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Perspectives on the Impact of the Financial Crisis in Asia

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Since September of this year, the global financial crisis has grown in severity and extended dramatically into Asia, impacting equity markets, financial systems, and the real economy. What does this all mean and what should companies and financial institutions do?

As is painfully obvious, Asia is not immune to the threat. For instance, in Korea, where banks are particularly vulnerable, the government recently announced a ~$100 billion bank-rescue package. In Indonesia, authorities halted stock-market trading on October 8 as a result of large declines. Even in China, where the economy is often cited as the silver lining for the world's problems, trouble seems to be brewing. Economic growth slipped to 9 percent in the third-quarter–which is still healthy, but sharply down from 10.1 percent in the first quarter and below the forecast of about 9.7 percent. Subsequent to the release of these figures, the Chinese government announced a number of fiscal policy steps to boost the slowing economy.

Although Asia's banks took on relatively small amounts of the toxic assets that have accounted for US$ 660 billion to date and mounting write-downs in western banks, the region has quickly begun to feel the effects of the global slowdown. Asian equity markets have dropped even more than European and US markets (50 percent plus from peak valuations). Prices of default insurance protection for Asian debt securities have spiked and interbank lending has dried up in a few Asian countries. Growth in many countries, especially those most dependent on exports to the US and Europe, has slowed sharply.

As a starting point, Asia is well positioned to weather the financial crisis given fundamental strengths in the macroeconomy and financial sector. However, it will be impacted by the decline in exports to the US and Europe, tightening of credit, particularly from foreign currency loans from western banks, and a wealth effect impact on consumption. Therefore, we expect to see growth continue in Asia, but slowdown significantly.

Scope for government action is extensive. Asian governments (outside of Japan and India) are, for the most part, not mired in domestic debt and are well positioned to stimulate growth fiscally, and for several countries through monetary policy as well. These policies could mean that Asian economies will become more inward oriented, following a policy that tries to spur domestic growth over the near term.

Companies and financial institutions will need to take active steps to manage the downturn, particularly the near-term issues of credit and liquidity. However, more aggressive cash-rich players may also be able to seize new opportunities.

ASIA'S POSITION

In general, Asia is well positioned to weather the crisis due to the strong macro and financial conditions prevailing in most countries.

Macroeconomic position

Asia has been the fastest growing region in the world for at least a decade. Its GDP grew at 4.1 percent CAGR from 2000-2007 compared to 3.1 percent globally. Its growth model is largely investment driven and its savings is very high (national savings is 33 percent of GDP in the region compared to 12 percent in the US). Trade has been a big factor over this period with net exports contributing 23 percent of the growth. More recently we have begun to see increased growth in consumption, especially in the larger countries such as China (where consumption grew at 7.5 percent CAGR between 2005 and 2008, compared to 6.9 percent from 2000 to 2005).

Based on a large export sector, most Asian countries are now showing large current account surpluses and have amassed large forex reserves. This is in stark contrast to the 1997 Asian financial crisis where most Asian countries had current account deficits, which made them vulnerable to a reversal of short-term capital flows. Currently, emerging Asia's current account surplus is approximately 6 percent of GDP, whereas in 1997 the region was running a deficit of about 1 percent of GDP. forex reserves are now 1.9 times external short-term debt in the region, compared to less than one times in 1997, creating a strong cushion against capital outflows.

Although the region's macro picture is strong there are a few noteworthy exceptions. Korea is currently the most vulnerable from a macro standpoint. The country's private sector has increased its debt, with credit to GDP going from 80 percent of GDP in 1998 to about 110 percent in 2008. The economy is also particularly exposed to exports with net exports contributing about 13 percent of GDP. Investor sentiment has recently turned sharply against Korea leading to rapid capital flight and more than a 30 percent devaluation of the currency.

India is also vulnerable due to its dependence on foreign financing (current account deficit of about -4 percent of GDP). Additionally, the Indian authorities are in a weak position to implement expansionary fiscal policy due to the country's already high fiscal deficit (-3 percent of GDP) and high inflation (9 percent) gives it muted ability to expand monetarily. A number of the ASEAN countries are also facing high inflation (11.9 percent for Philippines in September and 11.9 percent for Indonesia in August).

Financial position

Financial systems are by and large healthy. Although many countries have experienced robust loan growth, in most countries this growth has been in line with GDP. Also, Asian financial systems tend to be bank dominated, without the presence of a large and unregulated number of financial entities that helped create so much leverage in the west. Furthermore, many countries in Asia have gone through domestic credit crises and bank restructuring since the 1997-'98 Asian Financial Crisis, which led to a number of banking sector reforms. For example, Japanese banks were required to rebuild their balance sheets, leading to a total bank capital increase of 70 percent since 2001. Hong Kong, Korea, and Taiwan had consumer credit crises. In China, state-owned banks underwent a recapitalization program earlier this decade and authorities tightened credit conditions significantly from 2005 to 2007.

However, in recent weeks CDS spreads for a number of major Asian financial institutions have risen sharply. Contagion induced by exposure to US dollar funding seems to be a large contributor to market worries. Western banks have extended US$ 2.8 trillion in loans in Asia that will be subject to deleveraging. Financial systems in South Korea, India and Australia are particularly exposed and have seen the largest spikes in CDS spreads. In addition to US dollar exposure, Korean banks are relatively weak on a number of fundamentals, such as a 169 percent in loan-to-deposit ratio and 40 percent of funding taking place through wholesale markets.

Another emerging threat to the banking system is the unwinding of expensive real-estate markets. Real-estate prices have risen rapidly in the past few years fueled in part by rapid loan growth. For example, property prices in Hong Kong increased by 40 percent since 2006. Property prices in China rose by 20 percent on average since 2006, although appreciation in coastal cities was much more rapid. Recently, however, prices have begun to drop in many places (e.g., residential property prices in Shenzhen dropped 5 percent in September year-on-year). Although many Asian countries have had far more stringent lending standards compared to the west (e.g., China requires a minimum 20 percent down payment on a mortgage), rapidly declining real-estate prices will likely lead to rising NPLs in the near term.

FINANCIAL AND ECONOMIC OUTLOOK

The most recent growth forecast of the IMF (October 2008) calls for a slowdown in the region from 5.3 percent GDP growth in 2007 to 4.1 percent by the end of this year, and 2.9 percent in 2009. The growth rates for 2008, and 2009 are significantly below the estimated long-term growth rate of 5.2 percent, indicating that this slowdown is not to be taken lightly. A poll of 15 Asia economists and several clients indicates these growth rates may even be on the optimistic side. Most economists rated a “hard landing” scenario, where GDP would slow to 2.2 percent in 2009 and 2.4 percent in 2010 as most likely.

An export slowdown, the risk of ever-tightening credit conditions, and diminished consumption are the three channels through which the crisis is likely to affect Asia.

Exports

Exports are an important driver of GDP growth for Asian countries. During the “tech wreck” recession of 2000-01, exports contracted by 2.2 percent, investment flowed out and GDP growth declined from 4.5 percent to 1.9 percent.

Although a slowdown in exports to the US/EU will certainly have a significant impact, domestic consumption is now a strong driver of intra-Asia exports, and will partially mitigate the effects of the slowdown. Whereas in 2000, intra-Asia trade was worth about the same as trade with the US/EU, it is now greater than 1.5 times the trade with US/EU. In particular, consumption in China has the potential to partly cushion the blow to smaller Asian economies. We estimate that at least 50 percent of Chinese imports from other Asian countries are for domestic consumption, driving greater dependence on intra-Asia trade flows. Declining commodity prices will also support the commodity-import-dependent parts of Asia.

Credit and Investment

Asian countries have been able to fuel their investment-led growth from their large domestic savings. However, the recent equity market bust and the increases in credit spreads suggest a significantly tighter funding environment for Asian corporates. Markets with a significant reliance on US/EU bank funding will be hardest hit. Banks and companies in Hong Kong, Singapore, Korea, Australia, and Indonesia all rely on foreign bank credit for over 15% of their of total outstanding credit.

Banks are finding wholesale markets particularly challenging. Interbank lending rates in Hong Kong and India have spiked in recent days due to the credit-crunch contagion, rising by 2.1 and 3.0 percentage points in the 3-month interbank rate respectively from February to October. Competition from the newly "sovereign" western banks is raising funding costs for local banks, particularly in open markets like Hong Kong and Singapore.

According to MGI, we expect U.S. banks to potentially reduce their credit outstanding by $1.6-3.3 trillion as they move towards a lower leverage ratio on their capital. This will result in less credit extended to Asia as they perhaps disproportionally reduce their exposure to a region that for many is peripheral. Similar deleveraging will also occur from European banks. In addition, many MNCs have begun to extract cash from their Asian operations to cover shortfalls in other regions. To mitigate this, central banks throughout the region have eased interest rates, as well as provided short-term funding and loan guarantees. The credit squeeze will impact closed financial systems with greater reliance on local currency financing, such as China and Japan, much less. Nonetheless, the US dollar liquidity squeeze is impacting areas such as trade, where 90% of transactions involve some form of financing. Trade finance rates rising to as much as 300 bps above already elevated interbank rates and anecdotes abound of suppliers unable to secure raw materials for their operations due to the lack of trade credit.

Consumption

The expected decline in income from a slowdown in exports will have particularly acute effects on SMEs and lead to a spike in urban unemployment. Data is still too early to point to a clear impact, but anecdotal evidence suggests a significant effect on the export manufacturing sectors. For example, in the first 7 months of this year, more than 3,600 toy makers are reported to have gone out of business in China and 2.5 million workers will be laid off in the next 3 months[1].

In addition, the bust in the stockmarket is expected to dampen consumption. In the case of Japan, where the drop in the Nikkei index has been particularly severe (i.e., Nikkei currently at 1982 levels) this effect is of particular concern. The IMF estimates that every 10 percent decline in the Nikkei generates a contraction in consumption of between 0.15 and 0.30 percent. In developing countries, this effect in less pronounced, however given the magnitude of stock market declines can still be expected to have a significant effect on consumption (0.15 percent decline in consumption for every 10 percent decline in stock market returns).

[1] South China Morning Post, October 22nd 2008

POLICY RESPONSES

Governments have many policy tools to mitigate the impact of the slowdown. As mentioned, monetary-policy easing and central bank short-term lending has already been used. Only in India, Indonesia, and Thailand, where inflation is still a big concern, have central bankers been more cautious about easing rates. Additionally, strong fiscal positions and forex reserves have given countries like China the possibility to provide significant stimulus, as well as undertake public investment projects.

A key question on the policy front is the extent to which Asian countries are able to integrate and develop a regional plan to address the crisis. Several proposals are on the table to pool countries forex reserves and protect the financial systems. Other proposals are focused on facilitating intra-Asian trade, such as a trade finance guarantee program, as well as pooling sovereign wealth funds (SWF) to invest in infrastructure projects. In light of the likely deleveraging of western bank credit to Asia, central bank funds would find an immediate use to smooth the transition of banks and companies as they restructure the foreign currency loans.

KEY CHALLENGES AND OPPORTUNITIES WE SEE IN ASIA

Non-financial corporates

We see four key risks playing out in Asia for non-financial corporates:

1. Exposure to foreign currency and capital markets funding presenting companies with re-financing and liquidity risk, particularly heavily indebted ones.
2. Exposure to high volatility in currencies and commodities creating potential for direct losses on derivatives positions, as well as contractual and counterparty risks
3. Supply-chain exposure, where the liquidity health of key suppliers may endanger operations
4. Volume and price declines which will significantly impact profitability of Asian operations

In order to mitigate these risks, corporates need to immediately assess their funding requirements over the next year and make contingencies, including conserving foreign currency, assessing quality of receivables, drawing down existing credit lines, negotiating easier local currency loans, and leaning on suppliers and buyers for more preferred terms. Corporates should also review currency and commodities derivatives contracts and understand the impact, including any losses or whether a counterparty is in danger of default. This is particularly important in cases where there have been large price swings such as Korean Won or copper prices. In addition, they should assess options to support important suppliers who may be under pressure, as well as build contingency plans for severe down-side scenarios.

On the positive side, Asian corporates have built huge deposits (over ~$3 trillion). Now is the time to use this position of financial strength to look for opportunitistic acquisitions that will allow them to address key gaps in technology, talent, and global reach constraints (e.g, Nomura's purchase of Lehman's Asia and EU assets).

Large declines in regional currencies make Asian operations more attractive than ever to locate factories in the region and for multinationals to expand sourcing initiatives.

Financial institutions

We see four key risks for financial institutions:

1. Funding, particularly for banks with heavy reliance on foreign currency or wholesale funding
2. Counter-party defaults on transactions, particularly where large price swings have resulted in large exposures and there are risks that counterparties will be unable to pay
3. Increased non-performing loans, particularly from sectors most impacted by the crisis
4. Reputation risk from clients who feel cheated by financial products sold that are now generating losses

To address these risks, financial institutions should assess profile of wholesale-funding requirements and take measures to reduce foreign currency exposure, take part in national programs to supporting banking systems, and shift to more stable local currency funding. Also, institutions should immediately launch deposit gathering initiatives, beginning with corporate and SME clients

Key trading and derivative exposures should also be reviewed, particularly from contracts with large recent movements and assess counterparty credit quality in light of recent events

Lending portfolios should be triaged to identify loans to export oriented, dollar or trade finance funded companies. Delinquencies and sudden draw downs should be carefully monitored.

Finally, banks should quickly catalog the product holdings on their customer base and assess whether these are facing large losses and, therefore, the risks that customers will feel these have been mis-sold.

On the positive side, financial institutions have an opportunity to gain market share in key areas where rivals, particularly foreign banks are pulling back, including: a) Trade finance and foreign currency lending to strong corporates, particularly those where a bank wants to build stronger relationships; b) Rates and forex derivatives with local counterparties that foreign banks will no longer be able to deal with given counterparty limits; and c) Deposit business from corporates worried about the health of banks.

Financial institutions have an opportunity to adjust their pricing and product mix. They should take advantage of tighter credit markets and cultivate a position of "we stood by you during this time of crisis" to raise pricing, particularly in lending products. There is also an opportunity to meet customers' new demands for conservatism by developing low risk products (e.g. principle protection) as well as aggressively communicating the stability of their position.

Financial institutions should selectively pick available talent to enter new businesses, specifically targeting talent from weak or taken-over foreign institutions, particularly in wholesale banking.

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The financial crisis is far from over. Corporations, financial institutions, and policy-markets need to make sure that they address the immediate risks at hand, but at the same time consider the opportunities to strengthen their companies and economies.