Asia's elevated risks

By **IWAN J AZIS**

BANK of Japan governor Haruhiko Kuroda was right on target when he raised concerns recently over the unhealthy impact on Asian economies of accommodative global financial conditions. Ultra-easy monetary policy in advanced economies and, in particular, quantitative easing (QE) in the United States, have boosted global liquidity and caused capital flows to surge in emerging markets including those of Asia.

As financial-sector liquidity expands far more rapidly than in the real sector, its impact is difficult to predict, even with regulations in place to moderate such impact. Yet, the response of economic agents (individuals, companies and banks, whose activities influence an economy) continues to be to "dance to the tune".

Many Asian countries have experienced excess savings since the 1997 regional financial crisis. Liquidity has been further boosted by capital inflows after interest rates in the US and Europe fell in early 2000. At first, these flows went through the banking sector.

High risk: *Pro-cyclicality risk is particularly high in countries where the market is not deep, yet where the share of foreign ownership is high – Indonesia is a notable example.* PHOTO: AFP

Then, after being briefly interrupted during the global recession in 2008, the flows reappeared in 2009. This time, however, a substantial portion went into capital markets, driven primarily by a search-for-yield amid the low returns in advanced economies. The size of these capital flows has been huge and they have been more volatile than during the pre-1997 period.

For emerging Asia, the consequence of surging inflows and excess savings was a large expansion of liquidity and a lower cost of borrowing which, in turn, spurred credit creation and economic growth. At the same time, the pressure on exchange rates to appreciate and the overall risks to financial stability also increased. The risk became particularly high that rapid growth in liquidity could turn into a sharp contraction when capital flows reverse, in line with "pro-cyclicality".

But there was something else that elevated the risk. With plenty of liquidity and low costs of borrowing, banks, companies and others shifted their preference towards more risky investments.

Looking at the flow-of-funds data, the increase of banks' assets has been spurred by the surge of non-deposit sources of funds or "non-core liabilities". Banks used these funds to expand credits as well as to invest in financial assets such as securities and equities. A sizeable portion of the credits went to the property sector, contributing strongly to the formation of bubbles. Households' preference for investing in financial assets also increased significantly. The trend is even more evident among non-financial companies.

When finance began to flock to the capital market, the protagonists shifted from being banks to fund managers. Facing pressures on short-term performance, most fund managers prefer quick returns and are willing to tolerate riskier investment.

Increased reward on the upside and reduced penalty on the downside also motivates fund managers to be procyclical.

On the government side, the low cost of borrowing caused by massive capital inflows motivated many governments in emerging market economies to issue long-term debt. This raised revenues and allowed them to undertake "maturity adjustment": government bonds replace short-term debt. In the first six months of this year, the value of international sovereign bonds issued in emerging markets has jumped more than 50 per cent. The local currency bond has been growing fast too. In emerging Asia, the outstanding value of such issues had reached US$7.2 trillion by March this year.

If the winding down of the US easy-money policy leads to a shift in investor perceptions, market volatility may return. Such a risk of pro-cyclicality is particularly high in countries where the market is not deep, yet where the share of foreign ownership is high; Indonesia is a notable example.

The events of last summer confirm this. When, in May 2013, the US Federal Reserve announced its intention to reduce its asset purchases, markets in some countries that had received strong capital inflows were rattled. They received a double-blow in the shape of weakening exchange rates and fluctuating financial flows as money flowed out.

The flip side of the growing preference for financial assets is a far lower investment in factories, machinery, infrastructure, and other real sector investment. Small wonder then that Asia's capacity to create employment for a given level of growth – known as "employment elasticity" – has decreased right across the board.

Meanwhile, the wealth of a tiny proportion of citizens who have access to the fast-growing financial assets continues to rise, contributing to a "Piketty moment" of growing wealth and income inequality.

The behaviour of economic agents may be rational from a private perspective, but the resulting financial instability and inequality makes it socially non-optimal.

Even as world economies become more interdependent, national policy continues to rule, irrespective of its spillovers to other countries and the talk of policy coordination and cooperation.

No example is more illustrative of these trends than the introduction of ultra-easy money policy in advanced economies. This "financial nationalism" led to massive capital flows into emerging market economies. In Asia, the resulting surge of inflows and outflows has been much larger and more volatile than in the past. Also, it is occurring in the midst of a period of excess savings, stirring economic agents to respond with risk-taking behaviour.

True, this has boosted economic growth, but it has also elevated the risk of instability especially now with the progressing normalisation of US monetary policy. The risks associated with this are very real.

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