Credit Crisis, Asian Style

BY CHI LO

A top Hong Kong analyst sets the stage.

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The 2007–08 subprime crisis has more than a few similarities with the 1997–98 Asian crisis when it comes to causes and symptoms. But do not expect the western world to stage a fast recovery as Asia did from the regional crisis ten years ago. The subprime crisis is a man-made crisis, not a black swan event. To correct their mistakes in the coming years, regulators in the developed world will try to re-regulate banks. The danger of the subprime crisis to Asia is that it may send a wrong signal to the region, especially to China, and deter financial liberalization and innovation.

As the post-subprime crisis adjustment will be about asset deflation and de-leveraging, which will last for years, medium-term global growth will experience a structural downward shift, unless the developing world raises consumption sharply. The drop in developed world consumption will put an end to the emerging markets' export-led development model, crimping growth in Asia's export-led economies in the coming years.

IT'S NOT A BLACK SWAN

Some analysts argue that the subprime crisis is a "black swan" event. The term "black swan" comes from the ancient western concept that all swans are white. In that context, a black swan was a metaphor for something that could not exist. Ever since black swans were discovered in Australia in the seven-

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teenth century, the term "black swan" has been used to connote the actual happening of a highly unlikely event with unprecedented and devastating effects. But the subprime crisis itself is not a black swan, though the resultant credit crunch and confidence crisis may qualify. This is because all the events and factors leading up to the current crisis were known.

From a macro perspective, the Asian crisis and the subprime debacle have similarities in their causes and symptoms—namely a prolonged period of low interest rates leading to moral hazard, imprudent lending, regulatory oversight, excessive investment, and asset bubbles. But the advent of financial derivatives has made the subprime crisis more complicated.

The U.S. current account deficit ballooned to above the crisis threshold of 5 percent of GDP before the subprime crisis broke, just as in Asia before the 1997–98 financial crisis. Notably, Thailand, where the Asian crisis started, had a current account deficit of over 8 percent of GDP prior to the crisis; the United States had a current account deficit of 6 percent in the year before the subprime crisis!

Americans have gone on a debt-financed spending spree for over a decade, pushing the loan-to-deposit ratio in the banking system to over 100 percent. Everything from personal consumption to financial investment has been funded by debt. The blow-out in the U.S. loan-to-deposit ratio resembles vividly the situation in Asia prior to the regional crisis. Asia financed its excessive spending by foreign borrowing, as have the Americans. Foreign debts in both America and the three Asia crisis countries that needed International Monetary Fund bailouts (Korea, Thailand, and Indonesia) all soared before their respective crises.

However, nearly all of America's foreign liabilities are denominated in U.S. dollars, due mainly to the dollar's reserve currency and international trade status. Moreover, the U.S. government still enjoys strong international confidence in its debt servicing and repayment ability. Hence, the United States has not suffered a sudden seizure of capital inflow, and there has not been a dollar crisis. This is quite different from the Asian crisis when massive capital outflow caused a regional currency crisis alongside the financial crisis.

THE ASIAN CONNECTION

When one considers Asia's role in the U.S. financial crisis, it is certainly not a black swan. First, shiploads of cheap goods from Asia, notably China, helped keep U.S. inflation down. This prompted the Americans, and the U.S. Federal Reserve, to think that they could spend lavishly without igniting inflation at the same time.

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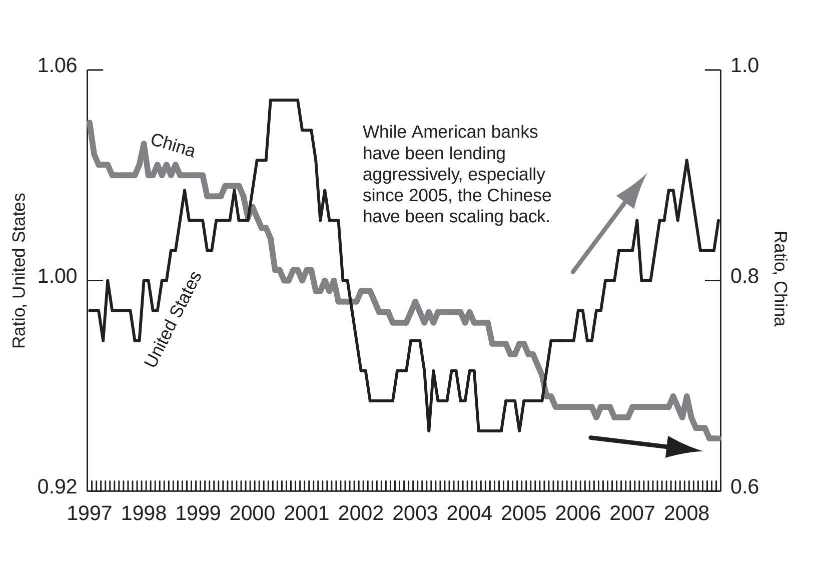
Second, Asian central banks' holdings of over $4.3 trillion in foreign reserves, combined with billions of petrodollars from the Middle East, provided the United States with enormous liquidity. This was mostly poured into U.S. Treasury and mortgage-backed securities, suppressing U.S. bond yields, inflating the housing bubble, and encouraging excessive U.S. household borrowing to fund consumption.

Asia's high savings also created ample liquidity and cheap credit for enhancing the leveraging power of western banks and speculators, thus fueling global asset bubbles. Through carry trades, these international players borrowed at low Asian—especially Japanese—interest rates and swapped the proceeds into high-yield currencies and markets.

In a nutshell, frugal Asians, with the Chinese and Japanese accounting for over 40 percent of the world's central bank reserves, have lived below their means with savings flowing westwards to allow the spendthrift Americans to live beyond their means. While it lasted, this cross-Atlantic saving-spending mischief became a stable disequilibrium, enabling Asia to supercharge growth by lending to America so that it could buy Asian exports. Now that the party is over, Asia will suffer too as the financial excess implodes.

Loan-to-Deposit Ratios



Sources: CEIC, PAAMC (HK).

THE END GAME

The deepening of the U.S. subprime crisis, despite the Fed's repeated massive liquidity injections, shows that the markets have failed to clear on their own and the global financial system has stalled. There are two routes to the end game—either a global financial meltdown or a full-scale government bailout. History and the recent government actions suggest the latter.

Going forward, forced consolidation will speed up with bank failures in the United States. Declining bank credit and bank retrenchment are going to hurt economic growth further. This is because bank credit goes to support real corporate and consumer spending, while non-bank credit (by those investment banks) goes to finance portfolio investment and does not affect real spending directly. The situation in Europe is worse, due to the European Central Bank's inflexible monetary policy, until late in October 2008. Property prices in many European countries will keep falling before they can stabilize late in 2009. The yield curves in both the United Kingdom and eurozone are inverted, suggesting economic recession ahead.

While Asian growth experienced a V-shape rebound a year after the Asian crisis, thanks to its young and vibrant economic structure and a quick return of confidence, don't bet the same on Europe and the United States. Even if the global concerted reflation and bailout efforts manage to stabilize confidence in the global financial system, history shows that the post-bubble adjustment in developed economies would take a long time.

After the Resolution Trust Corporation was set up in 1989, it took almost a year for U.S. stocks to reach bottom, and two years for credit and economic conditions to normalize. In its 1992 financial crisis, the Swedish government also enforced a wholesale government bailout to guarantee all bank liabilities and recapitalize the banks, but the Swedish stock market and economy still took more than two years to recover. Japan was even worse, as the set-up of the Financial Supervisory Agency in 1997 to clean up bank balance sheets did not help the economy recover until five years later; and some are still wondering if the economy ever did manage a true recovery.

The post-subprime crisis adjustment will be about asset deflation and de-leveraging, especially in the finance and household sectors. This type of adjustment will last for years because it takes a long time for the financial sector to rebuild capital. The subprime crisis is a man-made crisis, not a black swan event. To right their mistakes in the coming years, regulators will not let banks securitize lending and shift it off their balance sheets to create new lending capacity easily. The developed world's banking sector will become slimmer, less risky and less profitable. Money markets will also be smaller and dearer so that banks will have to rely more on traditional funding sources for deposits. A plain vanilla banking model of simple lending and borrowing will return, and fancy derivatives will be gone.

Spendthrift debt-financed U.S. consumers will have to retrench also; the U.S. current account deficit will need to

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continue to shrink to rebalance global saving and investment habits. Thrift will replace leverage throughout the developed world. The huge bailout costs also mean taxes across Europe and America will rise in the coming years, further crimping consumption power.

CHINA, AN ISLAND IN THE STORM

Market information shows that the Chinese banks have limited exposure to the U.S. subprime crisis. Weighted average exposure of the seven largest Chinese commercial banks (Industrial and Commercial Bank of China, Bank of China, China Construction Bank, China Merchant Bank, Industrial Bank, Citic Bank and Bank of Communications) to Lehman's default amounts to only 0.02 percent their total assets. Even if we include the U.S. government mortgage agency debts, the Chinese banks' exposure to the total subprime assets amounts to only 0.5 percent of their total assets. From a macro perspective, Chinese banks have been reducing their foreign asset holdings in recent years, suggesting that they had been cutting foreign risk exposure well before the subprime crisis.

China's banking system has been seen as the Achilles' heel of its economy due to poor asset quality, lack of market discipline, and an opaque operation model. The banking industry is still heavily regulated, risk control systems are still defective, and policy intervention still distorts the price of credit. So much improvement is still needed. But one cannot deny that things have changed for the better in recent years. The government's recapitalization efforts have worked with its public listing and foreign ownership strategies to improve the banking fundamentals. This is seen in the steady decline in the Chinese banks' non-performing loans and increase in their capital-asset ratios.

Ironically, Chinese banks look more solid than their western counterparts on the back of the U.S. subprime crisis. While the U.S. banks have been lending aggressively and imprudently over the past decade, causing the banking system's loan-to-deposit ratio to explode, the Chinese banks have been scaling back lending activity. The fall in the Chinese loan-to-deposit ratio reflects both Beijing's credit control to rein in runaway growth in recent years and improvement in risk control among the Chinese banks. For example, in the mortgage loan business, the minimum down payment is 30 percent and the average mortgage loan life is less than twenty years. These are much more stringent than the conditions in many developed markets. Rising competition among banks, public listings, and foreign ownership have also brought in some market discipline to the Chinese banking sector.

From a systemic risk perspective, the Chinese banks are by default safer than their western counterparts because of government ownership, heavy regulations, and their un-sophistication that bar them from getting involved in the highly leveraged investments and product development. China's closed capital account also helps minimize volatile capital flows. Hence, there is no counterparty risk, no confidence crisis, and no disruption of credit flow in the Chinese banking system as there is in the developed world.

IMPACT ON ASIA

Despite China's relative stability and its increasing importance in global demand, a western-world recession seems inevitable as part of the post-crisis adjustment. As a result, global growth will experience a structural downward shift in the coming years, unless the developing world raises consumption sharply. This looks unlikely in the short-term.

The drop in consumption in the developed world will put an end to the emerging markets' export-led development model that had supercharged their growth for over a decade, because external demand will be weak going forward. This also means that growth in the export-led economies will be constrained for many years to come.

From a policy perspective, the danger of the subprime crisis and the subsequent re-regulation of the global banks is that they may send a wrong signal to China and other Asian countries that financial innovation is bad and government control is good, as the restrictive Chinese model seems to have shown. This will be extremely unfortunate if it delays or even deters further financial liberalization in the developing world. Emerging market regulators should take the subprime crisis lesson seriously, and improve their regulatory systems but not shy away from financial liberalization and innovation. ◆