SPECIAL FEATURE: Risk of Credit Boom in Asia

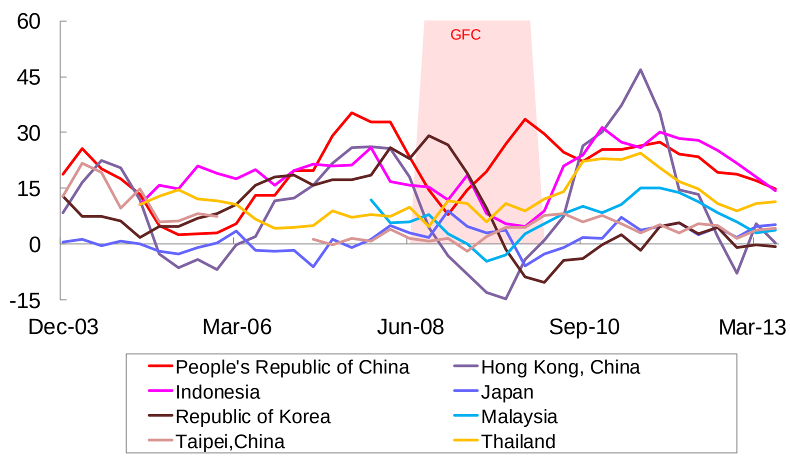
Widening interest rate differentials, strong growth fundamentals, and loose global monetary conditions have spurred a domestic credit boom in Asia. Over the past 6 months, credit growth in several Asian economies have growh over 10% (see page 12). Generally, rapid domestic credit growth heightens economic risk as it is often accompanied by more speculative investment, relaxation of credit controls, and deterioration in asset quality.

A lending boom can also increase risk if credit growth is driven by non-core liabilities, such as bank borrowings beyond retail, or household, deposits. This can happen when money is cheap, or when excess credit demand forces banks to rely on other non-core funding sources, which may include commercial deposits and foreign liabilities. More often than not, the rise in credit is also accompanied by rapid growth in risky assets (e.g. assets other than cash holdings, claims due from the government/ central bank, and other fixed assets).

A shift in the composition of assets and liabilities, particularly towards non-core components, indicate increased risk-taking by banks, which also encourages them to increase their leverage over the economic cycle. This trend is now evident in Asia, where individual country scatterplots of *level changes* of assets and liabilities show a greater slope for non-core liabilities and assets (between 0.52 and 1.02) versus core liabilities and assets (between 0 and 0.41). After the GFC, non-core liabilities appear to be growing faster than core liabilities in selected Asian economies, particularly in the emerging ones. The rapid growth can be explained by the fact that at present, the *size/level* of non-core liabilities in these economies continue to be small (e.g. low level-high growth), which places them at a less vulnerable position when compared to an economy exhibiting a high level-high growth pattern (such as in the case of the Republic of Korea.)

Nonetheless, this can eventually present new challenges to overall macro-prudential regulation in Asia. For example, any increasing reliance on non-core liabilities—if not carefully managed—can be a major source of vulnerability, particularly if the bulk of such liabilities come from foreign funding sources. Any sudden deleveraging can put Asian banks in precarious position, which can lead to a credit crunch. Likewise, increasing acquisition of risky assets by banks—driven partly by the abundance of cheap money—will also put a strain on their balance sheet positions.

Banks' Non-Core Liabilities (quarterly, y-o-y %)



GFC = Global Financial Crisis (Sep 2008–Dec 2009).
Note: Non-core liabilities refer to Total liabilities less retail/ household/ individual deposits.
Source: ADB calculations using data from CEIC.

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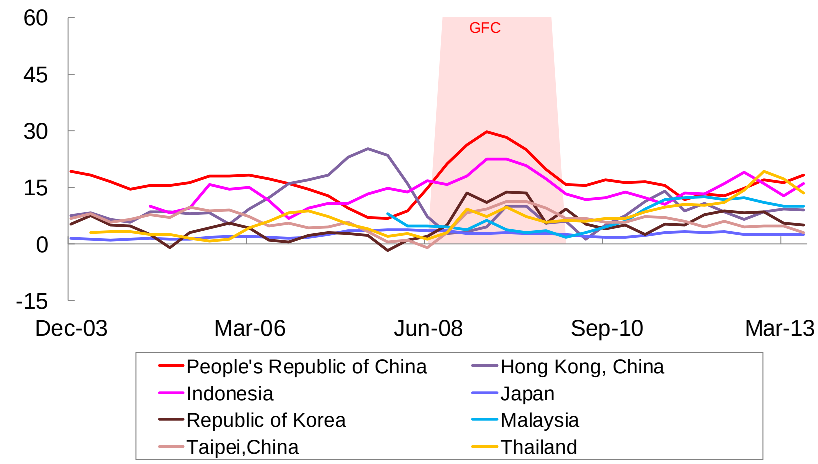

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