An Asian Crisis Now?

C.P. Chandrasekhar

While the world's attention is focussed on the continuing crisis in Europe and its global fall-out, another crisis is brewing in Asia. More than one Southeast Asian country, among those that were overcome by financial crises in 1997, has seen a substantial accumulation of private debt, especially household debt. In some, debt levels are high enough to fear a financial collapse. This has come as a surprise, given the resilience they showed at the time of the global crisis of 2008.

Worst off is South Korea, the rags to riches miracle that is now a member of the OECD, the "rich country club". According to a survey conducted by Statistics Korea and analysed by the Korea Development Institute, six out of ten households in Korea were in debt in 2011, and more than a third of them were unable to meet their annual expenses with their incomes. Debt also weighs heavy on current incomes. One in every 10 households spends more than 40 per cent of annual income on servicing that debt.

With these households having to borrow more to stay afloat and others joining their ranks, a large proportion of households could be caught in a debt trap that would force default. This is exactly what had happened in the United States and elsewhere, when the subprime crisis broke. If that is repeated, the impact on the financial system experienced there could follow in Korea as well. Already, a significant proportion of households in Korea has more liabilities than assets and cannot therefore clear dues by selling assets. In case of widespread default, the banks that lent to them will not be able to recoup even a part of their loans, leading to systemic problems of the kind that Asian emerging markets seemed to have been insulated from.

However, the runaway growth in household debt in Korea appears to be a longer-term phenomenon, having been underway since the 1997 crisis in the region. Starting at around Korean Won (KRW) 210 trillion in 1997, the debt of households in Korea rose to more than KRW 450 trillion in 2002 and stood at KRW 922 trillion at the end of June in 2012. The near-fivefold rise over 15 years has taken the ratio of household debt to net household disposable income from less than 100 per cent before the turn of the century, to the 3-digit mark in 2001, more than 140 per cent in 2006 and an unsustainable 160 per cent in 2011. The 2011 figure is higher than the level that prevailed in the United States before the subprime crisis broke. An implication of this has been the collapse of the household savings rate in what used to be a high-saving nation: from more than 15 per cent before the 1997 crisis to around 10 per cent in 2000 and a low of 2-3 per cent recently. Increasingly, instead of saving for the future, South Korean households are consuming out of what they hope would be tomorrow's income.

It is indeed true that traditionally banks in South Korea tended to "overlend" to the private sector. But there have been important changes. Before the 1997 crisis banks were substantially publicly owned and their lending to the private sector was focused on the then successful South Korean corporations. Problems began when in the 1990s South Korea chose to open up and deregulate its financial sector, partly as a quid pro quo for continued access to international markets on which its growth was based, partly to diversify into services led by finance because

of a growing loss of manufacturing competitiveness, and partly to meet the requirements set for OECD membership. The process, which increased the role of foreign finance in the South Korean economy also led to a shift of lending away from productive investment that had been the main target of directed credit till then, into sectors like the stock market, real estate and housing. That shift was financed with low-cost foreign finance, accessed in large measure by the private sector in South Korea, and directed less to the productive sectors and more to non-tradable services with a strong speculative component. This created the circumstances in which South Korea became vulnerable to the boom-bust cycles typical of foreign financial flows and to the contagion that spread across the region in 1997.

Interestingly, post-crisis adjustment in South Korea (and elsewhere in Southeast Asia) did not lead to the reversal of the liberalisation that enhanced the external vulnerability of a successful "miracle" economy and increased the fragility of its financial system. Rather, the role of the IMF during and after the crisis and the success of foreign finance resulted in the government opening the doors wider to foreign capital and diluting regulation of the domestic financial sector, even while taking over and guaranteeing repayment of the debt that foreign finance had, without due diligence, provided the domestic private sector.

Thus, both before and after the crisis, "overborrowing" by the private sector remained high, but the target borrowers were now engaged less in productive activity and more in areas like finance, real estate and housing. Moreover, after the crisis, bankrupt financial firms were displaced or taken over by new players, especially foreign firms. This led in turn to the importation into the country of the practices that had characterised finance in the developed industrial countries. Prime among them was a sharp increase in lending to the retail sector—housing, automobile purchases and personal credit—with the risk associated with such fragmented, large scale lending being concealed by pooling credit assets, securitising these bundles and transferring the risk. The net result is that in this third phase, even though lending to the private sector continued to be important in South Korea, households have been replacing corporates as leading borrowers.

Excess borrowing is also a result of the adverse impact that the growth pattern after liberalisation is having on the distribution of income in the country. While developed country status has increased the cost of living and the consumption aspirations of the population, incomes among the poorer sections of the population have not kept pace. In the event, as happened in the US, encouraged by an easy credit environment, the poor have sustained their consumption and diversified into new economic activities with the aid of credit. As the survey of household finances quoted earlier found, while the top 20 per cent too borrowed, the proportion of borrowers in the bottom quintile in terms of income was increasing the fastest. Moreover, while the rich borrowed to acquire real estate, the poor did so to just make ends meet.

The government and the Bank of Korea are conscious of the dangers implicit in this excessive debt overhang. They responded last June with measures to reduce bank exposure to the retail market and to induce borrowers to shift out of floating rate loans to fixed interest loans. The intention was to reduce the impact that any interest rate shock would have on borrowers under strain and unable to meet their debt service commitments. However, with financial liberalisation having created a layered financial system, this did not resolve the problem. Stricter bank regulation may rein in borrowing for speculation by the rich. But the poor, who cannot but

borrow, have turned to the non-banking system: mutual associations and credit unions, in particular, which are unregulated and charge exorbitant interest rates. That only worsens the problem.

Clearly, South Korea is experiencing an unsustainable build up in household debt, on a trajectory that seems self-reinforcing. But South Korea is by no means an exception. It merely shows up starkly a trend that is widespread in Southeast Asia. In Malaysia too, the ratio of household debt to GDP has risen from 33 per cent in 1997 to 78 per cent in 2011. As a result, though it has a household debt to disposable income ratio that, at 140 per cent, is lower than that of Korea's, it too is pointing to what could be the future for countries like Singapore (105 per cent) and Thailand (53 per cent).

Further, trends of the kind seen in South Korea after the 1997 crisis are visible in Malaysia too. Before the crisis, households accounted for a third of loans provided by the banking sector, and credit to the corporate sector accounted for 67 per cent of loans outstanding. After the crisis that ratio moved up and now stands well above the 50 per cent mark. The composition of lending also points to the changed drivers of credit in the new business environment. At the end of 2007, housing loans amounted to 55 per cent of household debt, automobile loans for another 23 per cent and credit card advances for a little more than 5 per cent.

Even in countries where the estimates suggest that retail lending is low, such as China and Thailand, this is because banks that do not lend directly to the household sector often do so indirectly. They provide credit to a second tier of intermediaries, often in the informal financial sector, which in turn lend to households. While a large proportion of these loans is for housing, other loans such as for purchases of automobiles or to finance credit-card receivables have also increased considerably. The focus seems to be on lending short term or against assets considered more liquid.

What we are witnessing is a replication of the trends observed in the developed industrial countries. That is perhaps inevitable since financial liberalisation or "reform" is aimed at replicating the Anglo-Saxon model of an "efficient" financial structure in countries across the world. As a corollary, it paves the way for the spread of the crisis from the US and UK to Europe, and now possibly Asia. Hopefully, Asian governments would take note and halt and reverse this process.

* This article was originally published in the Frontline, Volume 29 - Issue 20: Oct. 06-19, 2012.