South-east Asian property market carries growing risks

Friday, February 21 2014

Since the first announcement in May 2013 by former US Federal Reserve (Fed) Chair Ben Bernanke that the Fed might scale back or 'taper' its asset purchase programme if economic conditions improved, the world's bond and stock markets plunged. According to EPFR Global, investors withdrew an estimated 25 billion dollars from emerging bond markets in addition to the 29 billion dollars of outflow in equity funds in summer months of 2013. In this context, the Fed's decision to wind down its monthly asset purchasing programme by 10 billion dollars to 75 billion dollars from January 2014 has become a serious concern across South-east Asia, particularly for its property market.

Prospective buyers look at a model of upcoming public housing estates at the Housing Development Board gallery in Singapore (Reuters/Edgar Su)

What next

South-east Asian banks will be tested as the eventual end of quantitative easing (QE) adversely affects local currencies, capital flows, financial asset prices, borrowing costs, and repayment capabilities of corporate and household borrowers. A rise in interest rates and cost of borrowing could prompt a surge in bad loans. This risk is particularly acute for property markets (rather than productive sectors) in such economies as Malaysia, Thailand and Singapore, where prices are at record levels, affordability is over-stretched, household debt stands at around 80% of GDP and debt service ratio is high.

Impact

- Indonesia, with its large current account deficit, is especially vulnerable to risks induced by capital flight.
- Countries with weakening economic fundamentals such as Thailand are particularly vulnerable to tapering.
- Loans from shadow banks may well be concealing the true extent of household indebtedness in South-east Asia.

Analysis

The financial and property markets in South-east Asia have been major beneficiaries of QE between November 2008 and 2013. Even though South-east Asia's growth has been stronger than in the United States and Europe, much of it is driven by a modest rebound in exports and strong growth in domestic consumption, which in turn has been fuelled by 'easy money' and cheap credit:

- QE has not only worsened income distribution, as the rich benefit most from financial asset inflation, but also led to misallocation of capital (see ASIA: Evidence of rising inequality poses challenge - July 26, 2013). Instead of being used to enhance productivity and productive investments, much of the liquidity went to stock and bond markets, property markets and debt-financed household consumption.
- Consequently, debt levels in South-east Asia have surpassed the pre-2007 crisis level, but are still below the pre-Asia financial crisis level. Bank credit as percentage of GDP is highest for Thailand (159%), followed by Malaysia (129%) and Singapore (94%).

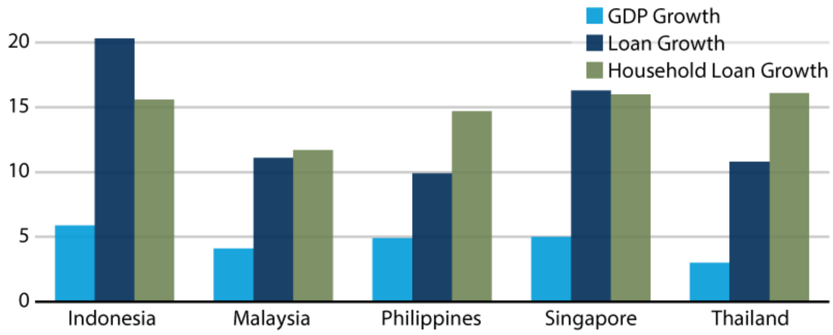
'Cheap money' has largely not been used for productivity improvements

Credit growth outpaces GDP growth

In the five major South-east Asian economies, credit growth outpaced economic growth by two to three times between 2009 and 2013, making them more vulnerable to economic and financial shocks:

- For example, average GDP growth in Indonesia between 2009 and 2013 stood at 5.9%, compared with loan growth of 20.3%.
- Whereas growth averaged 4.1% during the same period in Malaysia, loan growth reached 11.1%.

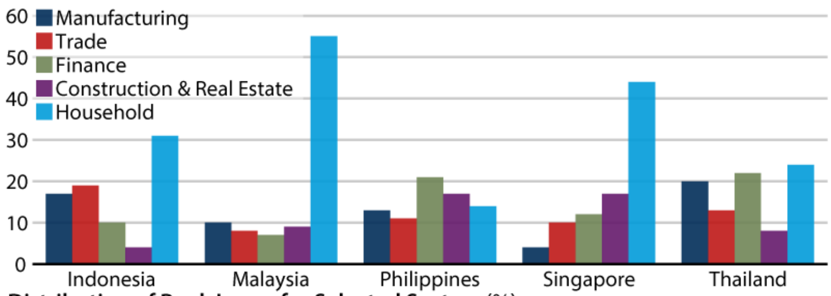
This means that these economies are more dependent on debt and that more credit is needed to generate every one percent of GDP growth.



Loan growth (%)
Source: Central banks of individual countries

Household loans

Between 2008 and 2012, in the five largest South-east Asian economies household loans constitute the largest category of bank credit. This is especially true for Malaysia, Thailand and Singapore, where household debt-to-GDP ratio has reached 83%, 80% and 77% respectively. Meanwhile, household incomes have not grown by as much, stretching household debt-servicing capability. Malaysia has the highest ratio of household debt to disposable income at 140%, with Singapore at 105%.



Distribution of Bank Loans for Selected Sectors (%)
Source: Central banks of individual countries

Productive sector resilience

The largest component within household loans is housing, followed by car and credit card. Together with loans to the construction and real estate sector, the exposure of banks to the property sector far outweighs that to the productive sectors such as manufacturing and trade. Hence, household and property sectors are more vulnerable to a credit crisis than the productive sectors.

Mortgage risk

Most household loans have gone to financing housing mortgages. Housing loans account for 48% of totals loans in Singapore and 27% in Malaysia (not including loans from shadow banks). In a period of low to negative interest rates, huge amounts of funds have flowed into the property markets, much of that amount borrowed:

- The housing market is no longer simply a market for end users, ie housing as a means of consumption. Housing has become primarily an asset class for investors and speculators. This has provided the momentum for double -- even triple -- digit escalation of house prices in certain markets.

- Housing affordability indices (the ratio of average house price to average annual household income) in many South-east Asian countries are highly stretched, some reaching double digits.

A rise in interest rates would hit borrowers badly as most housing mortgages are preconditioned on an adjustable rate. All these pose significant risks to the banking system and the economy.

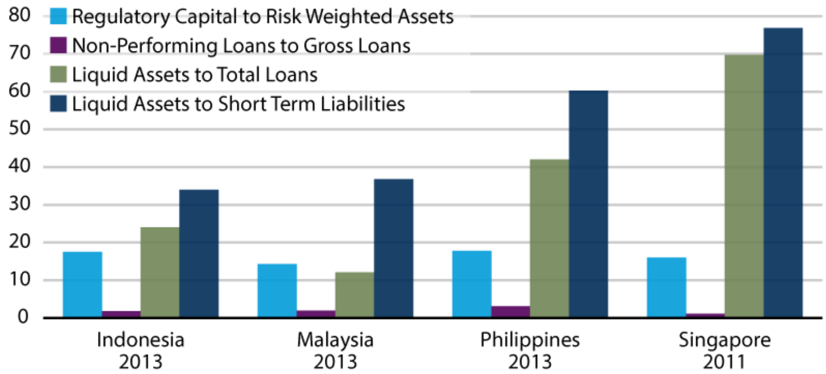
Bank resilience?

On traditional financial soundness indicators, banks in South-east Asia seem to be healthy. On average these banks are better capitalised than those in the United States and Europe:

- Regulatory capital to risk-weighted assets in South-east Asian banks stand at between 14-18%.

- Non-performing loans to total loans range from 1.1% to 3.1%.

- Liquid assets to total loans ratio range from 12.1% for Malaysia to 69.7% for Singapore.



Banking sector health in South-East Asia economies (%)
Source: Central banks of individual countries

However, most of these indicators are lagged indicators, particularly non-performing loans ratios.

Shadow banking risk

Another concern is the existence of the shadow banking or secondary banking sector. In countries such as Thailand, Indonesia and Malaysia, non-commercial banks and informal credit institutions account for significant amounts of extended credit. The disparity is evidenced by the differences in estimating household debt-to-GDP:

80%
Household debt to GDP in Thailand (including shadow banking loans)

- In Thailand the ratio of household loans extended by commercial banks to GDP is 26%, but HSBC estimates the ratio to be around 80%, presumably when loans from shadow banks are included.

- Similarly, in Malaysia bank loans to GDP is at 50% but including non-banks loans the ratio rises to 83%.

To the extent that the shadow bank loans are not well regulated or even captured in official data, financial risks are further heightened. (This risk is already acute in China (see CHINA: Default highlights dangers of shadow banking - February 12, 2014.)

Financial stability

Financial stability cannot not be defined mainly by the ability of banks to absorb financial and economic shocks. Rather, at the core of every banking and financial crisis lie two key concerns:

- whether growth of credit is sustainable in comparison to growth in other economic fundamentals such as income and productivity; and
- what proportion of credit is being used for productive investment, consumption and speculative investment.

These concerns underscore the significance of paying greater attention to over-extension of credit in the real economy and asset bubbles, particularly in the property sector (see SOUTH-EAST ASIA: Risk of asset bubbles is on the rise - April 4, 2013). More micro and macro prudential tools such as loan-to-value ratio and loan-to-income ratio are likely to prove more accurate indicators of financial health.