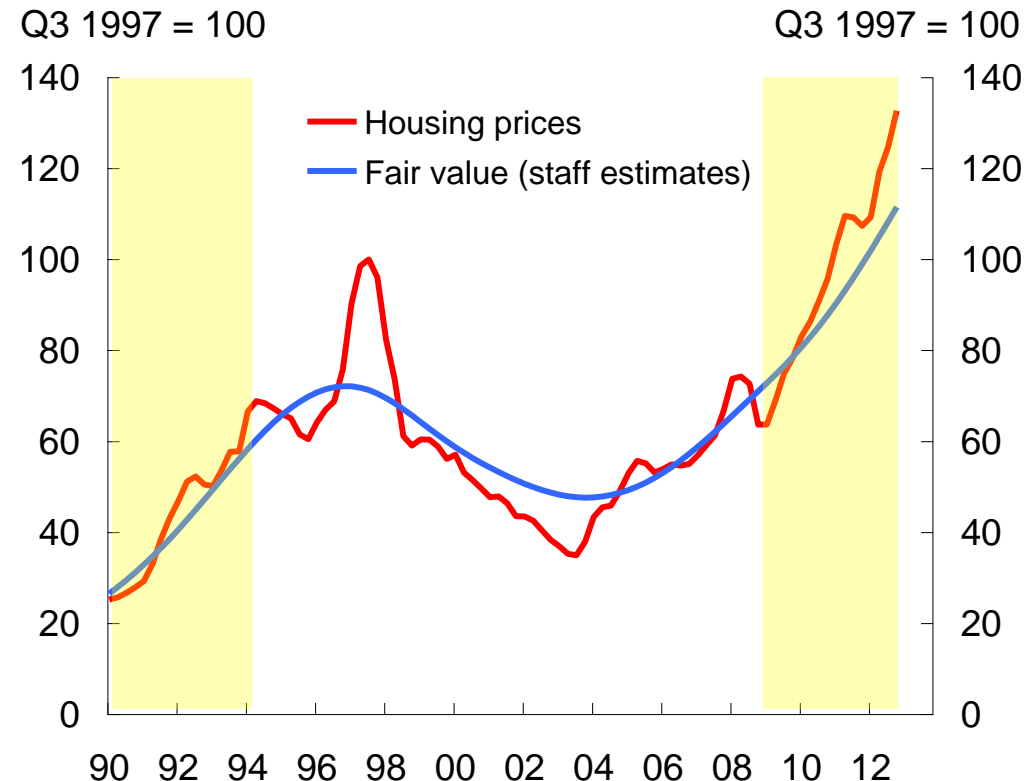


Sharp increase in property prices since early 2009



Sources: R&VD and Land Registry.

Property prices at bigger risk of overvaluation

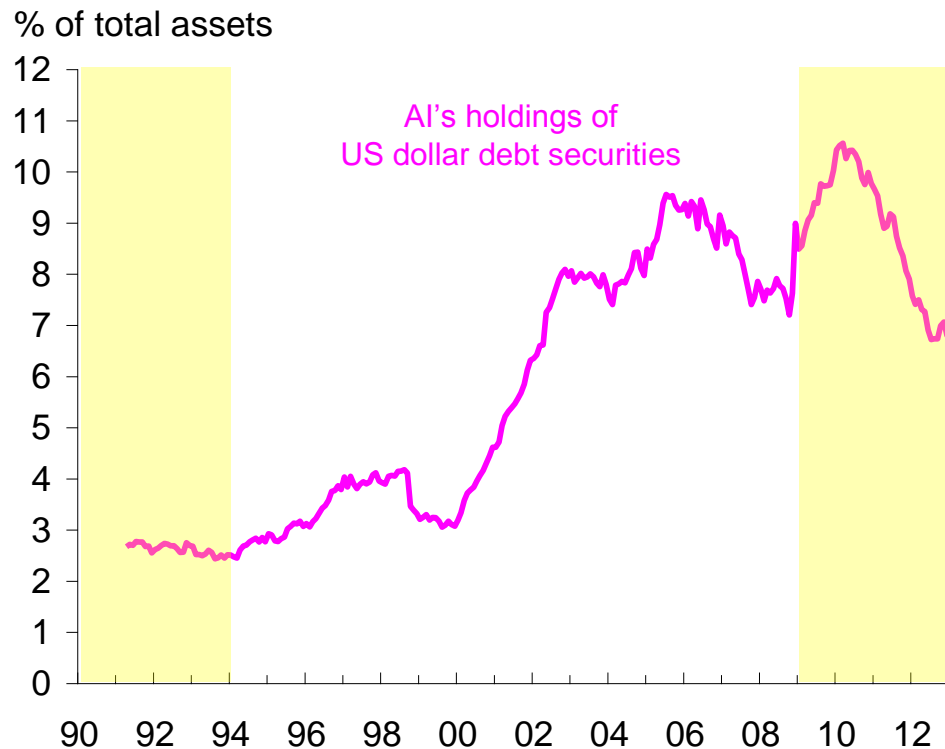


Sources: R&VD and HKMA staff calculations.

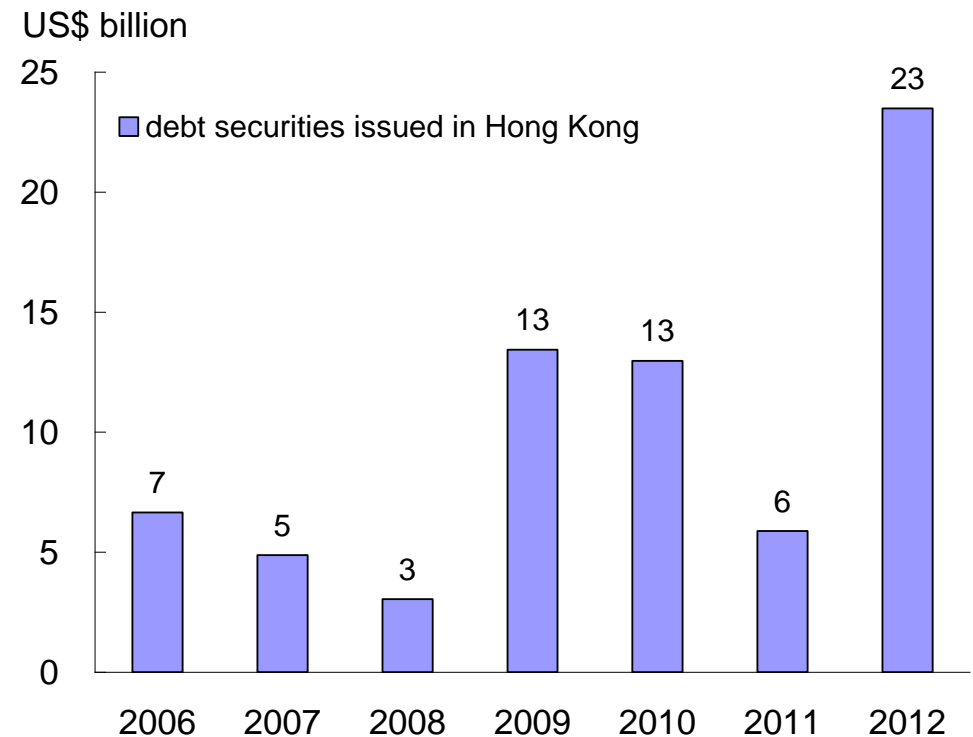
The potential impact could be bigger than during the 1994 bond market crash: larger exposure to US bond market



Larger exposure of Hong Kong banks to the US bond market



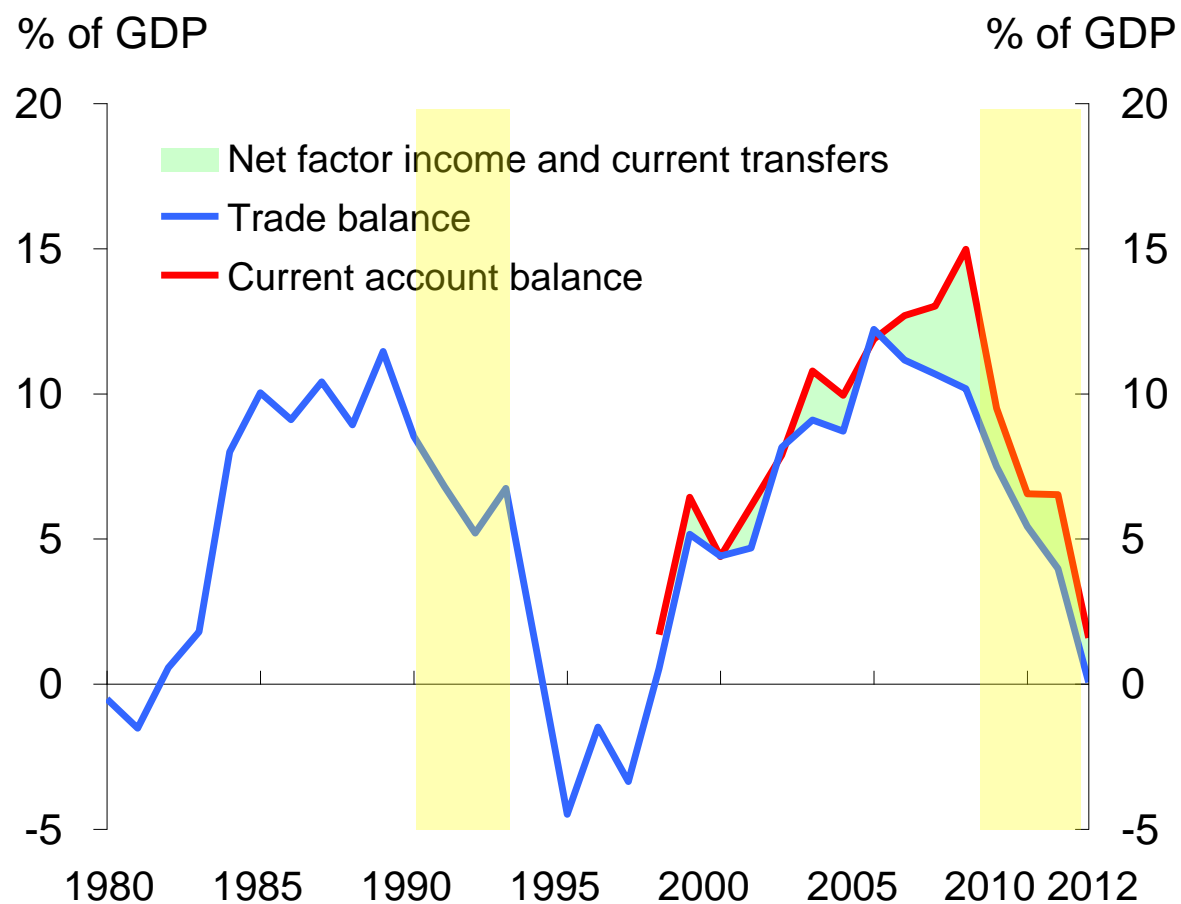
Hong Kong corporations using debt capital markets more intensively



The potential impact could be bigger than during the 1994 bond market crash: higher macroeconomic vulnerability



Sharp deterioration of the current account balance

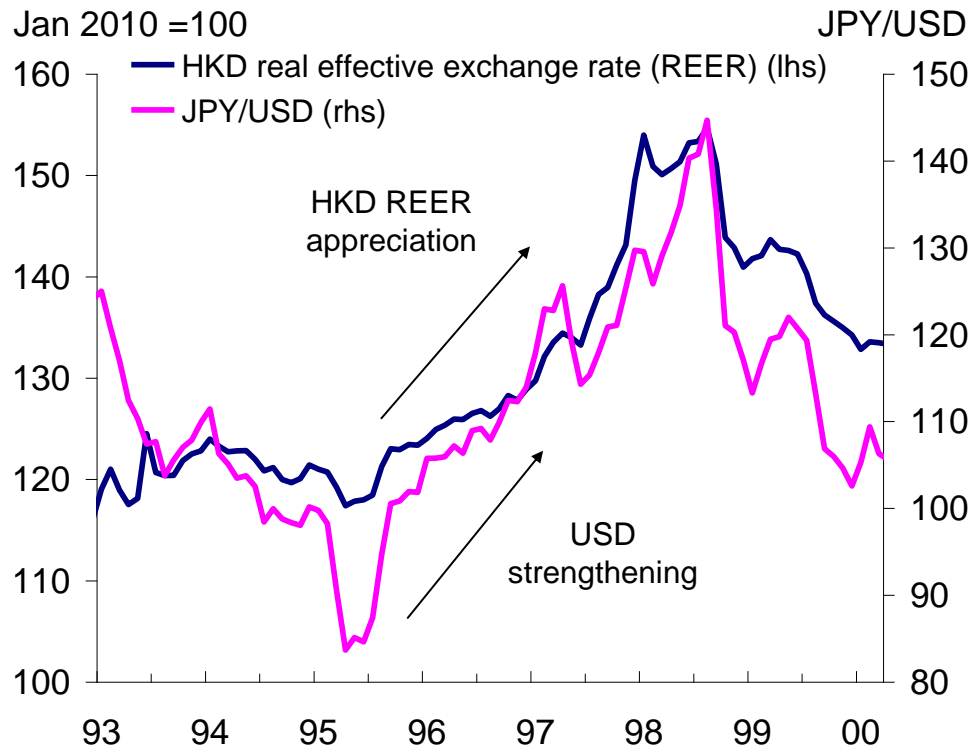


Risk of a sharp US interest rate hike leading to sharp strengthening of the USD: A replay of the Asian Financial Crisis?



Continued appreciation of HKD REER along with the yen/dollar rate during the mid-90s

Dollar strengthening and weak yen invited speculative attack on Asian currencies



Changes in real effective exchange rates for selected Asian economies

	% appreciation from Jun 1995 to peak	% downward adjustment	
		% depreciation	Adjustment period
Hong Kong	31.1	-28.2	Aug 1998 to Jul 2004
Indonesia	12.1	-65.8	Jun 1997 to Jan 1998
Malaysia	9.6	-32.5	Jun 1997 to Jan 1998
Philippines	19.4	-26.7	Jun 1997 to Jan 1998
South Korea	-0.3	-39.4	Jun 1997 to Jan 1998
Thailand	14.8	-42.1	Jun 1997 to Jan 1998

Note: For Hong Kong, the peak is at Aug 1998, and the adjustment period ends on Jul 2004 when the year-on-year headline CPI inflation first turned positive after a period of deflation. For other economies, the peak is at Jun 1997 and the trough is at Jan 1998.

Policy implications for Asia: Plan ahead to minimise the potential impact of capital flow reversals



- Concurrent unconventional monetary easing by major central banks and uncertainty in policy exit would mean more financial market volatility and uncertainty in capital flows ahead
- Mechanism to minimise the potential impact of eventual capital outflows on macroeconomic and financial stability
- In the case of Hong Kong,
 - ❖ Pre-emptive macro-prudential measures to rein in excess leverage
 - ❖ Contingency plans to deal with impacts from a sudden reversal of capital flows

Policy experience in Hong Kong: Prudential measures on mortgage lending



- Six rounds of countercyclical measures by the HKMA since October 2009
 - ❖ Tightened underwriting standards
 - Loan-to-value ratios (LTV)
 - Debt-serving ratios (DSR) and stress-testing
 - Loan tenor
 - Risk weight floor of 15%
 - ❖ Targeted at luxury homes, investment properties, multiple mortgages, and mortgage repayment by income from foreign sources
 - ❖ Close supervision and more on-site examinations

Policy experience in Hong Kong: Coordination with fiscal and land policies



Land and housing supply measures → Redress property market imbalances

Tax measures

❖ Special stamp duty (SSD)

❖ Buyer's stamp duty (BSD)

❖ Double stamp duty (DSD)

→ Dampen speculative and investment demand

Counter-cyclical measures

→ Maintain financial and banking stability

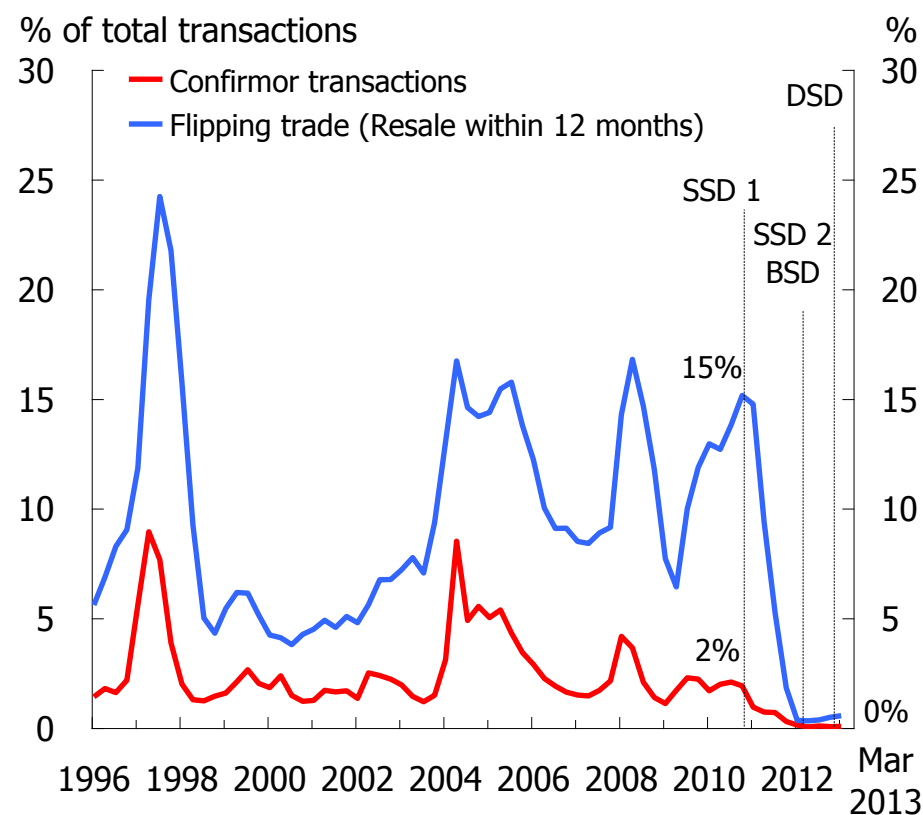
Policy experience in Hong Kong: Measures have reduced leverage and dampen speculation



Impact of HKMA prudential measures

	Before launch	Recent situation
Average LTV	64% (Sep 2009)	54% (Apr 2013)
Average DSR	41% (Aug 2010)	36% (Apr 2013)

Impact of tax measures



Important to understand the strengths and limitations of macro-prudential policies



- Macro-prudential policy is useful but not a silver bullet
 - ❖ Marginal effectiveness may diminish over time
 - ❖ Subject to policy circumvention and risk-shifting
 - ❖ Impact would depend on the transmission mechanisms and financial structure of individual economies
 - ❖ Need for coordination with other policies
- Need to think ahead on when and how to exit these measures, e.g.
 - ❖ The stage of financial cycle?
 - ❖ Potential risk of a disruptive asset price fall ahead?
 - ❖ Resilience of banks to a market downturn?
 - ❖ Desirable magnitude of policy relaxation?



- Extended period of extremely accommodative monetary policy by major central banks could risk amplifying financial cycles
- Sharp exchange rate movements of major currencies could induce more volatile capital flows in the region
- Asian central banks should get prepared not only for renewed capital inflow pressure, but also for interest rate risks and the reversal of capital flows
- Counter-cyclical prudential measures can be useful in mitigating the fallout of market collapse on financial stability but not a silver bullet
 - ❖ Require co-ordination among authorities and need to formulate exit strategy