

Debt in Asian Vulnerability*

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The all-time record that the Bombay Stock Exchange's [Sensex](#) has set in recent weeks is indicative of a trend in many emerging markets, especially in Asia. During the second and third quarters of 2013 the mere announcement that the US Federal Reserve plans to gradually withdraw from its policy of infusing liquidity into markets by purchasing securities worth \$85 billion a month resulted in the “taper tantrum” and the panic exit of international investor. Since then calm and even euphoria have returned to emerging economy markets.

In India, for example, foreign portfolio investors have poured net [investments](#) worth \$45 billion into equity and debt markets between October 1, 2013 and November 21, 2014. As a result, the Sensex has risen by around 55 per cent since late September. The view has, therefore, gained ground that financial investors have now “factored in” the taper in their calculations and come to the conclusion that it would not result in either a liquidity crunch or a rise in interest rates that requires going back on their debt-financed investments in emerging markets.

If we consider eight leading Asian emerging markets (China, Hong Kong, India, Indonesia, Korea, Malaysia, Singapore and Thailand), the net annual increment in their external liabilities on account of portfolio investments, which had fallen from \$200 billion in 2007 to a negative \$78 billion in 2008 as a result of the financial crisis, rose again to \$212 billion in 2012, before slipping to \$130 billion in 2013 on account of the taper tantrum. But signs are we would see a significant revival this calendar year.

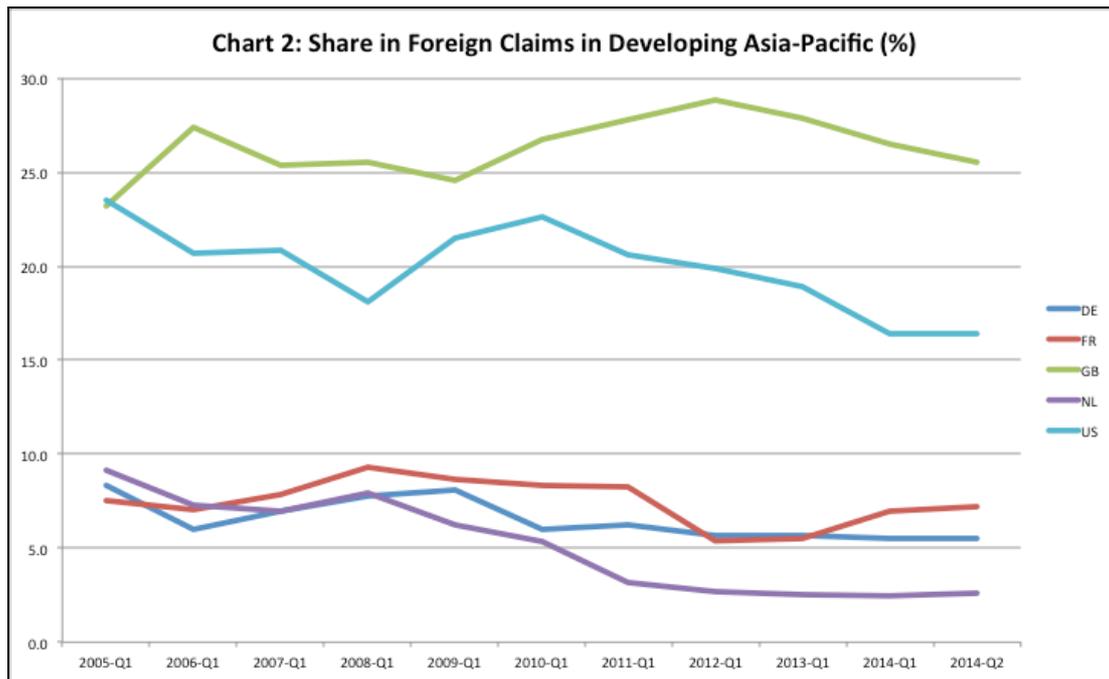
Three factors seem to be responsible for this return to business as usual. First, the evidence that the Federal Reserve has boosted its [balance sheet](#) so much in recent years (from around 800 billion dollars to more than 4 trillion) that there is enough excess liquidity already available in the system. Even if it holds back on infusing more, the impact would not be severe it is presumed. Second, central banks in the US and the UK have made clear that they will keep interest rates low for the foreseeable future since the recovery has been slow and limited. So margins are unlikely to be squeezed by an increase in the cost of capital. And, finally, as the Federal Reserve launches on the taper, the European Central Bank is giving up on its conservatism with regard to liquidity infusion and the Bank of Japan has loosened its monetary policy to deal with the recessions they have to address, adding new sources of global liquidity.

The confidence this has induced in Asian emerging markets and among Asian policy makers needs, however, to take account of two trends that recommend caution. One, which we do not pursue here, is the extremely large and unwarranted appreciation in asset values in these markets. Extremely high asset price inflation is an obvious indication of a speculative bubble that experience indicates calls for caution. The second is the extremely high exposure of agents of different kinds in these markets, and the rapid increase in that exposure. If any development—a worsening of the global recession, future rounds of the taper or some development that forces a rise in interest rates—adversely affects investor confidence, investor exit can be large as overexposed agents rush to the door in herd-like fashion.

In the past, Asian emerging markets have experienced this in debt markets, with the 1997 [East Asia](#) crisis being an extreme example. Yet, attention in recent times has been focused on equity markets with little attention to debt markets. A recent [study](#) from the Bank of International Settlements (Stefan Avdjiev and Előd Takáts, “Cross-border bank lending during the taper tantrum: the role of emerging market fundamentals”, BIS Quarterly, September 2014) points to the dangers implicit in that attitude. The study suggests there are reasons why emerging market economies’ (EMEs) debt exposure should not be ignored. First, the outstanding stock of cross-border bank claims on EMEs stood at more than \$3.6 trillion at the end of 2013 - roughly as large as the stock of all portfolio investment in EMEs. Second, during the taper tantrum, cross-border bank lending to EMEs slowed sharply, with its growth rate dropping to 2.5 per cent in the second and third quarters of 2013 from around 10 per cent over the previous two quarters. And, third, it is not just factors in the source countries that explain fluctuations in bank loan inflows, but characteristics in the recipient countries such as the current account deficit. So it is not just the effects of the taper that these countries need to be worried about.

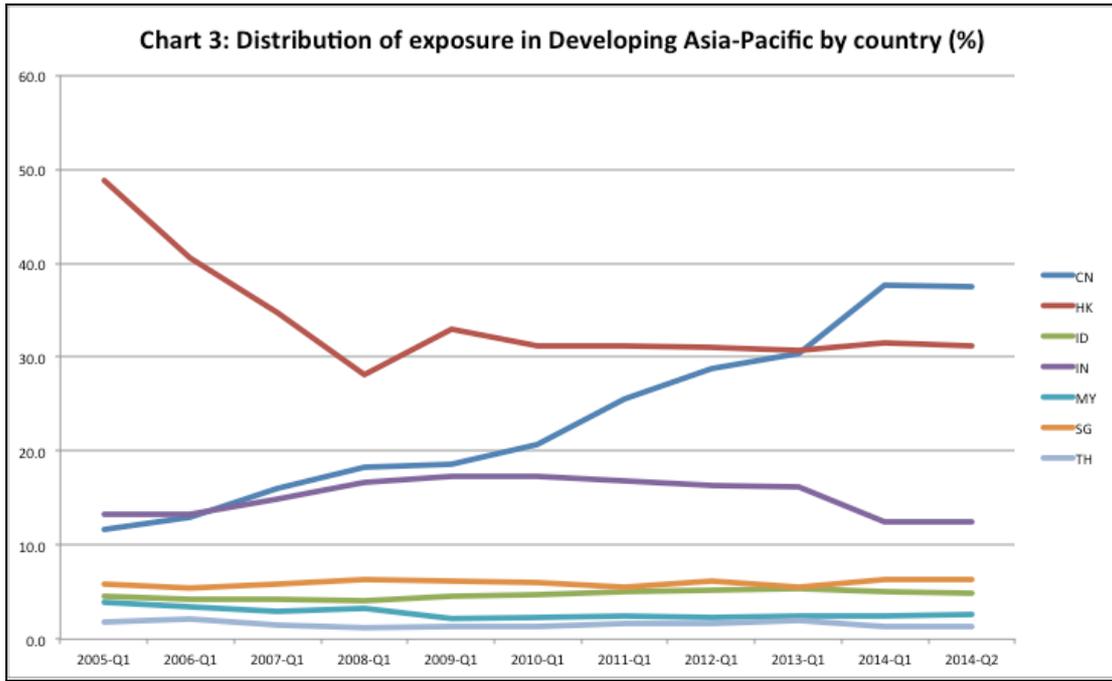


A look at the evidence with respect to Asian emerging markets suggests that the exposure to debt is a source of concern here as well. To start with, outstanding international bank claims have risen four-fold in the developing Asia-Pacific from \$503.5 billion at the end of the first quarter of 2005 to \$2164 billion at the end of the second quarter of 2014 (Chart 1). In fact, in four of the nine years, starting with the year ending the first quarter of 2005, the annual increase in international bank claims in eight leading Asian emerging markets exceeded the highest annual increment of \$212 billion in portfolio inflows to those countries, with the increase peaking at \$393 billion in 2010-11. International bank claims in these countries fell by \$110 billion in 2008-09. In the developing Asia-Pacific as a whole, while exposure rose by between 30 and 40 per cent a year during 2006 to 2008, it fell by 17 per cent in 2009 and has recorded much lower growth rates since. Thus volatility in bank exposure is considerable, making it a cause for concern.



This volatility is a matter for concern also because of the destination-country and source-country concentration of these international bank claims. The three countries in which international bank claims in the Asia-Pacific are concentrated are Hong Kong (which serves as a financial hub), China and India in that order (Chart 2). Over the years, Hong Kong and China together have accounted for between 47 and 70 per cent of aggregate exposure in the developing Asia-Pacific, with the figure exceeding 50 per cent in all but one. There are signs of a shift in exposure from Hong Kong to mainland China in recent years, encouraged no doubt by liberalisation of banking in the mainland. If India is added to these countries, the share of the three in developing Asia-Pacific exposure fluctuates between 66 and 82 per cent since 2005.

Given the role that local developments can have in inducing volatility and the danger of contagion signalled during the 1997 crisis this concentration of debt exposure is disconcerting. More so because banks owned by residents in two countries, the US and the UK account for the bulk of the exposure (Chart 3), varying from 43 and 50 per cent of the total during this period. In time the taper or other such developments can prove more damaging than in 2013. This does suggest that policy makers in [Asia-Pacific EMEs](#) must not merely drop their complacency and think of ways of limiting and reducing their exposure to foreign finance, but also take account of their growing exposure to debt besides portfolio investment.



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