BOK-IMF Conference Keynote Speech Executive Summary

Leverage in Asia: Lessons from the Past, What's New Now, and What to Watch Out for?

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Leverage is an "old" and well-known issue. Many economies, including in the Asia region, already have wide ranging experiences with leverage cycles and their attendant financial stability consequences. Nonetheless, concerns about leverage are again today at the forefront of policy considerations in many emerging markets, including in Asia. Domestic and external leverage have increased in many countries since the global financial crisis, or GFC, and both global and domestic factors seem to be playing a role as drivers.

The end of leverage cycles is often associated with a financial crisis. Typically one-third of credit booms have been followed by some type of financial crisis. The Asian crisis and GFC experiences also showed that private sector leverage can quickly migrate to public sector balance sheets once a crisis materializes. Post-crisis, the Japanese and European experiences show that slow deleveraging can weigh on economic growth for a long time while faster deleveraging—as seen in the U.S. and the Asian crisis-hit economies—is associated with faster economic recovery.

While Asia fared reasonably well through the GFC with relatively low leverage at the onset of the crisis, gross debt—especially corporate credit—has since grown rapidly in many Asian economies. A first reason was unconventional

monetary policies in the major advanced economies as they reduced funding costs in global capital markets appreciably encouraging a search-for-yield and large capital outflows. Domestic factors also matter. It is well-documented that pull-factors reflecting relatively faster growth prospects and higher returning investment opportunities in many emerging markets were a driver of capital flows, but the higher leverage also reflects policy responses to manage the shock from the GFC including most notably in China. Robust house price increases have also been associated with high or rapidly growing leverage amongst households and construction companies in some Asian economies.

Our concern about risks from increased gross leverage needs to reflect judgments about the extent to which this reflects economic fundamentals and is matched by assets and other buffers.

In light of the challenging outlook, we need to closely monitor and carefully assess the vulnerability from increased leverage. The picture we see is more nuanced than the headline debt numbers may suggest.

- At the country level, the net international investment position of most EM's has improved significantly since the mid-1990s.
- Large gross positions concentrated in sub-sectors of the economy could still signal vulnerabilities. Therefore, we need to look into sector-specific vulnerabilities.
- Moreover, the substantial issuance of dollar debt has created vulnerabilities in the context of Fed lift-off and US dollar appreciation.
- Lastly, while the partial overcoming of original sin is welcome, we should remember that it is not risk-free.

Improved policy frameworks and credibility combined with stronger external positions have helped Asian economies adjust to the large shocks the global economy has experienced in the last years. The response to the evolving shocks that Asian economies are likely to face going forward will need to nimbly leverage the region's many strengths while integrating in a consistent manner the various instruments and frameworks available to the authorities to mitigate risks. Three broad categories of policy responses should be in policymakers' toolkits: pre-emptive ones to reduce vulnerability before risks materialize; crisis management frameworks to counter acute distress; and ex-post measures for restructuring, deleveraging, and supporting economic recovery.

Starting with pre-emptive policies:

- It is crucial to rebuild macroeconomic policy space where needed. Strengthening medium term fiscal positions and allowing monetary policy to respond appropriately to its objectives while letting the exchange rate play its buffering role are crucial.
- Systemic financial stability risks can be mitigated by deploying macroprudential policy tools. The resilience of the financial system can be increased by building buffers to contain the effects of a range of systemic shocks, including a bust in asset prices, a sharp depreciation of the exchange rate, and a reversal of capital flows. Macroprudential policies can also be deployed to contain the build-up of systemic vulnerabilities, including widespread leverage. Central banks should monitor and openly discuss financial stability risks, and carefully consider the costs and benefits of potential action.

- Capital flow management policies (CFM) can play a role in supporting macro policy adjustment and safeguarding financial system stability in certain circumstances, but they should not substitute for warranted macroeconomic adjustment.

Once shocks materialize, policies to mitigate the resulting economic stress include:

- Allowing flexible frameworks to absorb the shock. The exchange rate should continue to function as a shock absorber to the extent possible. Monetary policy settings should be adjusted in the context of the inflation objective and clear communication will be at a premium. FX intervention should be reserved for the case of disorderly market conditions. Fiscal policy should in most cases remain geared towards meetings its medium term objectives. Steps to support liquidity conditions and capital flow management measures can also play a temporary role as part of a broad policy response.

Measures that should be put in place now to improve prospects for adjustment after the shocks have materialized include:

- Strengthening ex-post debt restructuring frameworks. The efficiency of corporate and household debt restructuring depends largely on legal institutions such as insolvency regime and creditor rights. Adjusting these framework is typically complex and time-consuming and action where needed should be taken early-on.
- Considering growth enhancing structural reforms to enable robust economic recovery while deleveraging. The need for structural reforms to boost productivity growth and human capital appears to have increased against many headwinds.