Asian Banks in Trouble*

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Emerging Asia, analysts argue, is all wrapped up in debt. For some time now they have warned about the dangers involved in the rising volume of private debt—both corporate and household—in Asia, as a result of a reversal of the tendency to reduce debt and repair balance sheets that began immediately after the Southeast Asian crisis in 1997. Stated otherwise, the effects on Asian debt of the 1997 and 2008 crises, or the one that primarily affected a few countries in the Asia-Pacific region and the other that affected the centres of developed capitalism, have been very different. While the former was followed by debt reduction, the latter the 2014 issue of the IMF's Regional Outlook notes, was followed by a rise in corporate leverage in emerging Asia, which "may represent a 'fault line'."

While there have been multiple sources from which this debt was incurred, bank credit remained the dominant and important source. Consider, therefore, the ratio of domestic bank credit to the private sector (BCPS) to GDP across the main emerging market economies (EMEs) in the region, viz., China, India, Indonesia, Korea, Malaysia, Singapore, and Thailand. In terms of a point of time picture, in 2013, Indonesia and India recorded relatively lower bank credit to GDP ratios of 34 and 53 per cent respectively, while the others had notched up ratios that stood well above 100 per cent (varying from 121 per cent in Thailand to 140 per cent in China, with the rest distributed in between).

These substantial differences in the level of exposure are also accompanied by differences in trends over time in the ratio of BCPS to GDP. Indonesia is again an outlier with its lower absolute ratio being accompanied by relatively moderate increases in that ratio, of around 30 per cent during both 2000-07 (before the global crisis) and 2008-2013. The remaining countries fall into two categories. On the one hand, India and South Korea saw relatively large increases in credit to the private sector during 2000 to 2007 of 61 and 87 per cent respectively, followed by either a low increase (7 per cent in the case of India) or a fall (of 9 per cent for Korea) during 2008-2013. On the other hand, Thailand, Malaysia, Singapore and China recorded a fall in the ratio in the first period, followed by a significant increase in the second. In sum, if a generalised statement is to be made for the period since 2000 it would be that except for Indonesia that has been an outlier, the rest have been characterised by relatively high levels of bank credit outstanding and by much volatility, with periods of bank credit expansion giving way to periods of moderation or contraction or vice versa.

When seeking to understand these trends it may be useful to keep three features of the region in mind. First, all emerging markets in the region have been liberalising regulations governing their financial sectors and easing monetary policy, both of which have increased the flexibility of the banking sector when making lending decisions. This provided the basis for an important commonality across the region: expansion-contraction or even boom-bust cycles in credit provision, which all of these countries (except Indonesia) have experienced to differing degrees. An over-enthusiastic banking sector is forced to correct either because of balance sheet stress. Second, liberalisation came earlier to Southeast Asia, which then experienced the financial crisis in 1997 that left China and India relatively unaffected. So India's credit boom and China's moderation during the first period require explanations that are independent of the last major crisis that affected the Asian region. Third, in the aftermath of the 1997 crisis Southeast Asian countries adjusted differently in terms of both the restructuring of the banking sector and the regulation of capital flows, leading to the variations in experience that are observed.

Indonesian exceptionalism since 2000, reflected in the low level and the gradual growth of bank lending to the private sector, is explained largely by the damage suffered by its banking industry during the crisis, which necessitated huge loan write-offs and recapitalisation. Indonesia was hardest hit by the late 1990s crisis because of the dramatic expansion of banking and bank lending during the 1990s. This was the result of a series of liberalisation measures adopted since the early 1990s, starting with the removal of interest rate and credit ceilings and leading up to the comprehensive "reform" of 1998 when private bank entry and branching were liberalised. Together with liberalised lending norms, this led to a sharp increase in bank credit to the private sector, from 47 per cent of GDP in 1990 (which is well above today's level) to 61 per cent in 1997, just before the crisis. Sectorally, increased lending was directed to the commercial real estate and retail segments including lending for consumption and speculative investment in the property market. Lending to the property sector rose from 6 per cent of GDP in 1993 to 16 per cent in 1996. Not surprisingly, when crisis hit the region, banks in Indonesia were badly affected, necessitating a change in banking practices that explains Indonesia's exceptional experience of both the level relative to GDP and the growth of that ratio after 2000 when compared to other emerging markets in the region. In sum, Indonesia experienced earlier what other EMEs in Asia have been troubled by more recently.

The adverse impact of the crisis was visible in Thailand as well where the private sector credit to GDP ratio, which peaked at 165.7 per cent in 1997, fell sharply to 96.9 per cent by 2001 and remained close to that level for a decade. It is only in 2012 and 2013 that the ratio has registered a sharp rise to 121 per cent, generating once again fears of a bust. In the case of South Korea, on the other hand, lending continued to rise quite significantly after 1997, with the private credit to GDP ratio increasing from 55 per cent in 1997 to a peak of 148 per cent in 2008, only to decline to 135 per cent in 2013. Banks here have implicitly served or were used as countercyclical instruments. But now, fears of a household debt crisis have been expressed over the last couple of years, forcing banks to restructure household debt at the instance of the government.

China and India have not as yet taken a hit of the kind the Southeast Asian countries did in 1997, though they too have been liberalising their financial sectors. But they have been registering rapid increases in their private credit to GDP ratios over different periods since 2000. China leads in terms of the level of the ratio of credit to GDP and has registered a continuous increase in the same except, interestingly, during 2003 to 2008 when the ratio fell, precisely during the years when it rose in India.

However, bank credit to the private sector has exploded since the global financial crisis, as part of the government's stimulus effort. This has led to growing concerns about the state of the banking system because of its exposure to the housing market bubble and to Local Government Financing Vehicles that have borrowed to invest in huge projects without the appropriate revenue model to meet the interest and amortisation commitments involved.

As for India, though the level of its BCPS ratio is much lower than in other Asian emerging markets (except Indonesia), it too experienced a sharp increase in the ratio during the high growth period between 2003 and 2008. As a result, signs of stress in bank balance sheets and fears of increased default and speculative bubbles in property and other markets now pervade discussion in these two countries as well.

Overall, therefore, while there are significant differences in the volume and growth of bank exposure to the private sector across Asian emerging markets, they are all confronted with signs of bank fragility due to overexposure to a few markets such as the retail sector (especially housing), to real estate and capital intensive projects in infrastructure and industry. In all these countries, therefore, debt is now a source of much concern, as the projects financed have not been faring well.

This impact of liberalisation on domestic credit is in most cases combined with the fragility generated by the excess exposure to external debt of the private sector. The September 2014 issue of the Quarterly Review from the Bank of International Settlements (BIS) argued that from the supply side the absence of adequate yields in developed country markets had resulted in enhanced financial (especially debt) flows to emerging markets, including those in Asia. The flip side was that corporations in these countries were overexposed to foreign currency debt and therefore to currency risks. The share of Asian emerging markets in international bank claims on all emerging markets rose from 30.4 per cent in Q4 of 2008 to 52.5 per cent in Q2 of 2014. External exposure of this kind implies that a depreciation of the currency in any of these countries can result in stressed corporate balance sheets. And since domestic banks have also lent heavily to these corporations, any balance sheet pressure on corporations could also affect banks adversely. These feedback loops can give the problem a systemic dimension.

This raises the question as to why countries stick with elements of liberalisation that encourage or induce the banking sector to sharply increase their credit provision over short periods to an extent that increases the volume of stressed assets and generates bank fragility. The principal reason seems to be that with governments increasingly adopting a more conservative fiscal stance and emphasising so-called "fiscal consolidation", credit financed, private consumption and investment have become crucial to sustaining demand and delivering growth. Among a host of ideological and other factors that explain the persistence with financial liberalisation despite the fragility fall-out is the fact that along a neoliberal trajectory there is a trade-off between growth and fragility and countries thus far have chosen growth and ignored fragility. That may not be possible for long.

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