Mizuho Economic Outlook & Analysis

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Asia's Debt Risks

The risk of financial crises is limited, but attention should be paid to slowing domestic demand.

< Summary >

- Expanding private debt is a minefield of potential risks in Asia. With Asian economies vulnerable to higher interest rates, steep rate hikes may trigger financial crises involving rising defaults and impair domestic demand.

- But the risk of financial crises in Asia is limited at least for now because (1) interest rates are unlikely to surge as a result of currency weakening or inflation, and (2) monetary tightening under macroprudential policies are likely to be calibrated cautiously.

- Nonetheless, given the possibility that the current gradual rise of interest rates and cautious macroprudential policy will continue, note that domestic demand such as investment and consumption may lose steam, or at least, slow down.

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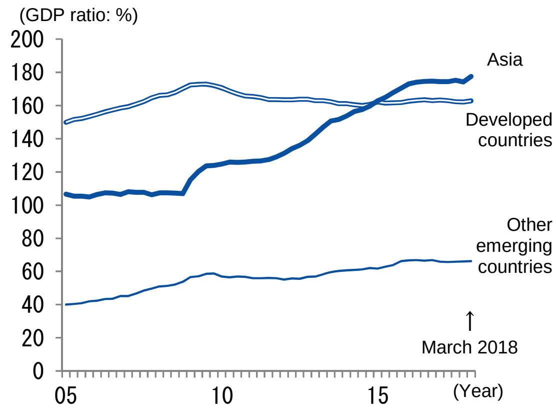
1. A minefield of risks in the high levels of private debt

Even though currency weakening since the beginning of 2018 is casting a shadow of uncertainty on emerging economies, Asia is unlikely to suffer a currency crisis as it did in 1997. At that time, Asian countries accumulated short-term foreign currency-denominated debt while increasing long-term local currency-denominated assets, including real estate, resulting in mismatches between the periods and currencies on their balance sheets. Consequently, when currency weakening rapidly increased the repayment burden on foreign currency-denominated debt, Asian countries faced foreign currency shortages that led to a wave of defaults. Compared with the 1997 crisis, the countries today have built up adequate foreign currency reserves to cover their short-term foreign debt.[1]

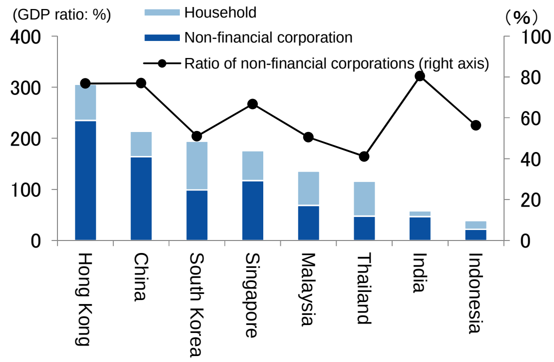
However, while liquidity risks stemming from balance sheet mismatches are limited, Asia sees private debt swelling both internally and externally on its balance sheet (**Chart 1**). The following chapters examine potential risks involving the expansion of private debt and analyze the possibilities of their realization.

Chart 1: Private (household + non-financial corporation) debt / GDP



Source: Made by MHRI based on BIS.

Chart 2: Private debt / breakdown of GDP (March 2018)



Source: Made by MHRI based on BIS.

2. Current situation of private debt accumulation

Looking at Asia's private debt (to GDP ratio) by country, Hong Kong, China, and South Korea share a large proportion (**Chart 2**). The types of private debt show that corporate debt accounts for 70 to 80 percent in most countries, while the proportion of

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[1] Koji Kobayashi and Jun Inoue, *Contagion risk of Turkey's currency shock – Similarities and differences with past currency crises (September 10, 2018)*, Mizuho Research Institute Ltd., Mizuho Economic Outlook & Analysis. https://www.mizuho-ri.co.jp/publication/research/pdf/eo/MEA180926.pdf

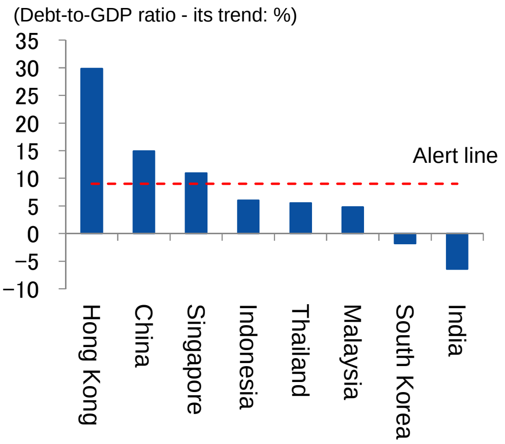
household debt is relatively high in Thailand, Malaysia, and South Korea.

However, the debt-to-GDP ratio tends to show an upward trend reflecting financial deepening, and therefore the high level does not necessarily indicate urgent risks. Instead, the Bank for International Settlements (BIS) monitors the credit-to-GDP gap (debt-to-GDP ratio – its trend) as an early warning indicator. A rise in the gap represents excessive debt deviating from the trend, suggesting the risk of default increase and financial crisis. BIS regards 9 percent as an alert line based on its past empirical data. (If the gap exceeds 9 percent, there is an at least two-thirds chance of a banking crisis occurring within a three-year time horizon.)

Looking at Asia's credit-to-GDP gaps based on this standard, Hong Kong, China, and Singapore exceeded the 9 percent alert line as of March 2018 (**Chart 3**). In the past, Japan's credit-to-GDP gap topped 20 percent in the late 1980s, portending a financial crisis (**Chart 4**) that eventually led to the collapse of the country's bubble economy in the early 1990s. Hong Kong's current over-30 percent credit-to-GDP gap suggests an unbalanced balance sheet. China and Singapore's credit-to-GDP gaps are both on a downward trend, but remain at the 10 percent levels with excessive debt.

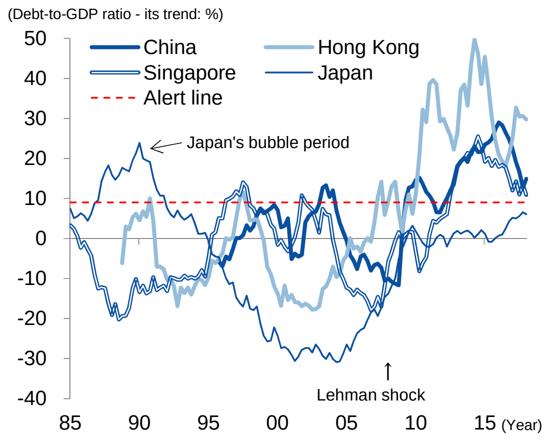
Asia, especially Hong Kong and China, has seen debt rising since the collapse of Lehman Brothers in 2008. With developed market countries introducing unconventional monetary easing measures, including the zero interest-rate policy, capital has flown into emerging market economies with relatively high interest rates, resulting in the expansion of external debt in Asia. Not only external but internal debt has expanded as well, and at the same time. This is because Asia also introduced monetary easing policies as economic stimulus packages and ignited more domestic borrowings. Looking at debt by country, China's large amount of corporate debt arose from active investment expecting positive effects of the government's economic stimulus measures after the Lehman shock. Meanwhile, household debt stands high in South Korea and Thailand because of South Korea's gradual deregulation of mortgage lending since the 2010s and Thailand's introduction of a first-car buyer scheme in 2011 as an incentive for low-income households to purchase cars.

Chart 3: Credit-to-GDP gap (March 2018)



Source: Made by MHRI based on BIS.

Chart 4: Credit-to-GDP gap (long-term changes)



Source: Made by MHRI based on BIS.

3. Vulnerable to the rise of interest rates

As a result of accumulating debt, Asia's economic structure has become vulnerable to the rise of interest rates. To verify this situation, the increase in interest payment burden (to GDP ratio) was estimated by assuming that the borrowing rate of existing debt rose by 1 percent. The results revealed that the burden increased substantially in Asian emerging economies in accordance with higher debt-to-GDP ratios, such as Hong Kong, China, and South Korea (**Chart 5**). Although it should be noted that a 1 percent rise will not increase the burden all at once as calculated because debt includes fixed-rate borrowings, the results demonstrate Asia's vulnerability to higher interest rates.

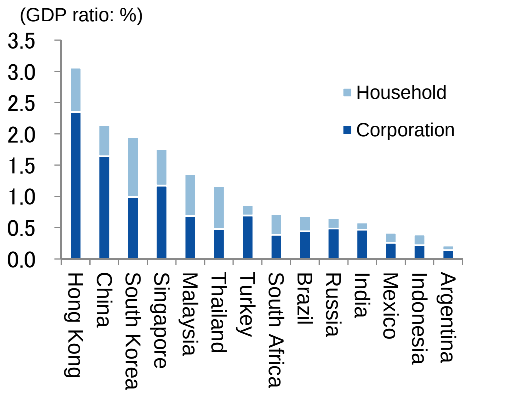
The rise of interest rates tend to have spillover effects on the corporate repayment burden and investment in Hong Kong and China loaded with heavy corporate debt, while household repayment burden and consumption are exposed in South Korea, Malaysia, and Thailand carrying large household debt. In terms of industrial sectors, higher interest rates may also cause a decline in property prices, given that Chinese businesses are developing real estate with borrowings and South Korean households are taking out more housing loans.

Actual interest rates in 2018 have shown an upward trend in overall emerging market economies, but Asia has seen a limited rise. Looking at policy interest rates, for example, Argentina and Turkey raised their rates by 39.3 and 16 percentage points, respectively, during the period from the beginning of January to the end of October in 2018. By contrast in Asia, Indonesia and the Philippines both raised interest rates a mere 1.5 percentage points, and rates in Hong Kong and India lifted by even lower 0.75 and 0.5 percentage points, respectively. While Argentina and Turkey's economies appear to be slowing down due to the significant increase in interest payment burdens, Asia's interest payment burden is estimated to have grown relatively slightly (**Chart 6**), with its economy unlikely to change suddenly for the time being.

However, steep interest rises in Asia could trigger a rise in bad loans as a result of higher interest payments and lower property prices, heightening financial risks in Hong Kong, China, and Singapore with their credit-to-GDP gaps exceeding the BIS alert line. Other Asian countries may also face an economic slowdown mainly in domestic demand, if not actually suffering a financial crisis.

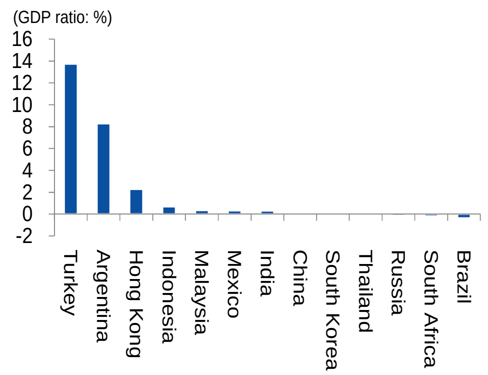
To prevent financial crises and economic slowdown arising from swelling debt, Asia is introducing measures to curb debt. China is allowing a moderate rise in market interest rates and introducing macroprudential policies (including shadow banking regulation). The country's downward trend in the credit-to-GDP gap suggests that control measures are producing some positive results. Likewise, Hong Kong, Singapore, and South Korea have adopted macroprudential policies to tighten their real estate investment regulations, and Thailand also announced a strengthening of regulations on real estate investment starting in January 2019.

Chart 5: Interest payment burden increase by 1 percent interest rate rise (estimates)



Note: Calculated by the total debt of the non-financial private sector x the range of change in interest rates / GDP.
Source: Made by MHRI based on BIS.

Chart 6: Interest payment burden increase as a result of policy interest rate changes since the beginning of 2018 (estimates)



Note: Same calculation method as Chart 5.
Source: Made by MHRI based on each country's statistics.

4. Limited possibilities for steep interest rate rises at present

This chapter analyzes the possibilities for steep interest rate rises in Asia in terms of direct upward pressure of the interest rate itself and indirect pressure tightened by more stringent macroprudential policies.

First, direct upward pressure of the interest rate itself intensified in Argentina and

Turkey hit by sharp currency falls, but had a limited impact on Asia, whose currencies remained comparatively stable.

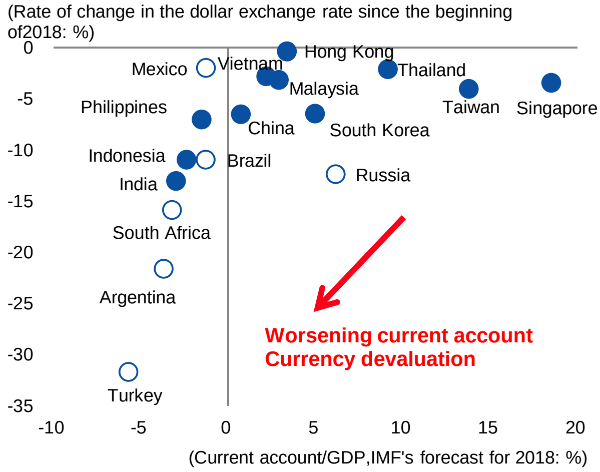
In the cases of Argentina and Turkey, with a high demand for foreign currencies used to finance the current account deficit, their currencies plummeted (**Chart 7**) after foreign currency inflows stalled mainly because of the US interest rate hike. As a result, both countries were forced to implement major interest rate hikes to defend their currencies. They were also compelled to combat inflation by raising interest rates since currency weakening boosted import prices, causing inflation to increase 40.5 percent year-on-year in Argentina and 24.5 percent year-on-year in Turkey as of September 2018.

Meanwhile, since Asia's current account is relatively healthy, the impact of currency weakening and its accompanying inflationary pressure is expected to remain limited, in spite of the prospect that US interest rate hikes will continue. It is therefore unlikely that Asia will have to resort to sharp interest rate hikes as Argentina and Turkey have done.

Second, Asian countries have been implementing macroprudential policies in the calibrated manners in order to get excessive debt risks under controlled. But if the policies were conducted too stringently, they would squeeze domestic liquidity, possibly triggering defaults and property price crashes as steep interest rate hikes would do. In fact, tough macroprudential regulations (real-estate financing regulations) are considered responsible for bursting Japan's economic bubble.[2] On the other hand, relaxed macroprudential policies will leave expanding debt out of control, incurring greater financial risks in the future.

In China, for example, the above-mentioned debt reduction measures have intensified downward pressures on the country's economy, including a rise in corporate defaults. In addition, given downward pressures further heightened by trade tensions with the US, China is shifting its core

Chart 7: Foreign exchange rates and current accounts



Note: The rates of change in the dollar exchange rate are based on the end of October 2018.
Source: Made by MHRI based on Bloomberg and IMF.

[2] Tomohiro Ishikawa, *ESRI Research Note No.19: Japan's Bubble, Deflation, and Long-term Stagnation – Review of an Oral History Study*, Economic and Social Research Institute, Cabinet Office (2011).
http://www.esri.go.jp/en/archive/e_rnote/e_rnote20/e-rnote019.pdf

policy from financial risk prevention to economic stimulus measures.[3] The People's Bank of China advisor Ma Jun recently commented to the effect that China has no intention of rapidly reducing its debt-to-GDP ratio in the short term (Bloomberg News on November 9, 2018).

Judging from China's case, Asian countries are more likely to cautiously follow macroprudential policies while keeping a close eye on economic conditions, rather than recklessly strengthen policy measures.

5. Attention should focus more on economic slowdown risks than financial crises

In conclusion, liquidity risks (external debt defaults) arising from currency weakening since the beginning of 2018 are limited in Asia, but accumulating internal private debt presents a minefield of financial risks. Specifically, soaring interest rates may bring credit risks (internal debt defaults) to the surface, provoking a financial crisis or economic slowdown (sluggish investment and consumption). Under the current circumstances, steep interest rate rises are likely to be triggered by (1) spillover effects of a sharp fall in currency values on domestic interest rates and (2) more rigorous macroprudential regulations on debt control.

Considering the economic fundamentals and policy trends in Asian countries, the possibility of these two triggers boosting interest rates that could spark off a financial crisis is considered limited at least for now. Steep interest rate rises caused by sudden currency weakening and policy changes should be monitored as a tail risk (risk involving a severe impact in actual occurrence but with a low probability of happening). Rather, interest rates are more likely to rise at the current gradual pace as long as currency weakening exerts a limited impact and macroprudential policies are cautiously followed. As a result, Asia's domestic demand, including investment and consumption, is not likely to stall, but exposed to the risk of slowdown.

[3] Yusuke Miura, *China beginning to steer toward stability – Destabilization risks likely to last longer as a result of postponing reforms (August 22, 2018)*, Mizuho Research Institute Ltd., Mizuho Insight (in Japanese only). https://www.mizuho-ri.co.jp/publication/research/pdf/insight/as180822.pdf