Asia's Economic Crisis: How Far Is Down?

If Asia 's governments fail to cure their sick banks, their economies' crisis – and its implications for the rest of the world – could grow much worse.

MEXICO'S economic distress of three years ago was widely dubbed "the first financial crisis of the 21st century" because of the speed with which the country's forced devaluation set back its economy and because of the repercussions for neighbouring Latin American markets. Although not yet with us, the 21st century has, by a similar definition, already claimed a second financial victim: East Asia . This week it was South Korea's turn to remind the world ofthe region's financial fragility, if any such reminder were needed. Speculation is rife that the country's economic difficulties will force it to follow Thailand and Indonesia, cap in hand, to the IMF's door.

South Korea has many woes in common with its beleaguered Asian neighbours. Its currency, the won, is under pressure. Like other countries in the region, South Korea is having to come to terms with an abrupt end to years of rapid economic growth. Like Thailand, in particular, it is having to weather a severe bout of political, as well as economic, turmoil. Most significantly of all, as events may prove, it is having to contend with a banking system that is rotten to the core.

As East Asia sputters, it is becoming clear that a decade of roaring economic growth concealed appallingly sloppy banking practices. Until now, against a background of strong regional growth, lending of dubious quality could be accommodated and disguised. But all the while the banks were growing increasingly vulnerable to an adverse turn of events-which is exactly what has happened in recent months.

On one estimate, the bad loans of East Asian banks now account for between lO% and 20% of their total loans, compared with a mere 1% in America (see chart 1), and that estimate may rise. The danger now, in South Korea and elsewhere in the region, is that a vicious circle of slowing growth, failing banks and contracting credit will cause not merely a brief and shallow recession but a deep and prolonged slump. The key to avoiding such a slump is prompt attention to the state of the region's banks. That may be a lot easier said than done.

<u>A home-grown crisis</u>

Most of the financial mess is of Asians' own making, and nowhere is this clearer than in South Korea. For years, the government has treated the banks as tools of state industrial policy, ordering them to make loans to uncreditworthy companies and industries. This has backfired. In recent months several of the country's biggest companies, including Hanbo, a steel group, and Kia, a car manufacturer, have gone bankrupt, leaving banks with enormous bad debts. Official figures put these bad loans at the end of June at only 6.1% of total loans outstanding. But Merrill Lynch, an American investment bank, reckons that, if international provisioning norms were applied, the figure would be more than 15%.

Each new corporate collapse gnaws at the banks' dwindling finances. Raising interest rates to defend the won will add to the banks' agony. At the nine largest institutions, bad loans already range from 94% to 376% of the banks' capital. Most of these banks, in other words, are already technically insolvent. On November 8th the central bank pumped 5 trillion won ($5.1 billion) into the financial system to shore it up. More cash may soon be needed.

South Korea's problems are affecting Hong Kong. Anticipating a renewed assault on the Hong Kong dollar, after that on the won, investors have already claimed a victim among Hong Kong's banks. On November 10th, and again the following day, depositors rushed to withdraw a total of HK$1.5 billion ($194m) from the International Bank of Asia, a middling institution, forcing regulators to say they would support it if necessary. The danger is that a run on one bank could quickly trigger a loss of confidence in others. It is this "contagion effect" that worries the IMF and rich-country governments, battling to avoid a financial meltdown across the region.

Bailing out East Asia 's banks, it must be made clear, will be neither easy nor cheap. Robert Zielinski of Jardine Fleming, an investment bank, estimates that the non-performing loans of South-East Asian banks alone will peak at $73 billion. That may not be vast in absolute terms when compared with, say, Japan's bad-loan problem. But it represents over 13% of South-East Asian GDP, a gulp-making figure. By comparison, America's savings-andloans crisis cost only about 2-3% of GDP to resolve. Mexico's banking crisis cost about 10-12%. No wonder the Asia region's bank shares have turnbled since last year (see chart 2).

How did East Asian banks get in such a state? The answer is that too many of them committed the same basic sins.

First, they took stable exchange rates for granted, failing to consider-and thus guard against-the possibility of currency devaluation. So bankers assumed they would forever be able to make an easy baht or rupiah by borrowing in dollars to buy local-currency assets. Now, however, borrowers are repaying loans in plummeting local currencies, making the banks dig into their own pockets to meet their dollar liabilities. According to the Bank for International Settlements, at the end of 1996 foreign-currency debt with a maturity of less than two years was equal to about 120% of foreign-exchange reserves in Thailand and nearly 200% of reserves in both Indonesia and Korea. The figures have almost certainly risen further since then.

The bankers' second error was to lend recklessly on property. Convinced that demand for offices, hotels and luxury homes would continue to soar, they threw money at grandiose construction projects. But overcapacity has caused rents and prices to fall sharply in many Asian cities. That, in turn, has squeezed some of the biggest banks, which now typically have between 10% and 35% of their loans committed to bricks and mortar. Political meddling made matters worse. Often, to curry favour, financial institutions have financed politicians' pet projects and allies. Some, especially in Thailand and Indonesia, have been little better than political piggy-banks.

But perhaps the most important error was caused by a mixture of hubris and inexperience. Convinced that rapid economic growth would forever rescue them from bad lending judgments, bankers failed to examine the financial risks they were undertaking: a lunch or a round of golf would do more to inform their credit decisions than spreadsheets of financial data. This "Asian way" of vetting borrowers has proved costly indeed.

It is not only bankers who are to blame. With a few praiseworthy exceptions, such as Hong Kong and Singapore, regulators have failed to check bankers' bad habits. Consider Thailand, which received a $17.2 billion bail-out from the IMF in August. For the past year, the country has provided an object lesson in how not to deal with a banking system in distress. Fora long time, the government and regulators turned a blind eye to growing evidence that lending to a property bubble had contributed to a dangerous level of bad debts. In 1996, one ofthe country's 15 commercial banks, Bangkok Bank of Commerce, went bust. The government rescued it The bank had lent large sums to corrupt politicians, provoking accusations of a stitch- up between the institution and its supervisors.

Thailand's central bank has also blessed the banking sector with lenient disclosure rules. Until recently, these allowed banks to regard a secured loan as "performing" even if no interest had been paid for a year. As the property glut grew worse, the value of assets held as security by lenders became a matter of guesswork. Earlier this year the government had to suspend 58 finance companies, or specialist lenders. But it has not yet suspended any of the country's commercial banks. That may have to change as more loans turn sour. The central bank is said to be spending 1oo billion baht ($2.6 billion) a month to keep the financial system going. Taxpayers' total exposure to insolvent banks may have reached 750-800 billion baht, equal to a sixth of GDP.

Lax supervision has hobbled Indonesia, too. Thanks to deregulation in the past few years, the number of commercial banks exploded. But the country's central bank failed to step up its monitoring of the risks involved. Last year Moody's, a credit-rating agency, gave warning of a "post-liberalisation frenzy". The closure last week of a number of banks is a sign that the country's regulators may at last be bolting the stable door.

Latin lessons

The cost of bailing out distressed banks has been upwards of $250 billion in emerging markets since1980, but the problem has by no means been limited to the developing countries. Over the past decade, America, Britain, Japan and a number of other rich countries have all fallen victim, to a greater or lesser extent, to economic instability generated and then amplified by the banks. Let East Asian policymakers wondering what to do about their troubled financial sectors examine these earlier experiences.

The best source of advice may well be those who witnessed Latin America's banking crisis of 1994-95. This had many features similar to those at work in Asia today: economies leveraged to the hit with shortterm, foreign debt; meddlesome politicians; currency devaluations; flighty foreign portfolio investors; imprudent and inexperienced banks; and, to cap it all, regional contagion. As Mexico's bad loans ballooned to a quarter of all loans outstanding, the illness spread to Argentina, where panicky bank customers withdrew 40% of their deposits in early 1995.

The cost of clearing up that mess was huge. In Mexico alone, the final bill for repairing the financial system is likely to top $30 billion. This would have been impossible to meet without an enormous rescue package from America and the IMF. Still Latin American governments deserve credit for introducing a series of measures that have put their banks on a sounder footing and helped to shorten the road to economic recovery. The lessons are:

• **Open banking to foreigners.** Since the crisis, foreign banks have poured into the region, lured by bank privatisations and a relaxation of ownership rules. The newcomers have brought capital, state-of-theart technology and high standards of credit-assessment and service, which the remaining local banks have to emulate in order to remain competitive. Over a fifth of Mexico's banking system is now in foreign hands. By contrast, Asia's banking markets are still highly protected (see chart 3).

• **Encourage consolidation.** Latin governments moved quickly, admittedly under international pressure, to close the worst banks. But they had to strike a balance, as too many closures risked undermining confidence rather than restoring it. The solution was to raise banks' capital requirements-and, above all, to enforce themthus leaving cash-strapped institutions no alternative but to merge with rivals or die.

Since 1995, over a quarter of Argentina's zoo banks have been swallowed by competitors, strengthening the system's resistance to shocks. Asian governments have been loth to shut banks down for good. Some have tentatively encouraged mergers, but have then usually given in to opposition from the bank owners, who guard their independence jealously.

• **Tighten supervision and regulation.** In Chile, for instance, a hands-on approach to policing bankshas turned the financial sector from a basket case into a model of strength. The central bankvisits banks regularly and classifies them according to how responsibly it thinks they are grading their loans; it then publishes its findings. Banks are made to classify their loans according not just to borrowers' past behaviour but also to their future prospects. Sometimes they are required to build reserves against loans that are not yet in default but look like becoming shaky.

Some governments have completely overhauled the regulators' duties. Argentina has developed a new approach to supervision which shares the burden of overseeing banks between the state and the market. The central bank monitors banks' auditors, as well as the banks themselves. Banks are made to issue bonds linked to the value of their deposits-the idea being that the price of the bonds indicates how strong the market considers the banks. In addition, Argentina's central bank has imposed capital-adequacy rules that are tougher than international norms in order to compensate for unforeseen volatility. That could be very useful in Asia .

• **Improve accounting and disclosure.** Latin regulators have learned that crisis hits harder when banks have been able to hide their problems behind misleading numbers. Mexico has made its banks adopt accounting standards based on America's. Argentina has also brought in tougher rules, including one that requires banks to set aside higher reserves for loans with high interest rates (ie, those that are deemed riskier). Contrast this with, say, South Korea, where banks do not even have to disclose, let alone make provisions against, all of their suspect loans.

• **Cut links between bankers and politics.** In Mexico, Chile and Argentina this has been achieved by putting banks in the hands of professionals, and enforcing anticorruption laws more rigorously. The problem persists in Brazil, however, where publicly owned regional banks are still abused by local governments.

Now, thanks in part to all this, Latin America is getting back on its feet. Even so, nothing can be taken for granted. On November loth the Brazilian government announced a package of tax increases and spending cuts worth ao billion reals ($18 billion), in the hope of restoring confidence in the economy. Interest rates have doubled to see off speculators who have attacked the currency. If rates have to stay high for very long, the efforts of Brazilian banks to get to grips with their bad-loan problems could come to nothing.

<u>Imitation isn't always easy</u>

Will East Asia apply these lessons? In some respects, the region faces an easier task than Latin America did a couple of years ago. Some countries may be running worryingly high current-account deficits, but economic growth is still higher and inflation far lower than in Latin America as the banking crisis there built up. East Asia 's banks will continue to benefit from the region's high savings rate, which allows them to fund themselves cheaply. In short, there is still much underlying strength.

Moreover, because much of their business is cartelised, East Asia 's banks are profitable by nature. If they are made to bite the bullet swiftly, they can write off most of their bad loans, using their cash flow (profits plus taxes and provisions) this year and next. That would rattle shareholders, but at least it would give banks a chance of cleaning up their portfolios by the turn of the century, lessening the longer-term impact on the region's economies.

In one important respect, however, Asia 's illness is harder to treat than Latin America's was. Latin America had a robust United States to act both as purchaser and benefactor-buying the region's exports once its currencies had depreciated, and speeding financial assistance by direct and indirect means. This is the role that Japan might have played in South-East Asia . But it cannot. Far from being the answer, Japan is part of the region's current problems. Its economy is too weak to act as a regional locomotive-and a principal reason for that is that its own banks have the same lingering sickness, too long left unattended, that can now be seen to afflict the rest of the region. In the scariest vicious-circle scenarios for Asia, Japan plays a central role.

If Latin America teaches how to deal with a banking crisis ,Japan shows how not to. Its method has been: do little but dissemble in the hope that the problem goes away. The Japanese government has dealt with its post-bubble banking crisis by lying about banks' financial condition in order to prevent runs on deposits, by letting banks use tax credits to write down loans, and by keeping interest rates at next to nothing (thereby allowing banks to borrow short-term money cheaply and invest it in higher-yielding government bonds). The underlying problem remains huge: despite enormous write-offs, banks still have bad loans of at least Y19 trillion ($151 billion). The Latin American prescription for banking-industry reform applies just as much to Japan as to Thailand and Indonesia.

Will the region's politicians support the needed reforms? Signs of resolve in Thailand, Malaysia and Indonesia-where rules on lending have been tightened-are mildly cheering. The international bailouts already agreed upon for Thailand and Indonesia have some tough conditions attached. However, it is unclear whether South-East Asian governments can summon up the will to stick to them. Japan's government continues to prevaricate.

The alternative to reform is horrible; yet it is all too plausible to suppose that the region's regulators and politicians will choose it by default. In Thailand, there are persistent rumours that the government may return to the IMF for more money, to soften the pain for the country's banks. In Malaysia, the government is still denying that its banking system has problems.

Right now the key country is South Korea. If the government adopts no Latin American remedies for its banks, the won is likely to fall even further. This will trigger new tremors in Hong Kong, and thus drag China, albeit indirectly, into the current mess. Worse, it will aggravate the plight of Japan. Korean exporters target many of the same markets as their Japanese counterparts, so a falling won could be bad news for Japan's ailing economy.

Most of the world's commentators still think that Asia 's economic crisis will cause a mere slowing of grow th in the region rather than something worse. By Asian standards, a slowdown would seem bad enough, so accustomed have people become to better things. But a much worse outcome-bad enough to have a serious effect on the world economy-should not be ruled out. An accelerating spiral of economic distress, with the banks as always playing the pivotal role, extending beyond South-East Asia to draw in South Korea, China and Japan, is entirely possible. If the region's governments act wisely and swiftly, it can be avoided. Will they?
