



April 2010

Asian Tightening Policy Vs “Asset Bubbles”

The issue of policy tightening in Asia continues to dominate the news headlines. India & Malaysian Central Bank recently increased their main policy rates by 25 bps. Why are Asian central banks tightening policy at a time when the global economic outlook remains uncertain? Will rate hikes in Asia derail the budding global recovery? Are bubbles starting to inflate in Asia? This article, sourced from Wells Fargo’s Economics Group, provides the answer to these questions.

What Are Central Bankers in Asia Thinking?

To understand why Asian central banks are starting to tighten monetary policy now, we must consider why they eased policy in the first place. Flash back to the autumn of 2008 when global trade was collapsing in the wake of the failure of Lehman Brothers. Because exports are very important for many Asian countries, the outlook for these economies was rather grim at the time. In response, Asian governments moved to support growth via expansionary economic policies.

Start with China. Not only did the Chinese government accelerate infrastructure spending, but it also directed banks to start lending aggressively. And lend aggressively they did. By late last year, lending was up by more than 30% on a year-ago basis. Due in part to strong credit growth and expansionary fiscal policy, real GDP growth in China bounced back sharply over the course of the year. Strong economic growth over the past few quarters has not been limited to China. For example, real GDP in Taiwan was up more than 9% in the fourth quarter on a year-ago basis. The Indian, Korean and Thai economies posted 6% growth rates in the fourth quarter.

In other words, the emergency policy measures that were put in place in late 2008/early 2009 are no longer appropriate now that the emergency has apparently passed. A year ago, when it appeared that the global economy was melting down, Chinese authorities directed banks to open the lending taps in order to support economic activity. Now that global economic activity is starting to recover, and the Chinese economy is humming along again, 30% loan growth is not needed anymore. Indeed, inflation – in both goods and asset prices – could become an issue if monetary policy remains extremely accommodative. Extraordinarily low interest rates in most other Asian economies are no longer needed either.

Does this mean that Asian central banks will tighten policy too much in the months ahead, thereby threatening to choke off the recovery in economic activity? Probably not, at least not in the foreseeable future. Although overall rates of CPI inflation have risen in recent months, core rates of inflation generally remain benign. For example, the overall rate of CPI inflation in Korea has moved up from less than 2% last summer to nearly 3% at present. However, the increase largely reflects the wild swing in energy prices over the past year or so. The core inflation rate, which excludes energy prices, continues to trend lower and is less than 2% at present. Similar stories about inflation can be told in most other Asian economies as well.

Do Recent Sharp Increases in Asset Prices Portend a Bubble?

The sharp increase in Asian equity markets last year and, in some cases, in property markets has some investors wondering whether asset bubbles starting to inflate in Asia. Asset price bubbles can be devastating for economies because bubbles often go hand-in-hand with increasing financial leverage. Once the bubble pops, economic actors (i.e. banks, business and households) can quickly become insolvent. Foreclosures and bankruptcies lead to forced asset sales, which then puts further downward pressure on asset prices. A vicious cycle of foreclosures and asset price declines can take root.

As with Chinese households, most Asian economies are not very leveraged at present. One way to measure leverage in the banking system is to look at the overall loan-to-deposit ratio. The higher this ratio becomes, the more the banking system is relying on borrowing from abroad to finance new loans. Not only have the loan-to-deposit ratios for some major

economies in the region trended lower over the past decade, but they are all comfortably below 1% at present. For example, the ratio in China has declined from 0.94 in 1997 to 0.67 at present. As a point of reference, the loan-to-deposit ratio for the commercial banking system in the United States exceeded 1 at the height of the credit market bubble in 2007. (It has subsequently dropped below 0.9)

External debt figures, which measure the amount of foreign borrowing a country has undertaken, are not alarming at present either. Although some countries in Asia had large external debt positions leading up to the Asian economic crisis of 1997 – 1998, the outstanding stock of foreign borrowing has declined significantly over the past decade. In Thailand, where the region wide crisis started, external debt exceeded \$100 billion in 1997 (more than 70% of Thai GDP that year). The outstanding stock of Thailand's external debt has subsequently declined to \$65 billion, which is less than 25% of Thai GDP. China's debt-to-GDP ratio is only 8% at present.

In contrast to present, where leverage ratios across Asia are generally very low, most Asian economies became highly geared during the mid-1990s. The financial crises that swept through the region in 1997-1998 dealt a significant blow not only to Asia's banking systems, but to many households and businesses as well. Consequently, many Asian economies spent the early years of "the noughties" (the decade that started on Jan 1, 2000 and ended on Dec 31, 2009) reducing debt and repairing balance sheets. Although lending picked up in the latter years of the decade, most Asian economic actors did not have time to get overly levered like their western counterparts. The re-leveraging of Asian economies over the next few years should help to underpin economic growth in the region over the foreseeable future.

Conclusion

There is not much evidence, at least not in our view, to support the notion that massive bubbles are forming in Asian asset markets. Will loan growth slow in China and interest rates rise in other Asian countries in the coming months? Yes. However, monetary policy settings will move from extremely accommodative back toward "neutral". Most Asian governments have historically shown a preference for policies that support economic growth. With few inflationary pressures at present, policies in most Asian countries likely won't become "tight" for a few more years.

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