



**ASIA'S BUBBLE CRISIS:
NO INSTANT CURE**

ASIA STRATEGY

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19 JANUARY 1999

Asia's bubble crisis: no instant cure

Asia economic turbulence has had three components: a foreign debt/currency squeeze, investors' panic and a bubble crisis.

- **The foreign debt squeeze is over.** It ended by summer 1998 for the pivotal countries and, in consequence, currency volatility subsided. Key sovereign bond prices rose and spreads contracted far back in the direction of pre-crisis levels.
- **The investor panic is over.** It ended by early autumn 1998 and, in consequence, equity and bond markets experienced large — even excessive — price rises.
- **The bubble crisis is not.** Depending on the individual country, it will require one to six years for full recovery.

Taiwan and **China** have performed strongly, but this is because their bubbles have not yet popped.

Singapore and **Hong Kong** tend to adjust faster than most, but this time Singapore has adjusted more proactively than in the past, while Hong Kong has resisted adjustment. Although Singapore's superior adjustment is somewhat offset by Hong Kong's healthier and friendlier backyard, we believe that a pegged currency and slow adjustment condemn Hong Kong to high real interest rates for a prolonged period.

South Korea and **Thailand**, meanwhile, have made difficult decisions and significant progress, but Thailand's ability to fund future growth could be jeopardised by delays in recognising creditors' rights.

Contrary to widespread expectations, we see little hope of an early recovery in **Japan** that would enable it serve as a locomotive powering Asia out of the crisis.

While the smaller countries have made impressive progress, major Japanese, Chinese and US risks hang over the Asian recovery. These risks are potentially among the largest since the Great Depression. While they may be averted, they should be reflected in prices — but that does not appear to be happening.

The current run-up in the US and Asian markets is liquidity-driven at a time when earnings are low or falling in both areas. The liquidity itself is mainly provided by the US Fed, which is trying to counter global deflation with policies that consciously risk a US stock market bubble. These conditions and policies may persist for some time, but they create a high-risk environment.

We believe that the market misunderstood currency volatility as a problem of competitive devaluation rather than a foreign debt crisis. Because of this, there are great fears that China's renminbi will be devalued. However, while a moderate devaluation of the renminbi would carry little risk, the attendant possibility that China's reformation programme will fail because of a rigid currency carries immense risk.

Continued . . .

We consider the best investment strategies for this period are:

- a) BUY sovereign, US dollar or euro-denominated bonds of economies, notably South Korea, Thailand and Hong Kong, where default risks are extremely low and the perception of risk is likely to improve in time;
- b) BUY equities of South Korean companies that have successfully restructured — ensuring the restructuring is real, rather than just announced;
- c) BUY the Singapore Straits Times Index (1,499.81 pts) and SELL Hong Kong’s Hang Seng Index (10,147.40 pts), as the latter’s currency peg and slow adjustment point to high real interest rates in a property-dominated market;
- d) BUY Korea’s Composite Index (614.57 pts) and SELL Thailand’s SET Index (381.82 pts) so long as the former’s reform programme remains relatively strong and Thailand delays passing foreclosure and alien business laws;
- e) BUY category leaders and simultaneously SELL laggards in markets that are likely to be stressed for years (eg, BUY the top banks and SELL the laggards in South Korea and Thailand, or BUY the top property companies and SELL the worst in Hong Kong); and
- f) BUY Hong Kong companies, such as Legend (HK\$2.55, 0992.HK), that serve strong markets outside the SAR.

William H. Overholt

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All prices contained herein are as at 15 January 1999 market close.

Introduction

The Asian crisis has been interpreted in a number of ways:

- primarily an evil conspiracy by speculators (Malaysian Prime Minister Mahathir);
- an unnecessary and accidental banking panic (Jeffrey Sachs);
- a bad stretch of road on the way to globalisation (Paul Krugman);
- the outcome of perverse 'Asian values' (ideological editorial writers of both right and left); and
- a global competitive currency crisis (most others).

While each of these views captures an aspect of reality, none explains the full depth, timing and consequences of the crisis. **We believe that investors who accept any of these partial views will respond to the wrong signals, lose money and waste opportunities.**



Those who blame the whole crisis on evil speculators cannot explain why the speculators had such spectacular successes in big places like Thailand and such feeble results in small places like Singapore, nor can they explain why South Korea popped with no significant speculative pressure at all.

Those who think it was just an irrational accident simply haven't looked at the size of the bubbles and reflected on the fact that such bubbles always pop eventually.

Those who think it was just a bad stretch of road on the way to globalisation of financial markets cannot explain why Japan, China and Taiwan have such serious similar problems without any substantial roots in globalisation.

Those who think the problem is Asian values need to take a look at the US savings and loan crisis of the early 80s, which was a similar bubble created in the same way: by laws that for many years held interest rates artificially low.

And those who think it was mainly a currency crisis don't understand that Japan and China have the biggest problems without a currency crisis (Japan's bubble burst more than half a decade before its currency began to decline).

Asia's fundamental problem has been a series of financial bubbles. To understand this, and to understand the sequence by which Asia's crisis is unwinding, requires an excursion into history.

The Asian crisis: an overview

Currency crisis is a symptom, not the cause

The Asian crisis initially presented, to use a medical term, a sequence of currency collapses. The collapse of the Thai baht on 2 July 1997 was succeeded by collapses of the South Korean won, the Indonesian rupiah and the Malaysian ringgit. In tandem, there were moderate declines in the New Taiwan dollar and Singapore dollar, and considerable but successfully resisted pressure on the Hong Kong dollar and China's renminbi.

Because the crisis presented as a currency collapse, much of the market has continued to diagnose it as fundamentally a currency problem — sometimes interpreted as a cascade of competitive currency devaluations, sometimes as the work of fiendish speculators — but fundamentally a currency issue. We believe that such a view mistakes a symptom, or a precipitant, for the fundamental cause. Hepatitis often initially presents as a yellowing of the skin, but the yellowing is not the real problem.

The real Thai crisis: property and financial bubbles

Most people believe the Thai baht's flotation was the start of Asia's economic turmoil. More properly, the crisis should be dated a year earlier to the crumbling of the Thai Bills of Exchange market after July 1996 and to Somprasong Land's (delisted) February 1997 default on its eurobond. Somprasong Land was the first Thai company to default on a eurobond, and the default marked the point at which the Thai property bubble began to pop. In 1996, demand for office space had been 550,000 sm and declining, while builders of office space had committed to construct 1m sm per annum each year through to 2001. In 1996, 4,700 condominiums were sold, while 12,500 remained unsold and 21,900 were due to be completed in 1997.¹ Bangkok Land (THB4.70, B-LAND.BK, not covered) had effectively built whole suburbs of apartments, which became ghost towns due to the lack of demand. Despite this huge oversupply, prices remained relatively flat. At some point, supply and demand were going to converge, squeezing the bubble and popping it with a bang that would shatter the economy and financial system.

Even before the property bubble itself burst, it came under pressure, and related bubbles started bursting. Thailand had a multibillion-dollar market for Bills of Exchange, comprising 90-day paper issued by local corporations and guaranteed by local finance companies for purchase by banks. The trouble started in June 1996 when it became clear that Thai Granite (suspended, GRANIT.BK) would have difficulty servicing its Bills, which were guaranteed by a finance company called Timex. When it became clear that eventual default was likely, a major US bank made preliminary moves to invoke its guarantee, and it became clear that under Thai law Timex would be able to stall payment indefinitely. After the actual default occurred in July 1996, other foreign lenders studied the situation and discovered to their horror that under Thai law all finance companies could avoid paying virtually indefinitely. This writer's research staff at the time published a warning of what was to come in August 1996; by October 1996, when three defaults were under way, the more savvy banks were abuzz with concern that the entire Bills market had no foundation. There ensued a process of slow-motion collapse, creating huge losses for foreign banks and their customers.²

Following this, foreign lenders gradually became aware of a much broader point about the position of banks and other creditors in Thailand: under Thai law creditors effectively had no way to seize assets that had been placed as collateral for loans to debtors who subsequently defaulted. During February 1997, this writer's research staff held a seminar in Bangkok where a local lawyer appraised shocked foreign investors of their almost complete inability to recover substantial assets from Thai

¹ See Jones Lang Wootton, *Bangkok Property Outlook No. 4*, January 1997

² See Aaron Henderson, *Thai Bills of Exchange: Storm Warning* (August 1996) and *The Thai Finance Sector: The Storm has Begun*, (October 1996), in *Asia Window*, Bankers Trust Co.

companies which defaulted on loans or bonds. In May 1997, holders of bonds issued by Alphatech (suspended, ATEC.BK), Thailand's most prestigious hi-tech company, discovered not only that it could not pay but that it had published accounts that apparently turned a huge loss into a large profit and concealed the transfer of a substantial amount of funds out of the public company into a private firm. It had been able to do this because of local laws which tolerate a high level of opacity in financial reporting (it is worth noting that the company was audited by one of the world's most prestigious accounting firms). On reflection, it became obvious to the banks that such practices were widespread and that foreign investors were vulnerable to huge losses from similar situations.

Banks' panic was rational

The result of all this was an exodus of foreign bank loans and fixed-income investors from Thailand, and a historic financial crisis. Banks realised three things simultaneously:

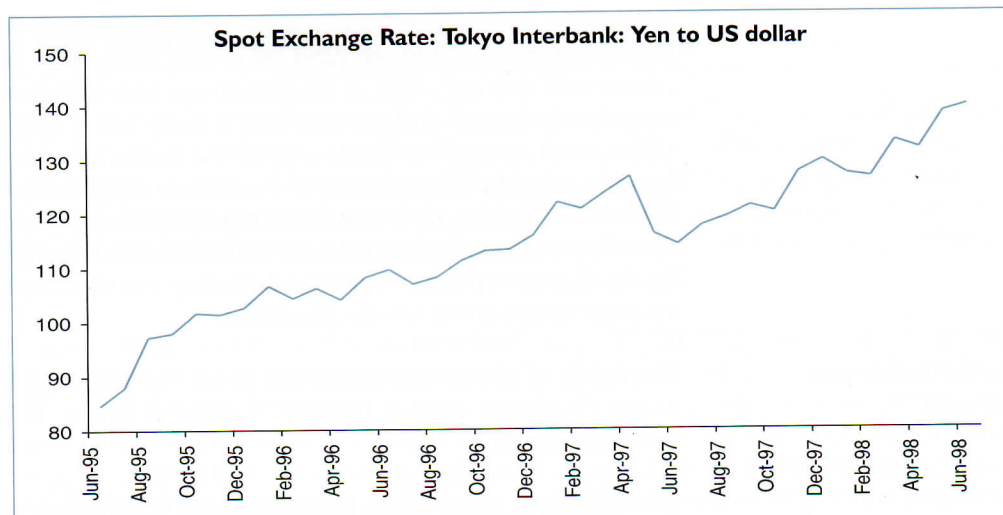
- a popping bubble was endangering a wide range of even the most prestigious Thai companies;
- a lack of transparency in company accounts under prevailing Thai regulations obscured the real financial status of their customers; and
- Thai bankruptcy laws failed to provide most of the customary first world protection to creditors.

Decades of smooth sailing had lulled foreign banks and local companies alike into thinking that the fundamental rules of lending — solid cash flows, real collateral, honest accounting, market interest rates, avoidance of mismatched maturities and avoidance of mismatched foreign exchange exposure — could be ignored. The primary lesson of the crisis was that they couldn't.³ The ABCs of sound business applied even in Asia. All this preceded the foreign exchange crisis and would have occurred even without the foreign exchange crisis. In fact, China, Japan and to a lesser extent Taiwan have been facing very similar problems without any foreign exchange crisis; Hong Kong has had a major property bubble burst without any foreign debt crisis.

The yen drove the crisis timing

Both the timing of the Thai bubble popping and the subsequent collapse of the baht had much to do with the way Japan handled the implosion of its own bigger financial bubble. Japan's bubble was probably the largest financial bubble in world history. During the late 80s, companies on the Tokyo Stock Exchange had a combined market value of just under half that of all other world stock exchanges combined. The land under the emperor's palace, a small plot in the middle of Tokyo, was valued the same as all of California. Land in the City of Tokyo itself was valued at about the same level as all the land in the US. As in Thailand, this was a bubble that had to burst — and did. As in Thailand, when it did, the decline in property values hit banks hard, because they had lent so much to property and construction companies based on their property collateral. Faced with a huge financial crisis, the Japanese government waffled and, instead of performing ruthless triage on the banking system, sought to recapitalise banks by keeping interest rates very low so that the banks would have a low cost of funds. (The policy of low interest rates also became a key part of unsuccessful efforts to stimulate the economy out of ensuing recession in the later 90s.) Extremely low interest rates made the yen unattractive and induced a huge decline in its value compared with the US dollar.

³ For an important if sometimes overstated perspective, see the book by the President of Thomson Bankwatch: Philippe F. Delhaise, *Asia in Crisis: The Implosion of the Banking and Finance Systems* (Singapore: John Wiley & Sons, 1998)



Source: CEIC

This decline in the yen's value affected smaller Asian economies like Thailand. Many had pegged their currencies to the US dollar or (in Thailand's case) to a basket of currencies containing mainly dollars. Every year, as the dollar weakened against the yen and other currencies, the exports of Thailand and other Asian competitors became cheaper in their most important markets, and this greatly facilitated the export-led economic takeoff of the past generation. When the yen suddenly weakened, the other side of the coin was a stronger US dollar, hence a stronger baht and less competitive exports. During 1996, partly as a result of this, Thailand suffered a current account deficit amounting to a huge 7.9% of GDP. (There were other factors, including the weakness of Japan's demand for exports, Chinese competition, and cyclical downturns in the semiconductor market, but such factors were less important.) This in turn attracted speculators who believed that a big current account deficit was probably caused by an overvalued currency and that they could therefore profit by shorting the currency.

The new speculative game: fund bubbles

Ironically, this calculation was largely incorrect, but the speculators ended up making more money than they had ever dreamed possible. Virtually every model showed the Thai currency as either fairly valued or modestly overvalued — by perhaps as much as 10%. As in the US, the bulk of the current account deficit was an artefact of a low savings rate; to invest and grow at its accustomed pace, the Thai economy had to supplement local savings with foreign savings amounting to some 5% of GDP. But when speculators attacked the currency, the Thai government attempted to make the currency more attractive by raising interest rates. Given that the whole economy was sitting on a bubble inflated by cheap money, high interest rates ensured that the bubble would pop — with a spectacular bang. As the bubble burst and horrified foreign bankers discovered that they had none of the standard recourse, they demanded their money back. Since everybody in Thailand suddenly and simultaneously needed dollars to repay their bankers, the US dollar became wildly expensive. What happened to the baht was one of the great short squeezes of financial history. Instead of dropping 10% and rewarding speculators moderately, the baht nearly halved in value and made rich men of all who had attacked it.

In short, the fall in the baht had little relationship to the competitiveness of the Thai economy or to any measure of the intrinsic value of the baht. Speculators mostly made a killing from a short squeeze that they did not understand when they placed their bets. This event transformed the nature of currency speculation. The smarter speculators realised instantly that the new game was not to seek out mildly overvalued currencies but to attack the currencies of economies suffering from financial bubbles. The rewards were some five times larger than rewards in the old game. And it turned out that Asia was full of bubbles that could be exploded by high interest rates. This was not a competitive currency devaluation game. It was not contagion. It was a highly profitable demonstration effect.

Asia had experienced bursting bubbles before — notably the Taiwan stock market bubble of the late 80s, Japan's property and stock market bubbles of the same era, Hong Kong's property market in 1982, and the Marcos-crony bubble in the Philippines which burst in phases between 1982 and 1985. The pops were fairly spectacular, but they were isolated. In the late 90s, however, the bubbles were linked. They were linked causally by the connection of all the smaller countries to Japanese currency, Japanese demand, Japanese investment, and dependence on cheap Japanese loans. Above all, they were linked by the speculators in a way that had never previously occurred. All the countries which had intentionally or inadvertently channelled funds into key sectors, either at rates below what local markets would have charged or in amounts larger than local markets would have provided, had developed huge financial bubbles.

Each economy had a bubble

Thailand had a property bubble caused by channelling huge amounts of cheap US dollars into a property market that should have been paying higher baht interest rates. South Korea had a chaebol bubble: gigantic conglomerates had gorged since the early 60s on huge amounts of cheap credit directed their way by a government determined to make them as big as possible, as fast as possible. Indonesia had large numbers of first-family-connected companies, which for three decades had received preferred access to credit (and everything else). Malaysia had a variety of favoured bumiputra companies, which had been inflated by cheap credit. China had a multitude of state enterprises, which had survived only because of credit that was not only cheap but in many cases had been a straightforward gift. Taiwan had a consumer and industrial bubble inflated by government use of the banks to ramp up economic growth, key companies, and the stock market. Hong Kong's property sector had been inflated by Britain's artificial restrictions on supply and by an era of negative real interest rates. As soon as currency speculators attacked and drove interest rates up, these bubbles popped and speculators made enormous amounts of money. The currency factor was secondary. For instance, Hong Kong's currency proved invulnerable, but speculators made large profits by shorting a stock market driven down by collapsing property prices; for the more intelligent speculators, attacking the currency was just a means of forcing interest rates up and popping the property bubble.

China's and Japan's bubbles: no speculators to blame

In China, a currency and interest rate system that is invulnerable to foreign speculators saved the economy and banking system from foreigners but that only bought some time. As in Japan, the bubble threatened the viability of the nation's most important businesses and banks even if there was no foreign exchange crisis.

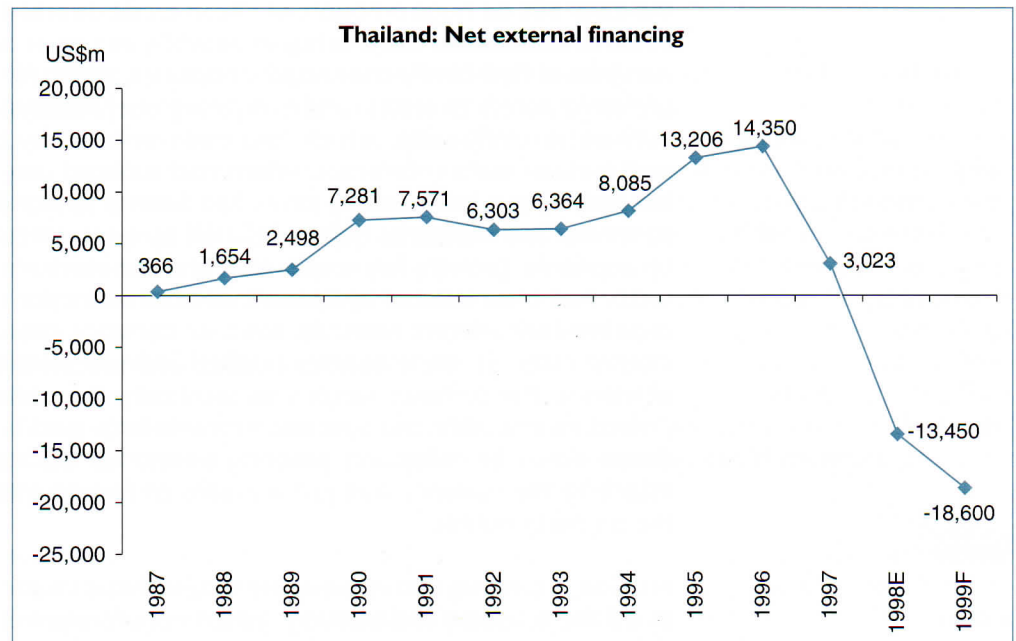
Three crises: debt, price and bubbles

As speculators figured out how to make money from Asia's bubbles, and as foreign banks discovered how vulnerable their customers were, and how little protection local laws provided to creditors, three crises ensued: a debt crisis, investors' panic and the bubble crisis itself. These were analytically separate, and they resolved at different rates.

The foreign debt/currency crisis

Years of prosperity led to complacency that conditions would inexorably improve

In most of Asia's emerging economies, companies have chosen to finance themselves primarily with relatively short-term bank debt (typically three-year loans), even when they are funding longer-term projects. Bank debt has typically been cheaper than going to the capital markets and it does not require expensive accounting requirements and the potentially embarrassing public disclosure necessary to issue bonds. Three to four decades of prosperity had led to complacency on the part of creditors and borrowers that, with minor bumps, conditions would inexorably improve; there was little fear that it would become impossible to roll over loans or that such loans would somehow become inordinately expensive. In China and Japan, high dependence on bank loans was partly mitigated by the fact that most of the loans were in local currency, but in smaller economies a high proportion of the loans was in foreign currencies.



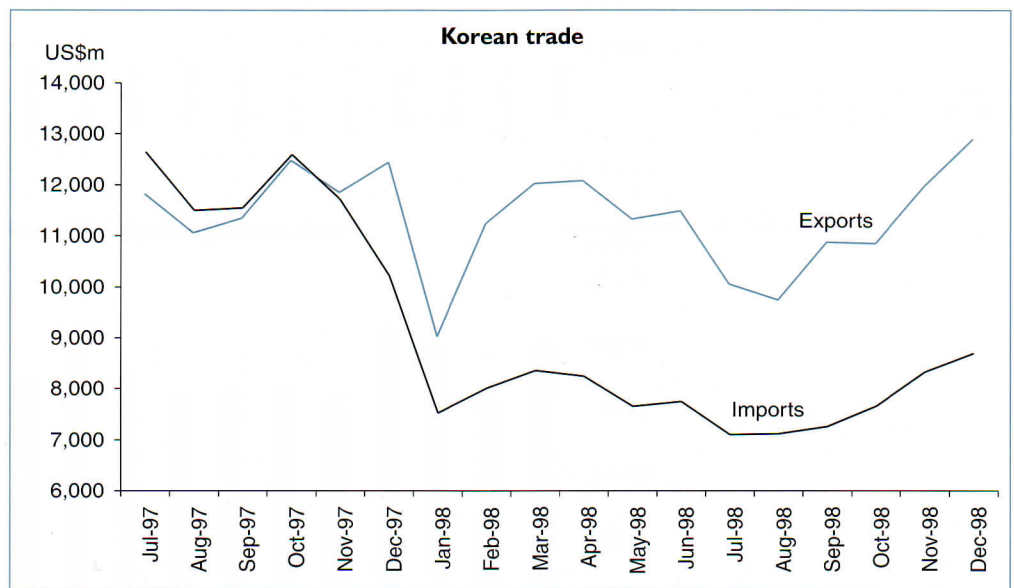
Source: IIF

In key countries, notably Thailand, Indonesia and South Korea, local interest rates were kept relatively high to offset the inflationary pressures of rapid economic growth, but the regulators permitted financing in US dollars, which carried much lower interest rates. And authorities tied the currencies more or less closely to the US dollar so that much of the risk of having to repay loans in US dollars was removed. The obvious consequence was an extraordinary inflow of US dollars. For local companies, this provided cheap financing. For foreign banks and arbitrageurs that could borrow cheap US dollars and lend at higher rates in local currencies, this produced windfall profits. The result was a rise of external financing which in Thailand nearly doubled in the two years prior to the crisis.

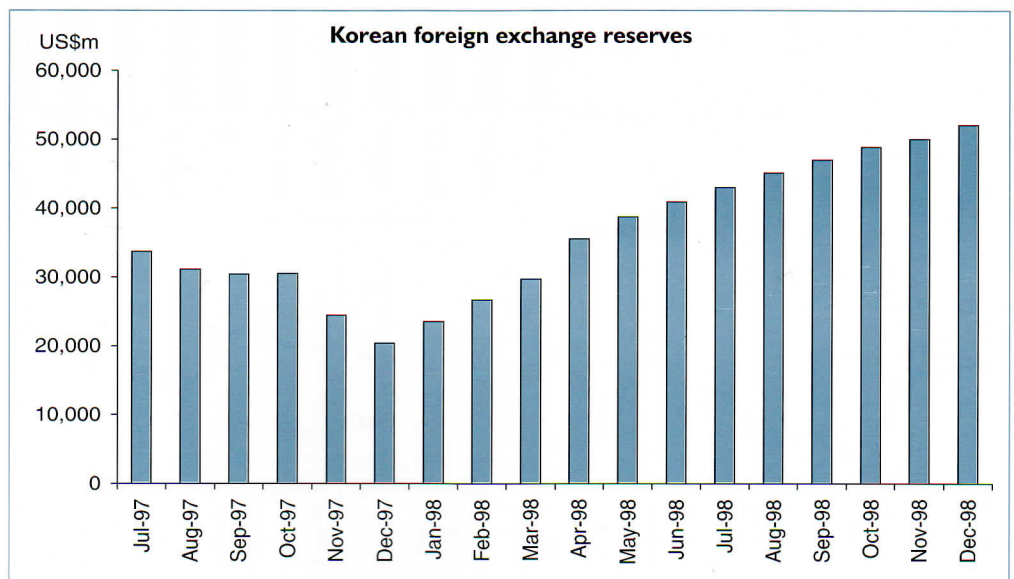
Because arbitrageurs wanted to limit their exposure to future currency risk, as the volumes of such financing rose the terms shortened. By 1997, the amount of short-term debt had become unsustainable. Any event that raised the price of money or restricted the willingness of banks to lend would create a foreign debt crisis. At just this point, currency changes beginning in Japan raised the price of money exactly as bankers' discovered their vulnerability in Thailand and other Asian countries sharply reducing their willingness to roll over loans. They stopped rolling over the loans and a massive foreign debt crisis ensued in Thailand, Indonesia, and South Korea.

The debt crisis caused the currency collapse

The debt crisis was the cause of the currency collapses. In the two pivotal countries, Thailand and South Korea, the debt crises were strategically minor despite the immense temporary pain they caused. The overall debt levels of both countries were quite moderate; the only problem was that the debt was so heavily weighted on the short-term side. The International Monetary Fund's austerity measures, which were based on the Latin American debt crises, resolved the debt and did so with amazing speed in the two pivotal countries. (In larger perspective, the IMF measures were like swatting a fly with a cruise missile.) By mid-summer 1998, South Korea's debt crisis was effectively resolved and Thailand's was well on the way to resolution. In fact, the agreement by major banks to roll over their South Korean exposure effectively resolved the country's debt crisis overnight, but between December 1997 and June 1998, South Korea's reserves recovered so completely that one could say the crisis was over. By the end of the year, South Korea's recession had so collapsed imports that even a relatively stagnant export performance brought reserves up to historically high levels. In fact, South Korea's total foreign exchange reserves rose from US\$20.4bn as at the end of 1997 to US\$52bn as at the end of 1998, and useable foreign exchange reserves rose from US\$8.87bn as at the end of 1997 to US\$48.51bn.⁴



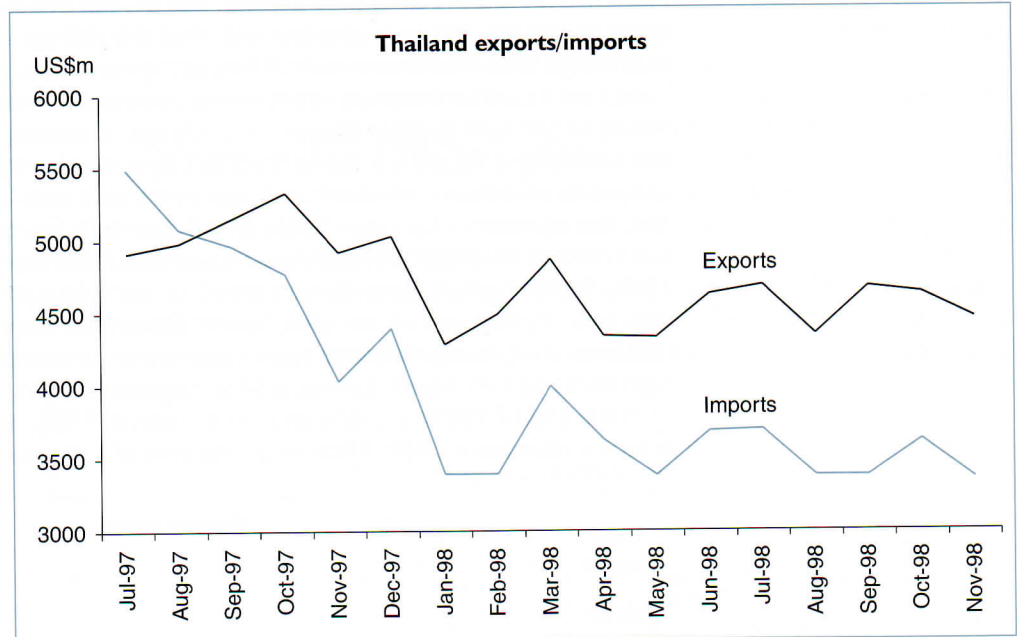
Source: CEIC



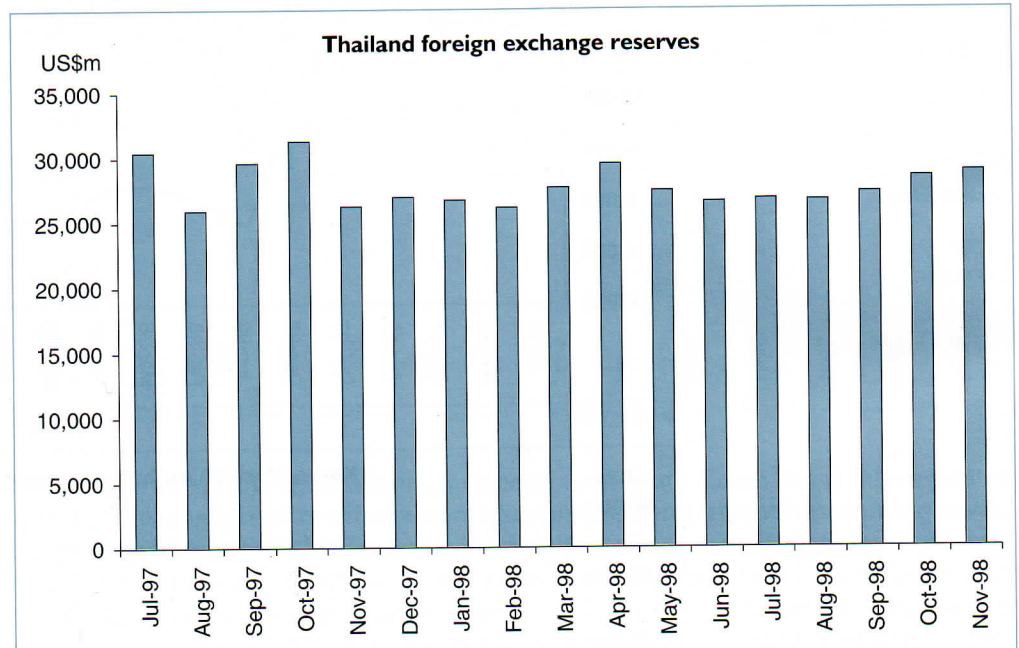
Source: CEIC

⁴ Korean government announcement cited in "Korea's Trade Surplus Widened to \$4.19 Billion in Latest Month," *Asian Wall Street Journal*, January 5, 1999, p. 5

Essentially the same process occurred for Thailand, although Thai reserves and debt service ratios are not yet so decisively out of the woods as South Korea's.



Source: CEIC

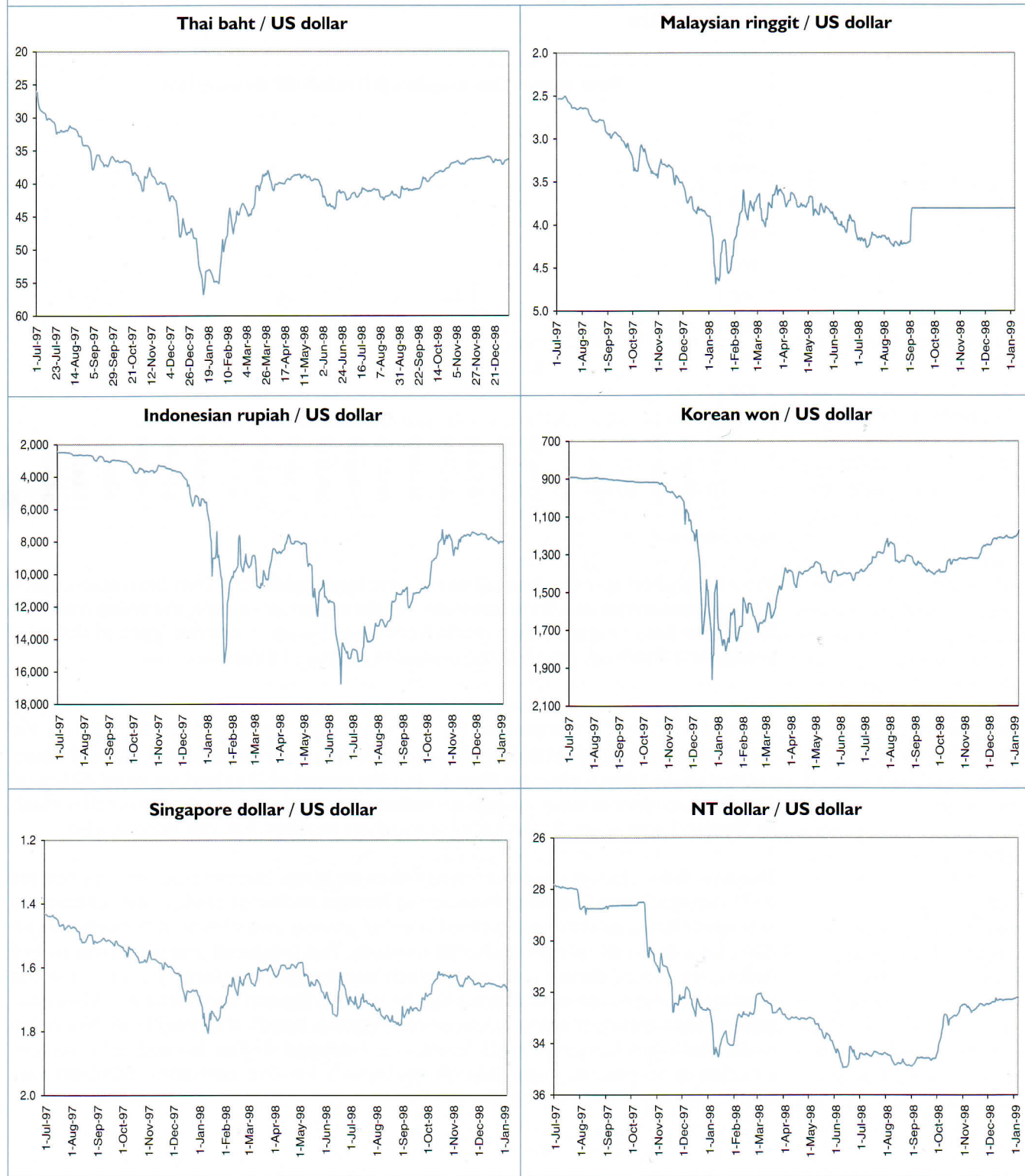


Source: CEIC

Currencies rebounded after debt squeeze

As the foreign debt crisis eased, the short squeeze on currencies disappeared and currencies staged a very strong rebound. Investors who understood that the currency collapse was not about long-term competitiveness, not about a long-term financial squeeze (except in Indonesia), and not just about the arbitrary actions of speculators, made a great deal of money in this rebound.

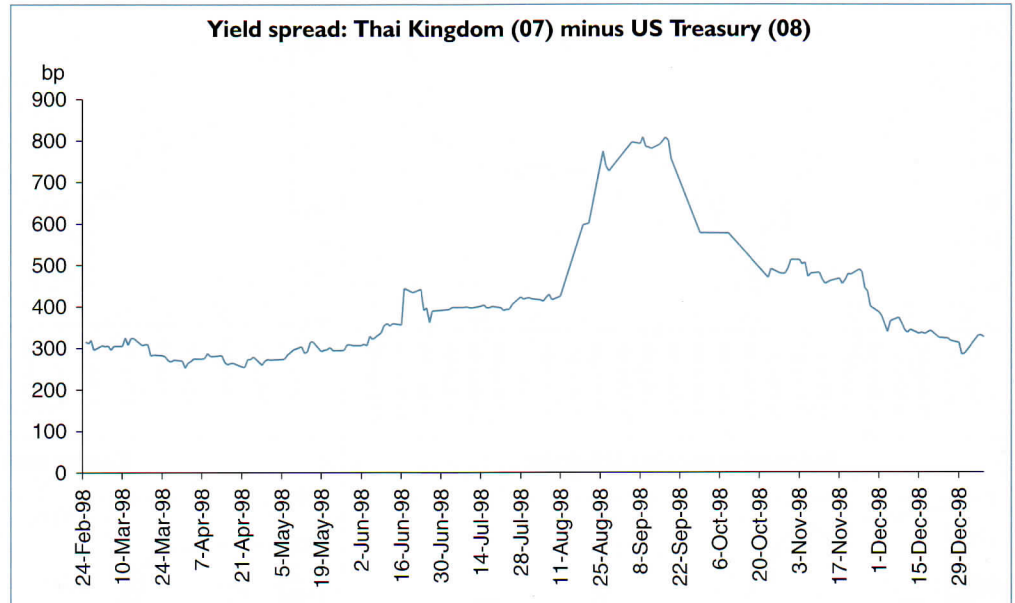
Currency depreciation and appreciation in 1998



Source: CEIC

Debt crisis over, bonds appreciated

Similarly, the easing of the currency crisis made the countries' sovereign bonds less risky and spreads tightened enormously, with prices rising appropriately. Investors in Korean bonds, which went from 900 basis points over US Treasuries to 350bp over, made a great deal of money. This was based on important, lasting improvements in South Korea's fundamentals, and the improvements will almost certainly continue. The same is true of Thailand. Likewise, the sovereign and quasi-sovereign bonds of economies like Hong Kong which were negatively affected by the collateral damage of their neighbours' problems will likely show very profitable improvement over the coming months.



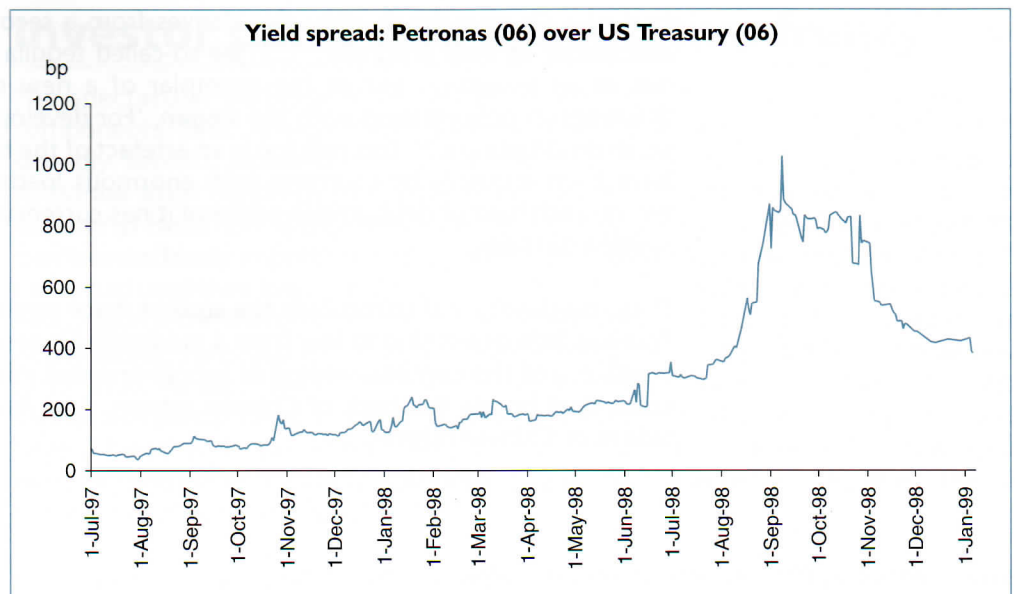
Source: Bloomberg

In sum, the short squeeze associated with the foreign debt crisis has been and remains the key for currency and bond investors. For the region as a whole, the swing countries have been South Korea, which (aside from China) is the economic giant of the third world, and Thailand, which is the pivotal economy in Southeast Asia.

Rupiah also strengthened due to end of short squeeze

Indonesia and Malaysia presented different cases. Indonesia's short squeeze stopped because Indonesian companies, for the most part, stopped paying. This left the rupiah much weaker than before the crisis, and very much weaker than its neighbours' currencies, but much stronger than during the period of the short squeeze. Although the short squeeze is over, spreads on Indonesian paper have not narrowed as much as Thailand and South Korea because the debt problem has not been solved.

Malaysia did not have a serious foreign debt problem, but the eloquent statements of Malaysia's Prime Minister, denouncing foreign exchange trading as unnecessary and speculators as immoral, created a belief among investors that Malaysia might consider closing its foreign exchange markets. This produced investors' rush to exit before the doors closed — a rush which accelerated measurably every time the statements were repeated. Eventually the rush to the exit convinced the Malaysian government to close the doors. Spreads on Petronas bonds, the benchmark Malaysian issue, remained longer at crisis levels and remained higher because of investors' reluctance to return, even though Malaysia's foreign exchange position was fundamentally stronger than Thailand's.



Source: Bloomberg

For other countries, which did not have debt crises, including Hong Kong, Singapore, Taiwan and China, currency pressures also eased after the resolution of South Korea's and Thailand's debt crises.

Once one realises that the great Asian currency collapses were the artefacts of a short-term foreign debt squeeze, one eliminates two of the great bugbears of current Asian markets: inordinate fear of the consequences of the Brazilian devaluation of January 1999 and of a potential Chinese devaluation. Outside Indonesia, there are no more great Asian foreign debt problems, so the great currency collapses of 1997-'98 should not be repeated. One fears such collapses only if one believes in a model of autonomous "currency contagion" or, alternatively, that speculators can cause these huge falls in the absence of underlying debt-based vulnerability to them. That is not what has been happening in Asia. Latin America, which does have recurrent foreign debt problems, is vulnerable to some currency domino effects, but Asia no longer is. So the Brazilian problems, and possible Mexican successor problems, should have limited consequences for Asia unless they manage to spook the New York stock market.

The same logic applies to the other great foreign exchange bugbear of Asian markets: a possible Chinese devaluation. The whole world has ganged up on China to demand a rigid currency on the theory that, if China devalues, "contagion" will create another round of Asian crisis. That is nonsense. A moderate Chinese devaluation would have no substantial medium- or long-term effects on most of the Asian currencies. Korean economists agree, for instance, that a 15% devaluation would have little effect on the Korean won. Such a devaluation would have no effect at all on the Hong Kong dollar, though speculators who do not understand this would drive up Hong Kong interest rates for a few weeks. (The market consensus that a renminbi devaluation automatically implies a Hong Kong dollar devaluation flies in the face of historical evidence and currency logic: since the Hong Kong currency peg was instituted in September 1983, the renminbi has devalued from RMB2.1:US\$1 to its current RMB8.3:US\$1 without affecting the Hong Kong currency. The theory that the renminbi and the Hong Kong dollar are now inextricably linked seems to rest on some weird concept that the 1997 change of flag in Hong Kong changed the currency system. It didn't. Nor can one argue that the tighter linking of the two economies over the years makes Hong Kong's currency more vulnerable; in fact, a renminbi devaluation would enhance China's trade, Hong Kong would earn more from its bite of that trade, and its currency position would modestly strengthen.)

Fear of a Chinese devaluation also derives from a second misunderstanding, best articulated by Paul Krugman: "...[T]he so-called tequila crisis must now be viewed not as an exception but as the exemplar of a new rule, summarised by some Washington policymakers with the slogan, 'For developing countries, there are no small devaluations.'"⁵ This rule too is an artefact of the fact that recent devaluations have been primarily by countries with enormous loads of short-term debt. China has no such load of debt, and in addition it has currency controls that can prevent a sudden outflow.

These bugbears, and particularly the second, have potentially tragic consequences. Asia has little or nothing to fear from a moderate Chinese devaluation, but failure to devalue, and the consequent loss of export-oriented jobs, could conceivably be the straw that breaks the back of Chinese reform. And Asia has much to fear from a failure of Chinese reform.

⁵ Paul Krugman, "The Return of Depression Economics," *Foreign Affairs* January/February 1999, p. 64

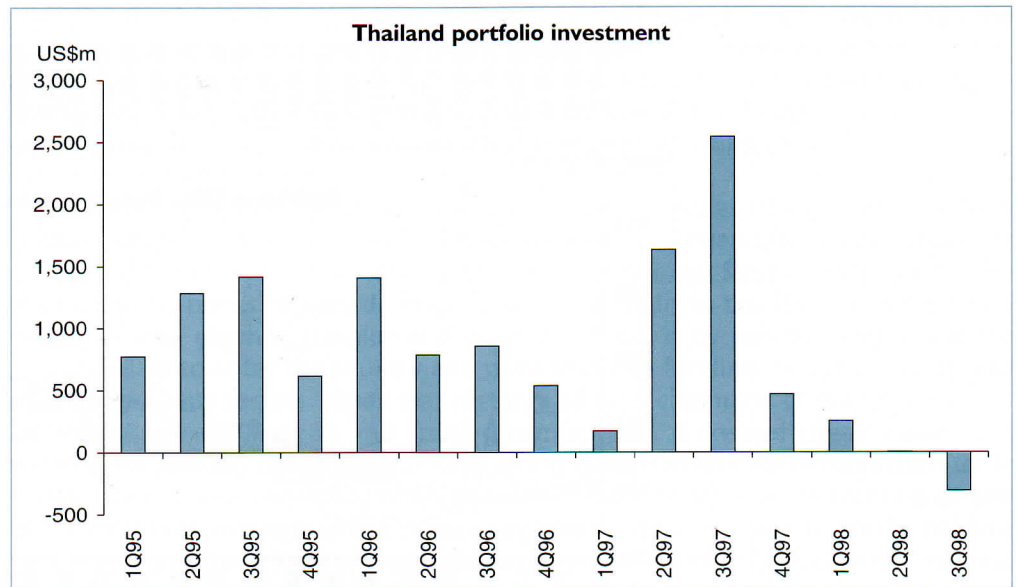
Investor panic and speculative frenzy

*Fund withdrawals:
Local risks,
Japanese problems,
banking panic*

The spectacular withdrawal of foreign funds from Asian markets had several components. First, foreign banks discovered how big their risks were and reacted strongly. Second, Japanese banks were in so much trouble at home that they had to withdraw from hundreds of billions of US dollars of their loans abroad and in a number of cases had to shut down overseas operations completely. This component was tremendously important and of lasting consequence. For many years, Japanese banks had used their low cost of funds to undercut all competitors and in consequence had captured the lion's share of deals throughout Asia and indeed throughout much of the world. Particularly in Asia, this had lowered the cost of funds for ambitious companies. As Japanese banks got into trouble, this extraordinary flood of cheap capital was precipitately and permanently withdrawn. Third, portfolio investors and banks, faced with mounting losses, dumped their regional securities positions belatedly and indiscriminately. "Get me out, regardless of price," was the major theme brokers heard early last year.

*Portfolio investors
didn't panic enough*

Some analysts, including most notably Harvard professor Jeffrey Sachs⁶, have attributed virtually the whole Asian crisis to an irrational banking panic. In light of the scale of the potential losses banks faced, we would argue that this interpretation is totally unsustainable. The banks were crazy on the way in, when they made billions of US dollars of loans to companies they didn't understand, in legal environments they didn't bother to study, and for collateral that could not legally be foreclosed, but they were mostly sane on the way out. Portfolio investors actually panicked too little and too late. An examination of net portfolio inflows for the worst-affected countries shows that portfolio investors hung on irrationally long; for instance, Thailand received record net equity portfolio inflows in 3Q97, even though the baht collapsed on 2 July and the bubble had begun to burst months earlier. (See the chart below on portfolio flows into Thailand. This chart is denominated in millions of US dollars to overcome the distortion caused by the baht's devaluation.)



Source: CEIC

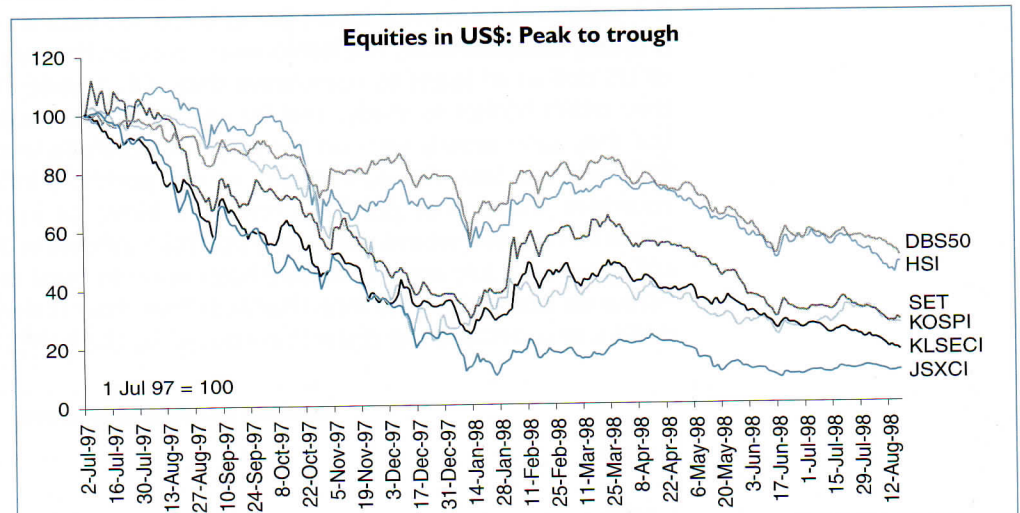
⁶ In a 1998 debate with this writer at Harvard's Asia Center, Sachs described the crisis as simply an avalanche that started accidentally with one pebble falling down the mountain and precipitating an unexpected chain reaction. Professor Richard Cooper, the moderator, gently reminded Sachs that an avalanche requires a 45-degree slope. That slope and the bubble are just different metaphors for the same phenomenon: a region-wide set of financial situations that were a catastrophe waiting to happen. When one looks in detail at the Japanese and Taiwan stock markets of 1989 or at the Thai property and Korean conglomerate markets of 1997, no serious person could argue that these bubbles were sustainable indefinitely. The closer one looks, the more the question becomes how bankers and other investors could ever have been foolish enough to have allowed the situations to become so absurd in the first place. To do so, one must have recourse not to the banking theory but to the psychology of the crowds and the history of such curiosities as the Tulip mania and the South Sea bubble.

Autumn 1998: panic over

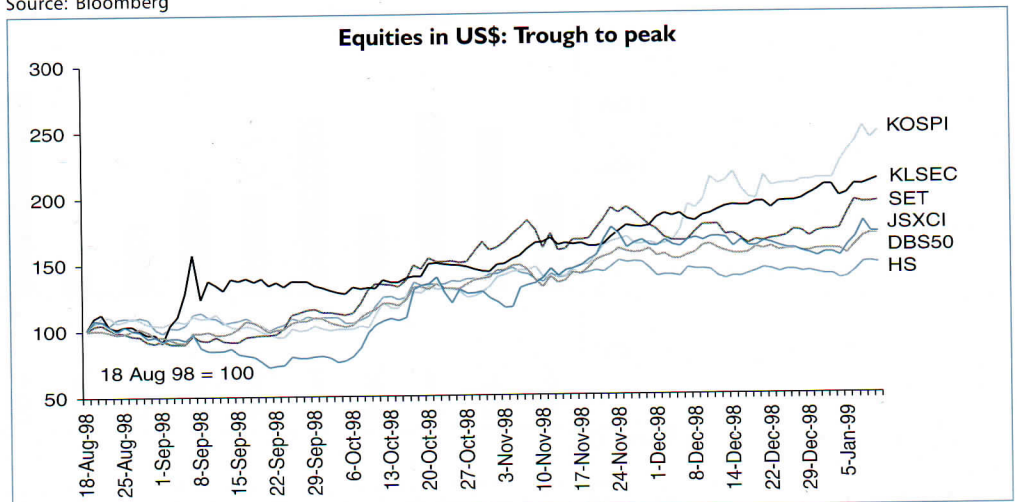
By the autumn of 1998, the residual panic was over, for a variety of reasons. The easing of the currency short squeeze made currencies move up — including the Indonesian rupiah. The debacle of Russia, the insolvency of Long Term Capital Management, and the Brazilian financial squeeze reduced the hedge funds' ammunition and thereby reduced volatility. The US dollar weakened, taking the last pressure off key Asian currencies, including the Hong Kong dollar. Above all the US Fed reduced interest rates three times and Europe followed with a more limited reduction on interest rates.

Result: large profits

The end of the phase of investor panic brought a small flow of money back to Asia's equity markets. And local speculators came back to markets like Thailand. Asia funds which were sitting in cash and fearful that their investors would liquidate put some money — not much, but some — back into the markets. Some investors saw an opportunity to profit from currency appreciation while using local securities purchases as an option on recovery. This limited amount of money flowed into extremely illiquid markets and, together with currency appreciation, yielded large gains in percentage terms. Thus, after the end of the foreign debt crisis brought profits to currency and bond investors, the end of the investor panic phase brought very large gains to equity investors.



Source: Bloomberg



Source: Bloomberg

These gains from small flows of money then gave way to further gains as liquidity provided by US and European interest rate cuts and by Asia's rapidly declining interest rates, created a large pool of cash that was desperate for someplace to go.

(In US\$ terms)	HSI	KOSPI	SET	KLSECI	DBS50	JSXCI
From Peak to Trough (1 July 97 to 17 Aug 98)	52.48%	73.51%	72.32%	82.52%	50.36%	89.23%
From Trough to Peak (18 Aug 98 to 9 Jan 99)	47%	147%	95%	112%	70%	71%

The bubble crisis

Thus, the easing of the debt/currency crisis and investors' panic removed two of the three crises behind Asia's downturn, and the easing of these produced major gains for investors with enough courage to operate in these markets and the analytic skill to decipher what was happening. But outside Indonesia the foreign debt crisis was a tactical problem, not a strategic one, and investors' panic was actually a small part of the overall problem — a typical market overreaction that was quickly reversed.

The bubble aftermath remains — and it is the big one

The major problem — the bubble crisis — remains, and policy measures put in place so far are adequate to cope with the two minor problems but not with the main one. The bubble crisis is the source of the huge loss of economic growth, the evaporation of millions of jobs, the worst political stresses and the biggest investment losses. The bubble crisis is why Asia's problems have persisted long after currencies stabilised, debts became repayable, and investors returned from panic to calculation.

The IMF solved the small problem, exacerbated the big one

The IMF's intervention resolved a tactical problem — the debt crisis — while greatly exacerbating the more important problem. As noted, the total foreign debt of South Korea and Thailand was moderate and sustainable. Beyond that, the two governments' domestic budgets had been more than responsible. Thailand's ultra-conservative budget masters had run 10 consecutive years of budget surpluses, the extreme opposite of the Brazil-style situations to which the IMF was accustomed. In this context, with a recession looming, the IMF imposed a Brazil-style solution, demanding that the government run a huge surplus. This was like demanding Herbert Hoover run a 3% of GDP budget surplus in the US at the start of the Great Depression. The bubbles had to burst eventually, but there were alternative degrees and speeds of bursting that were possible. Cheap money would keep them inflated longer and ease the consequences of their popping; expensive money would ensure a maximum bang. In effect, the IMF completed the speculators' work for them, driving interest rates through the roof and ensuring that the bubbles would collapse with maximum speed and maximum devastation. This was not, of course, malicious; it was the consequence of focusing policy on a derivative aspect (currency values) of a minor crisis (the short-term foreign debt crunch) while neglecting the major problem — the bubble crisis. The correct strategy to have followed would have been China's — deliberately deflating bubble sectors while massively reflatting others.

Inflation of Asia's bubbles took decades; the consequences of their deflation will endure for many years. Financial bubbles are created by channelling more credit, or cheaper credit than normal, into sectors of an economy. South Korea did this by instructing its banks to provide huge volumes of credit to the chaebol, which as a result became gigantic conglomerates. Thailand did it by constructing a way for cheap dollars to enter the country and provide cheap funding for the property and finance company sectors. Japan was history's all-time champion of bubble creation: by restricting consumption and limiting competition, it created cheap investment funding for virtually the entire economy. Hong Kong had an unusual approach to its bubble creation. By restricting property development to 18% of the territory of one of the world's most overpopulated areas it artificially restricted supply, and by holding to a currency peg at a time of high inflation it created an era of negative real interest rates. The combination achieved what once seemed impossible, when Hong Kong's retail property prices in the mid-90s exceeded those of Tokyo's Ginza to become the world's highest. Indonesia and Malaysia used more personalised versions of South Korea's method of pumping up favoured firms.

Bubbles inflate either prices or production

Financial bubbles create either excessive prices or excessive production in the affected sectors. The collapses of property and stock market prices in Japan, Thailand, and Hong Kong illustrate the problem of excessive price bubbles. Price bubbles often collapse quickly, causing great pain but vanishing with great speed. Production bubbles tend to endure longer. Production bubbles, also known as overcapacity, are one of the reasons why the consequences of the Asian bubbles have just begun.

Overcapacity

Cheap money causes overcapacity

Excessive investment, because of the availability of cheap funding, has led to overcapacity in many industries. A canonical example is motor vehicles. In the US, where funding is on a purely market basis, three companies (Ford, GM, Chrysler) have struggled to survive in a market of a quarter billion people. In Japan, where interest rates have been artificially low and special funding has always been available under the main bank system, Toyota, Nissan, Honda, Daihatsu, Mazda, Mitsubishi, Suzuki, Isuzu and Fuji Heavy have coexisted in a market half the size of the US. In South Korea, where the chaebol have special access to banks, Hyundai, Daewoo, Samsung, Kia and Ssangyong have occupied a market with a sixth of the population of the US and a third of per capita income. Although their markets are now more or less global, the reasons they developed and sustained such numbers of car companies were cheap funding and protection. So great was the chaebol access to funds that entering an industry like motor vehicles became more a matter of prestige than a matter of financial calculation. The characteristic Japanese/South Korean focus on market share, rather than profitability, derived from such access to virtually unlimited funds. The result is global overcapacity, with the problem peculiarly concentrated in Asia although European national champions such as Rolls-Royce, Saab, Volvo, Renault, Fiat, and Peugeot certainly have a problem too. The shake-out in the motor vehicle industry has just begun.

Overcapacity is pervasive

In South Korea, nearly every major industry faces such a shake-out. Telecommunications, steel, paper, petrochemicals, memory chips, ships, textiles and many more possess vast overcapacity and will be unprofitable until restructuring occurs. Restructuring damages the interests of chaebol with huge financial and political clout, of their backers in the government, and of some of the world's most intransigent labour unions. While the problem is global, it is particularly concentrated in Asia, and particularly in Japan and South Korea. While global overcapacity in motor vehicles is 17.5%, in non-Japan Asia it is 38.4%.⁷ South Korea has the world's two largest steel mills and the world's biggest shipbuilders. China has the capacity to clothe practically the whole world's population and to provide toys for virtually all the world's children. The process of restructuring will be protracted, expensive and belligerent. The magnitude of the problem is suggested by the fact that in the summer of 1998 the combined debt-to-equity ratio of the top-30 chaebol hit 802%.⁸

Overcapacity endures longer than overpricing

Commodity price collapse

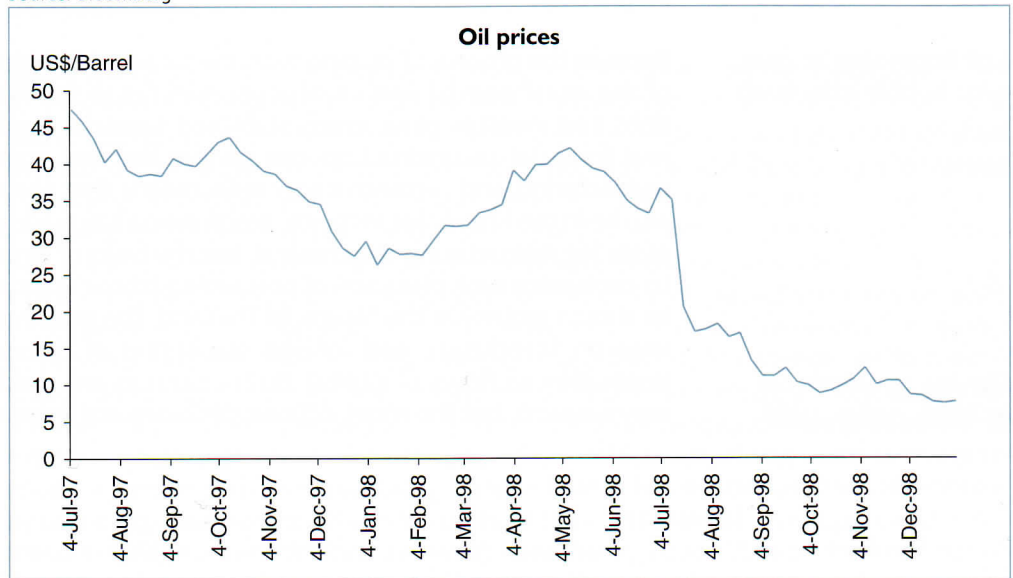
A special aspect of overcapacity concerns commodity prices. The Asian miracle in its heyday created rapidly rising demand for commodities and as a result inflated both prices and production capacity. When the Asian miracle went into hibernation, a reciprocal collapse of commodity prices occurred, affecting both commodity companies and commodity producing economies from Nigeria to Brazil to Canada to Australia and Russia. The ramifications of these price collapses included declines in consumption and investment in numerous countries throughout the world, along with diminished capacity in Latin America, Africa, and Russia to service their debts.

⁷ "The World Auto Market: A Tale of Too Many?" International Bank Credit Analyst, February 1998, p 23. I am also indebted to comments from Jay Woodworth of Woodworth Holdings.

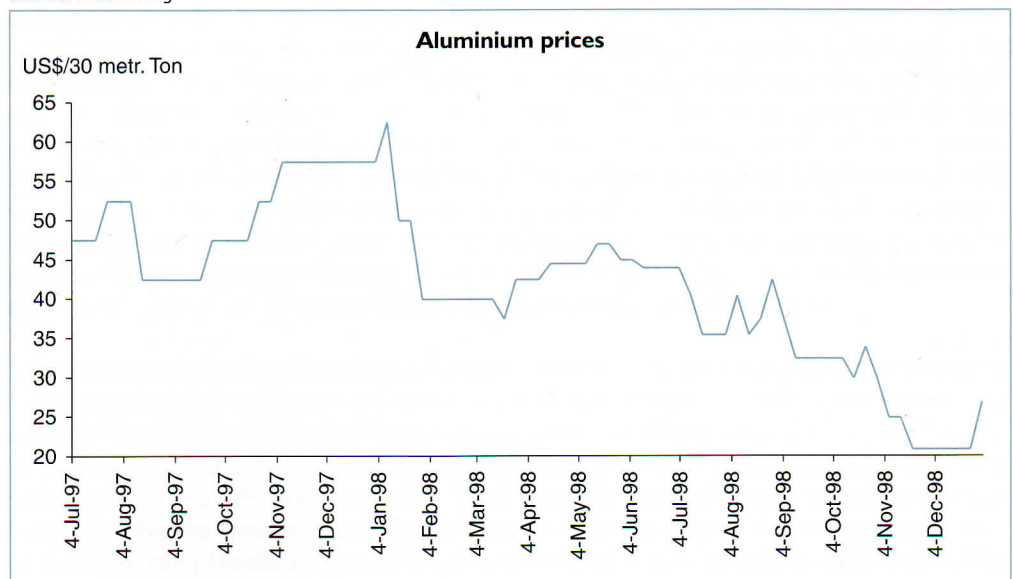
⁸ "The Chaebol That Ate Korea," *The Economist*, 14 November 1998.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

Financial reconstruction

Asia's banks must be rebuilt

The devastated financial sectors of Asia will not revive quickly. Asia's banks as a group have negative capital. Japan has no solid commercial banks. Thailand's finance company sector has lost more than half its members. South Korea has no banks with substantial skills in allocating capital according to creditworthiness and efficient use of resources. Financially, Asia looks like the site of a nuclear weapons blast. Reconstruction has multiple aspects. Bad loans must be written off and the residual assets sold in order to redeploy capital efficiently. Banks must be recapitalised and in many cases (South Korea and China much more than Thailand and the Philippines) taught the skills of efficient capital allocation for the first time. Beyond these difficult tasks, which are the foci for most policymakers, the degree of financial devastation requires acknowledgement that to some extent the role of the old banking systems simply cannot be revived. In the future, the old banking systems will to some degree have to be bypassed. More funds will have to be raised from bond markets rather than banks. Industrial companies like Toyota will have to take on banking functions that traditional banks can no longer adequately perform. And foreign banks will have to play a much larger role in most of these countries. The alternative is economic stagnation.

Just beginning to cope with bubble aftermath

Because the process of dealing with the financial bubbles has only just begun, much of the worst pain of Asia's real economies lies in the future. The end of the foreign debt and investor panic crises stabilised financial markets, but only restructuring and financial reconstruction can restore the real economies. The scale of these restructuring and reconstruction tasks means that the most difficult political tasks also lie in the future. For instance, South Korea has made great progress in developing plans for restructuring the chaebol, but the tasks of actually persuading the chaebol to implement such plans and of persuading labour unions to accept the consequences lie almost entirely in the future. In Thailand, the government remains unable to pass laws on foreclosure and foreign ownership of businesses that would enable a restoration of flows of capital. Both countries are making valiant efforts and both may succeed, but the most difficult decisions are those of 1999, not those of 1998.

The key decisions fall in 1999, not in 1998

The state of the bubbles

Since the actual condition of Asia's economies vary widely, it is useful to provide thumbnail sketches of where each stands in the bubble crisis.

*Modest bubbles,
proactive
management*

Singapore has had relatively modest bubbles and has dealt with its problems proactively. The government has allowed property prices to decline, encouraged a decline in wages and facilitated a decline in the exchange rate. It has acknowledged that certain manufacturing industries must be allowed to fade into the sunset. It has liberalised certain industries, most notably fund management, and made a focused effort to stride forward in areas of particular competitive advantage such as futures trading. The Singapore government's political management of the crisis has also been singularly smooth, particularly in comparison with neighbouring countries; it has explained the problem clearly to its citizens and talked down wages and costs by having senior executives set an example and take cuts first. But Singapore is severely hampered by the small size of its domestic product and financial markets and by its dependence on providing services to the ailing economies of Indonesia, Malaysia and Thailand. In short, Singapore has the best policies but the worst backyard.

*Resilient economy,
healthy backyard,
resisting adjustment*

Hong Kong has the most flexible economy in the region, and like Singapore it has vast foreign exchange reserves, which preclude any foreign debt crisis. However, it had a huge property bubble which has distorted its economic priorities, impoverished the real living standards of the majority of its population, and increasingly threatens to polarise its politics. Because the bubble was much bigger than Singapore's, the economic downturn has been a lot more severe. And the Hong Kong government has repeatedly tried to impede the inevitable adjustment process. Unlike Singapore, Hong Kong has a pegged currency, and this means that the adjustments of asset prices and wages must be greater. But the government has taken a series of measures to prop up property prices and has objected to efforts by key companies to reduce wages. Slow adjustment means a prolonged period of high interest rates, deadly for a market dominated by property and banks. Whereas Singapore has channelled its extra resources into areas of clear competitive advantage, Hong Kong is trying to create a new hi-tech manufacturing base, where it has no competitive advantage. By retaining government ownership of more than US\$11bn of shares purchased in a massive 1998 market intervention, Hong Kong has removed 20% of the free float of its index shares and thereby sacrificed its decisive advantage in the financial competition with its competitors: overwhelmingly superior liquidity in a global financial market desperate for liquidity. All this prolongs the agony, but Hong Kong nonetheless has an exceptionally flexible economy and, like Singapore, banks that are so strong that the crisis presents no serious risk to the banking system. On the political side, Hong Kong also shares more with Singapore than with the places experiencing more severe distress; although Hong Kong has lacked Singapore's strong sense of direction, Hong Kong has clearly preserved its freedom, its legal system and a relatively placid political scene during a unique transition and a uniquely stressful period. And Hong Kong's backyard, namely China and Taiwan, has so far remained relatively healthy, an immense advantage compared with Singapore.

*Worsening credit
squeeze*

Taiwan's stock market bubble popped in 1990 and the economy has continued to experience solid growth despite the travails of its neighbours. This economy has the world's fourth largest foreign exchange reserves, so there is no foreign debt crisis. Taiwan nonetheless has a financial sector bubble, and its problems, reflected in a serious credit crunch, are worsening. Until recently, Taiwan's banks were completely controlled by the government, and Taipei has been unable to shake the Asian habit of manipulating banks to goose the economy and prop up failing institutions. The result is a local version of the Asia-wide phenomenon of excessive leverage. The banks have lent too much and too incautiously.

The proportion of stocks bought on margin is too high. The ratio of private debt to GDP, at nearly 180%, is the highest in the world.⁹ Bankruptcies are soaring. Several banks and finance companies have failed. Stock market investors are failing to close their trades. Banks are increasingly afraid to lend. As elsewhere in Asia, just when Taiwan's economy needs more growth, exports are under pressure. The government is responding by bailing out institutions, mobilising a stock market fund to prop up the market and generally fighting the market rather than using the tide to flush out the rubbish. Taiwan's fragmented, resilient, relatively market-oriented economy will continue to outperform most of its neighbours, but the near-term financial squeeze could be quite severe.

*Biggest problems,
strongest policies*

Among the smaller countries, **South Korea** has the most complex problems but also the greatest resources and the greatest political will to move forward decisively. Most of the country's largest companies depended on credit handouts; many are insolvent and virtually all are unprofitable. The industrial system needs a complete overhaul. The banking system was extremely primitive, essentially a set of ATM machines for the government, and even today has little training in the efficient allocation of capital. The banking system was in fact much closer to China's than to somewhat more sophisticated systems like those of Thailand and the Philippines. Essentially the whole banking system has collapsed and, along with the industrial system, must be reconstructed. Moreover, reconstruction must be accomplished in the face of one of the world's most belligerent labour movements. But South Korea has world-class brands, world-class technology and world class market penetration. It has a president who is powerful and decisive, as well as determined to impose market-oriented reforms despite the forbidding chaebol and unions' opposition. Crucially, it has a tangible history of going out of the way to honour its foreign debts, and its financial laws and enforcement mechanisms give creditors the right to foreclose on insolvent debtors. The outcome is not yet fully decided, but if the country maintains its current momentum it should do much better than Asia's other deeply troubled countries.

As elsewhere, the crucial year is 1999, not 1998. The president is pushing for rapid reforms while he still has the crisis atmosphere from the December 1997 financial collapse and the political momentum of his January 1998 accession to power. The chaebol and unions are fighting for time, desperately hoping that, as the April 2000 general election nears, the president will become desperate for the money, growth and votes that the chaebol and unions control. The most hopeful sign for reform was the president's recent withholding of all loans from the LG group until it agreed to a major restructuring proposal. The most worrying sign is the utterly unrealistic proposals the chaebol put forward for financing their restructuring. The momentum is positive, but the game is not over.

*Creditworthy, but not
attractive to creditors*

Thailand, the original 'popped bubble', has been a poster child for IMF austerity and has begun the process of recapitalising its banks and unloading their bad loans. But Thailand is lagging in the process of implementing laws that would give creditors the right to foreclose on debtors or to own many kinds of local businesses. Such laws are subject to veto or amendment by the Thai Senate and some of the country's most troubled debtors are powerful senators. If the key laws do not pass the Senate, or are watered down into insignificance, or are subject to crippling interpretations by the courts, then Thailand will be unable to recover its former dynamism because investors will never fully return to the old game now that they know how heavily the deck was stacked against them. Moreover, Thailand may face some longer-term constraints. It has not invested in educating its people to the extent that Taiwan, South Korea, Hong Kong and Singapore have, and because of this it is potentially vulnerable to competition from countries like China. It should move up gracefully into higher value-added categories, leaving the cheap textiles behind. In the past it has always moved up gracefully, but there could be more of a problem now. On balance, Thailand remains one of the third world's most diversified and competitive economies and its strengths put it well ahead of most of its troubled Asian

⁹ Cf. *The BCA China Analyst*, December 1998, pg 29

competitors. It has a far better financial and political position than Indonesia, is far more trusted by investors than Malaysia and has a clearer economic vision than the Philippines. But unless there is speedy passage of the key reform laws Thai confidence in the theory of "first in, first out" (ie, the first country to get into the crisis will also be the first to recover) may well be misplaced.

Opted out

Malaysia has opted out of the game. It was in a much stronger foreign exchange position than Thailand and South Korea, but the threat of foreign exchange controls spooked foreign portfolio investors, and the reality of the foreign exchange controls alienated them. So strong has Malaysia's foreign exchange position been that it can survive and even prosper for a while without portfolio investors' strong support. But foreign exchange controls only buy time. In China, foreign exchange controls are being used to buy time for an extremely ambitious and painful programme of state enterprise and banking reforms. Malaysia has a group of protected companies which present the same kind of reform challenge as South Korea's chaebol and China's state enterprises. The question is whether, having adopted Zhu Rongji's strategy for buying time, Malaysia will also adopt an analogous programme of ruthless reforms. So far, there are some reforms and personnel changes but not a rigorous revamping. Because Malaysia's foreign exchange position has always been much stronger than Indonesia and Thailand's; because Japan and various foreign banks are still willing to lend at attractive rates and because it has many highly competitive exports, Malaysia's risk is not some sudden financial crisis but rather that investors' disillusionment with it could linger long after exchange controls are lifted. Investors will for a long time wonder whether there could be yet another reversal of financial policies. This could slow the revival of local financial markets and ultimately reduce medium-term growth, a problem now exacerbated because it has become intertwined with a political succession crisis and increasing ideological divisiveness.

Heavy debt, political pause

Indonesia faced the worst debt crisis, the most personalised bubble and the worst succession problem. Unlike South Korea, where the chaebol were instruments of national policy employed by successive presidents and where the founder, Park Chung Hee (President, 1961-79) did not get rich, Indonesia's bubble companies were all tied to President Suharto. The latter took his country from one that was not a nation politically and which economically lagged far behind Ghana, Nigeria and Burma, into the forefront of respected third-world nations and progressive third-world economies. If Suharto's economic achievements were once overrated, they are now much too underrated. But he was supported, or tolerated, as a dictator due to the economic benefits his regime had bestowed and when the bubble burst, so did the political regime. Indonesia alone among the bubble-busters has not come to terms with its foreign creditors, and it cannot summon the domestic cohesion or foreign credibility to do so until the crisis of the political regime has been resolved. The present government hopes to separate itself from the past and establish a popular mandate through national elections on 7 June 1999. Its critics believe that the government so controls the country's electoral resources that the election will be meaningless. The regime's economic policies have been competent but, in the absence of a political solution, riots, hunger and separatist sentiment are spreading.

Muddling through

The Philippines went through a huge crisis during 1985-86, which refreshed the nation's political leadership and purged many of the worst economic excesses. Since then, the country has never employed channelled and subsidised credit to pump up favoured sectors or the economic growth rate. It never experienced explosive growth, nor has it suffered from an explosive bubble. The country's banking regulations are tighter than in most of Asia, other than Hong Kong and Singapore, and are mostly real banks engaged in real competition. Importantly, when Asia's crisis began, the country was enjoying, under President Ramos, the fruits of the most reformist economic policies in the nation's history as an independent country. Now there is a new leadership; President Estrada has so far neither made any big mistakes nor articulated a visionary reformist agenda. Under him, the Philippines seems destined to be neither a great takeoff nor a great popped bubble, but a rather unremarkable example of muddling through.

Bubble overview

Strong progress, most difficult decisions ahead

On balance, the smaller Asian countries have made substantial progress in coming to terms with their respective bubbles. The political courage displayed by the leaders of Thailand, South Korea, and even Indonesia in implementing painful austerity programmes and imposing politically difficult banking reforms should not be dismissed by those who are impatient. These things do take time. Outside Indonesia, the foreign exchange and investor panic crises have been fully resolved. But the full resolution of the important crisis, the bubble crisis, remains. The adjustment pain, particularly loss of jobs, will get worse before getting better, and the most difficult political decisions are 1999 decisions, not 1998 decisions — Thailand's foreclosure and alien business ownership laws, South Korea's implementation of chaebol and labour reforms, Indonesia's election and debt renegotiation. The deal is not yet closed and the smaller countries' ability to close will depend upon what happens in the larger world economy as well as in their own.

Five-year reconstruction, universal success not inevitable

Assuming the smaller countries are able to follow through, the reconstruction of financial systems in Indonesia, Thailand and South Korea, and the reorganisation of South Korea's industrial structure, are five-year processes rather than one-year ones. Some return of growth is possible much faster than that, and markets can respond even faster. But there is a danger in assuming implicitly either that success is inexorable or that economies afflicted by what are in effect nuclear bubble explosions can bounce back with the same speed as countries whose problems were more narrowly confined to classical foreign exchange crises. A rebound to real vigour will require that the most ambitious reform plans be fully implemented; Thailand will never reacquire the capital flow for rapid growth without a real foreclosure law and South Korea will never resume its former vigour unless the chaebol are actually forced to meet the test of the market without financial subsidies. The example of Japan's decade-long failure to recover shows one cannot assume that reforms will be done just because they are necessary. Recovery is not inevitable in all cases.

The global context: China, Japan and US risks, deleveraging versus reliquification

Prerequisites of recovery

Asia's recovery presumes not only that its reforms continue to progress but also a reasonably benign global and regional environment. In particular, the recovery of the smaller countries requires that:

- Japan avoids a financial meltdown;
- China avoids a banking crisis; and
- The US stock market avoids a crash.

Each of these assumptions may well be fulfilled. But the combined risk that one or more of them could fail is sobering.

Japan

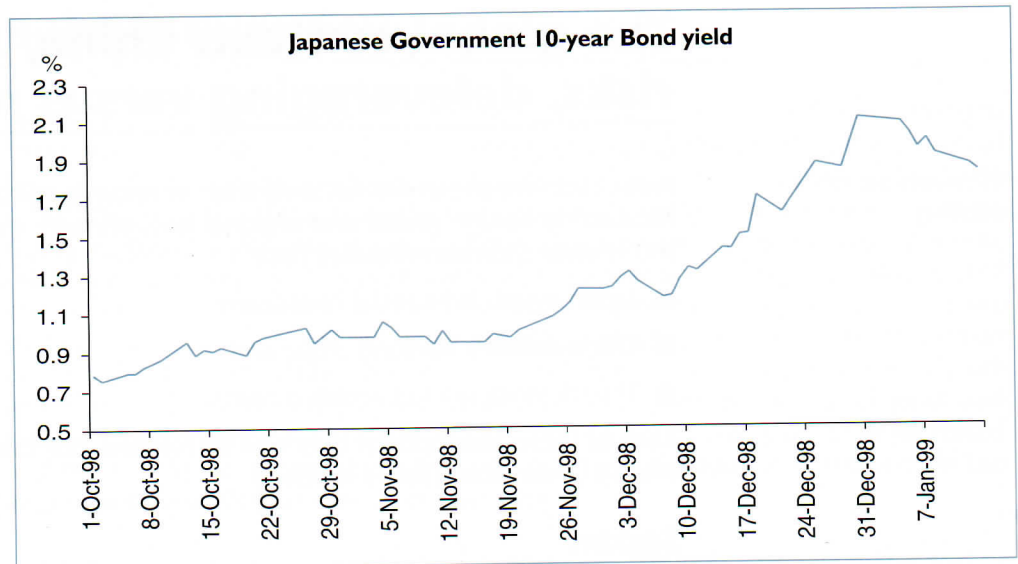
Biggest bubble, longest recession

Asia's economic giant has experienced nearly a decade of stock market and property deflation, stagnation and recession. During this decade it has gone from the most admired economy in the modern world to the sick man of the G7. The country's decline shows that a bubble crisis can be totally crippling even in the absence of the foreign exchange crisis and investor panic that afflicted the smaller Asian economies. The post-war Japanese leaders were able to build the whole economy rapidly by artificially restricting consumption in order to pump up savings and investment and reduce interest rates. This provided the ideal conditions to mobilise all the nation's resources for economic recovery. But when the recovery was complete, it provided the ideal conditions for the biggest and broadest-based financial bubble the world has ever seen.

Japan will not be a locomotive

Just as the IMF addressed the crisis of the smaller countries too narrowly, focusing on debt/currency problems at the expense of the more important bubble problem, so Japanese leaders and most foreign analysts focused on the recession problem as if it were just a classic weakness of demand. If you are short of demand, as the US was during the Great Depression, then stimulating the economy with easy money and big budget deficits will resolve the problem. For a long time, most prescriptions for Japan focused almost exclusively on this aspect. The implicit assumption was that, if one could just get Japan growing again, gradually everything would be all right; subsequently the nation could be a locomotive pulling Asia out of its crisis. As Paul Krugman famously said, "There is nothing in economic theory that says an economy with problems can't grow." Then, as the malaise persisted and banking problems worsened, the prescription was broadened to include banking reforms; by that time there were no strong commercial banks left in Japan and it became less and less clear how one could consolidate the banking system without just conglomerating smaller-sized problems into larger ones.

Japan has stimulated itself nearly to the point of no return. For a long time interest rates were close to zero. Deficits have been so large and so persistent that this former model of fiscal prudence is starting to make Italy's balance sheet look good. Now interest rates are rising so fast that the cost of financing the deficits threatens to wipe out much of the intended stimulus. Growth achieved through heroic deficits during 1999 may prove to be a pyrrhic and temporary victory. Rising interest rates on bonds have collapsed their value, with the result that banks already squeezed for capital are being pushed closer into the corner by hideous losses on their bond portfolios. Bonds constitute the majority of Japanese banks' capital, and in two months the value of these bonds has halved. Rising interest rates have in turn made Japanese bonds more attractive to Japanese and foreign investors, contributing to a spectacular rise in the yen that could curtail the country's export growth. Those who prescribed this medicine have given Viagra to a heart patient.



Stimulus plus bank reform won't cure

So long as more fundamental reforms do not occur, the Japanese crisis cannot be resolved through any combination of stimulus and banking reforms. The traditional combination of international protection, local cartelisation, labour immobility and unusually low interest rates for its largest companies, locks much of Japan out of the modern, competitive world. The industries that are part of the modern, competitive world, most notably cars and consumer electronics, are magnificently successful. These industries are like a tennis player's right arm, well exercised and hyper-competitive. But much of the rest of the economy, most notably property, construction and retail, is like a middle-aged beer-drinker's paunch. And the commercial banking sector is like cancerous lungs, threatening the viability of the whole body. In this situation, fiscal stimulus is like giving the patient Gatorade; it may increase the patient's energy level for a short time, but it does not lead to recovery. What the Japanese economy requires is thorough liberalisation, which would precipitate the kind of squeeze the US Midwestern rust belt experienced in the 80s, followed by the kind of remarkable recovery that rust belt subsequently enjoyed.

The prescription of stimulus as the primary policy is convenient for Japanese politicians because it enables them to avoid difficult political issues. And offers Western theorists an opportunity to use textbook prescriptions derived from analyses of the US Depression 70 years ago. But these convenient prescriptions won't fix Japan. Employees who look around them and see a high percentage of their fellow workers not actually doing useful work, will remain anxious and unwilling to spend almost regardless of the degree of fiscal stimulus. And sophisticated investors who see they can make a third more for the same investment by investing in the US are likely to do just that if the government puts more money into their pockets. Positive change is occurring; workers are moving more, local companies are becoming leaner and foreign companies are enhancing competition. But this is happening at a glacial pace because the political leadership has a vital stake in the old order.

Bank reform is glacial. The banking system needs to be bypassed

Likewise, banking reforms are happening at a glacial pace. Japan lacks the option of having strong banks to take over its weaker ones as there are no longer any strong commercial banks, so the government just folds a couple of the more disastrous ones. The government has provided funds, which the remaining banks can access in order to avoid failure, but the banks' leaders do not want to dilute their ownership, so they only take enough to avoid disaster and the government does not force them to change. The most likely outcome would seem to be continued banking stagnation, with serious risk of downside surprises. The most likely scenario for national financial recovery may not be revival of existing commercial banks but rather what one might call the Toyota-Nomura-Deutsche Bank scenario. Strong industrial companies like Toyota, which can access funds at better rates than commercial banks, will take on banking functions and eventually acquire banking licenses. Investment banks will

increasingly provide, through issues of equity and fixed income securities, the funding that formerly came from commercial loans. And foreign banks will play a much larger role in Japan. All this, however, will take time.

If Japan does all the right things, if it accepts the need for vigorous exercise to reduce its middle-aged paunch and has surgery to cure its financial cancers, it will likely still be in the recovery ward for several years. Although massive stimulus could create some 1999 growth, it will not cure the country or turn it into a locomotive for Asia's recovery. The locomotive, if any, will continue to be the US.

The United States

This is not the place for detailed analyses on the US economy. Suffice it to note that the principal stimulus to Asia's economic recovery comes from a vigorous US economy that, precisely because of its vigour, runs huge current account deficits whose counterparts are huge surpluses for South Korea, Thailand, and other Asian economies. This US vigour depends more upon the health of the stock market than at any time in modern history. Unlike the situation a decade ago, when Americans' wealth largely resided in their homes, now the centre of gravity of their wealth is their mutual fund holdings. Americans spend freely because they feel prosperous due to the stock market rise; without that, the negative US savings rate and the highly leveraged position of US consumers would lead one to expect an early fall-off of consumption growth. A sudden drop in the value of these mutual fund holdings would likely induce a rapid contraction of consumer spending and a US recession. That in turn would curtail Asian recovery.

As long as the Fed pumps up the money supply and the baby-boomers pump up their investment funds, the US stock market rise can theoretically continue regardless of earnings. However, Asian observers are made nervous by indicators to which they are more sensitive, due to their recent experience, than Americans:

- historically high valuations;
- equity prices are rising while earnings are weakening;
- market excitement focused on shares where earnings are all promise and no reality; and
- the omnipresent argument that we are in a new era and traditional valuation methods no longer apply.

This is frightening stuff to investors who have been burned by Chinese red chips, Taiwan banks and Thai growth stocks.

China

This country is the best of things and the worst of things. It has the most pro-active policies and the worst bubbles.

The baseline for considering China's policy effectiveness is what Zhu Rongji and his colleagues accomplished in a set of reforms which began in 1994. They unified China's three-currency (official rate, market rate and foreign exchange certificate) system. They stabilised the currency's value in the face of then-high inflation. They attracted foreign direct investment of up to US\$45bn per annum. They increased foreign exchange reserves from US\$21bn to US\$145bn. They limited China's foreign debt to roughly the size of its foreign exchange reserves. And they reduced inflation from 22% to negative numbers while maintaining growth in the 8% range and stimulating a series of record grain harvests. This set of accomplishments over four to five years is one of the most magnificent performances in economic history, particularly considering the size and complexity of China.

A US stock market collapse would bring recession and end Asian recovery

Worst bubbles, best policies

*1994-1997:
Breathtaking reform success*

*1998-2000:
Breathtaking problems*

This proactive management is now being tested against a horrific backdrop of problems. China's domestic problems are South Korea's writ much larger, in a much poorer country. (China does not have South Korea's foreign debt problems.) As in South Korea, China's principal enterprises have been bloated with bank loans, which were inappropriately large and inappropriately cheap. The majority of these enterprises lose money, the aggregate of the state-enterprise sector loses money, and the consequences fall on the banks, which are increasingly crippled by bad loans. The banking system is estimated to have RMB2tn of bad loans. The international trade and investment companies (Itics) are estimated to have RMB0.5tn of bad loans. And there are about RMB1.2tn of bad inter-company loans. Combined, these add up to roughly one-third of GDP, ranking China's bad-debt situation among the worst of the Asian countries with financial problems. In all likelihood, the bad news is greatly understated. That has been the universal experience in the accounting of bad loans.¹⁰

There are mitigating interpretations of these numbers. Since the banking system subsidises state enterprises, which in turn provide nominal employment and subsistence incomes for a large population that in the US would be on welfare, one can interpret the bad loans as the world's cheapest welfare system. If one adds the bad loans to the government's stock of debt, the resulting figures are moderate shares of GDP, compared with the debt of well-respected European countries. There are two problems with such interpretations. One is that a banking system has an internal logic that cannot be disregarded. Bad loans beget bad loans. Using banks as a welfare system creates habits and processes of lending that grow exponentially into a catastrophe. Second, whereas European countries can collect taxes of 40-50% of GDP, China has difficulty collecting much more than 10% and that proportionately limits its ability to fund obligations that become large relative to its economy.

Proactive management

Unlike the smaller Asian countries, and unlike even Japan, all of which hid their problems and delayed dealing with them until the crisis struck, China has long acknowledged its problems and adopted proactive policies. To save China's banking system, the leaders believe that they must first clean up the banks' customers, namely the state enterprises. They adopted a programme of vigorous reforms, which was projected to cost at least 30m state-enterprise jobs. In addition, they planned to restructure the central government with a view to cutting total central government employment by about half. They have also attacked banking problems directly, restructuring the central bank, trying to hold banks more accountable for the fate of their loans, closing the worst bank (Hainan Development Bank), closing the second most prestigious Itic, publishing a restrictive new securities law, and attacking practices at the two top brokerages. The decision-makers are forthright about the scale of their problems, the prescriptions are drastic, and the institutions being restructured are the biggest and most influential. All of this is reassuring.

*Tested approach,
daunting scale*

Also reassuring is the observation that Zhu Rongji is now implementing on an extremely large scale the approach that worked on a smaller scale during 1994-97. Then he forced inflation down by limiting banks' total loans, by forbidding loans to bubble sectors like property, and by dictating loans to bottleneck sectors, and he kept growth up by investing in infrastructure and other bottleneck sectors — a very socialist approach, but it worked. Now he is trying to deflate state enterprises and banks, while trying to reflate infrastructure and housing. The similarity in structure to what was tried before and succeeded is the good news. The bad is that this time the scale is so much bigger, the difficulty of fuelling the housing and infrastructure sectors both quickly and efficiently is extremely daunting, and the employment problem is so much more politically sensitive.

¹⁰ At the time this report went to print, the problems of Guangdong Enterprises, one of China's larger and more respected companies, led to the revelation that its debts are about twice what they were initially reported to be. This is probably not an unusual situation.

Kill the banks to save them?

To offset redundancies, the government is seeking to generate jobs by maintaining an 8% economic growth rate. Since that is difficult in the current economic environment, with export demand declining and anxious consumers not spending, the government is insisting that banks make loans beyond what they want to make. In other words, starting with a desire to save the banks from their bad loans, the government is pushing them to make loans bankers think undesirable. If anybody can break out of this dangerous circle, Zhu Rongji can, but there is certainly substantial risk.

The downside risk for China is probably not South Korea's collapse but rather a Japanese-style liquidity trap. Impoverished China cannot afford a liquidity trap. Nor can Hong Kong and Taiwan afford a Chinese downturn in the near future.

Once again, the New York, Japan and China situations could work out for the best. But investors need to price their perception of the risks into their purchases.

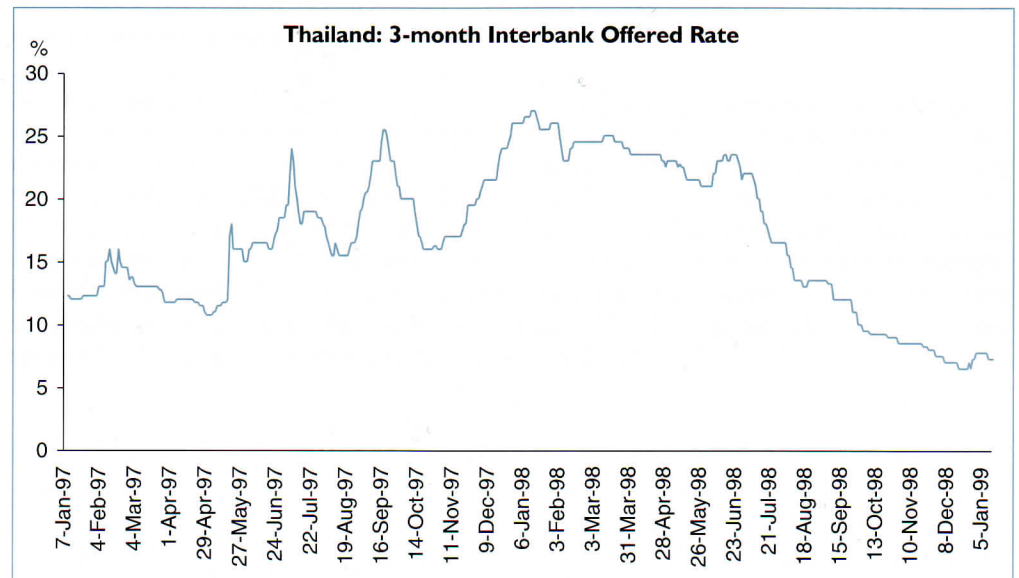
Liquidity no, liquidity yes

Deleveraging

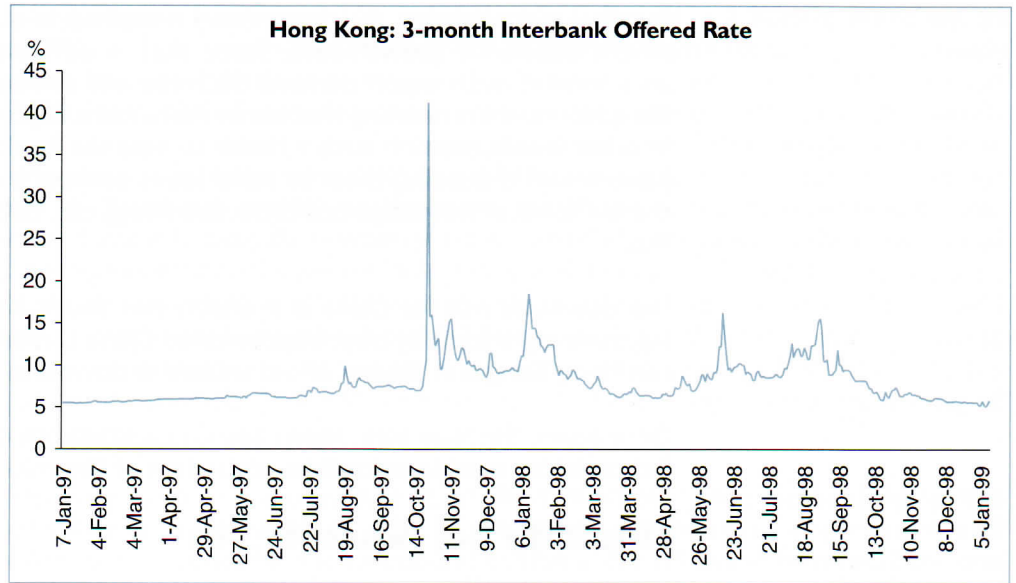
Faced with the emerging markets crisis, banks around the world implemented a flight to quality. Lending and portfolios flows to emerging markets dried up. The high-yield loan market dried up, not just for emerging markets but also for G-7 companies. Faced with more volatility than they could analyse, the hedge funds took beatings in G-7 interest rates, in Brazil, in Russia, and in their attacks on the Hong Kong dollar. LTCM and other hedge funds had to de-leverage. Asian banks' capital was so impaired by bad loans that lending dried up. Above all, Japanese banks, whose low cost of funds had enabled them to defeat all competition for many years, had to pull back from hundreds of billions of US dollars of offshore credit exposure; this by itself has been a primary driver of recession and currency pressures in Hong Kong, Singapore, Brazil, and elsewhere.

Releveraging

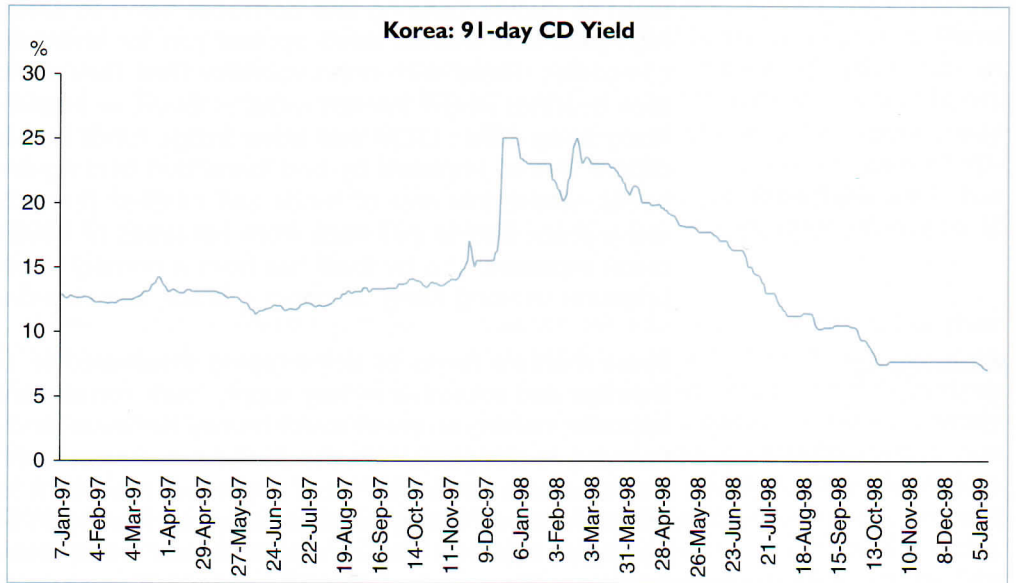
These multiple forms of deleveraging threatened to turn a long era of excessive leverage and excessive money supply, with consequent financial manias, into the opposite, namely an era of scarce money, deflation, and potentially even depression. Reacting to this global risk, the US Fed cut interest rates three times in succession at a time when a narrow US focus might well have led it to raise interest rates in order to cool what was widely perceived as an overheating US economy. As US rates declined and Asian countries transcended their debt crises, interest rates in Asia plunged — sometimes from around 30% to around 10%.



Source: Datastream



Source: Datastream



Source: Datastream

Investment recommendations

Crazy quilt of market deflation and inflation

The result of the two processes — deleveraging and interest rate declines — has not been a clean average of the forces of money supply contraction and money supply expansion. Instead, there has been a crazy quilt of financial mania and deleveraging. Japanese banks are still deleveraging, along with many other Asian financial institutions. On the other side, US mutual funds are desperate to buy when there is little to buy. Asian equity markets are booming when there are no earnings. Local punters whose experience tells them that Asian markets always bounce back fast are bulls. Local analysts who look at earnings are bears. US analysts who look at money supply and funds' cash levels are bulls. Global analysts who look at the big risks from New York, Japan and China tend to be bears.

It is well to understand all these positions. The bulls and the flood of money have dominated the last few months. Bad news from New York, Tokyo or Shanghai could validate the bears overnight.

Liquidity the driver

In this situation, anyone who can bug Fed chairman Alan Greenspan's office can afford to be a bull, because as long as the Fed keeps expanding global money supply the bulls are likely to be right. But the minute global money supply stabilises, the bears will likely have a party. So, globally and particularly in Asia, this is a good time to be a short-term, risk-accepting trader with an ear in the Fed.

What does a reasonably conservative Asian investor with a longer-term view and a short-term aversion to risk do?

BUY improving sovereign bonds

The most attractive investments with substantial liquidity are sovereign and quasi-sovereign bonds denominated in hard currency. We believe that Thai, South Korean and Hong Kong bonds are sound value and are likely to appreciate over time as the rating agencies gradually adjust their ratings to accommodate the large foreign exchange reserves and more stable post-bubble economic environments. Hong Kong bonds should appreciate over time, in part because we believe Moodys' insistence on using China's rating as a ceiling on Hong Kong's rating does not reflect the reality of the SAR's fully validated autonomy. When Hong Kong was under British sovereignty, the bond ratings reflected Hong Kong, not British credit quality; the same pricing principles should eventually dominate investor thinking about Hong Kong.

For a different reason Malaysian quasi-sovereign bonds are attractive. There are substantial risks, both political and financial, in the Malaysian situation, but we believe that these have been overpriced into Petronas bonds.

BUY Korean restructuring

Among Asian equity markets, the one with the greatest prospects to make gains and hold them would seem to be South Korea — so long as President Kim Dae Jung continues to have the initiative with the chaebol. South Korea's growth is reviving more quickly than that of the other deeply troubled economies. Its foreign exchange reserves are now huge. The strength of the Japanese yen gives South Korea competitive room for manoeuvre. The big chaebol have more access to foreign funding than their Thai, Indonesian and Malaysian counterparts. And they have solid saleable assets that they are allowed to sell to foreigners, along with a legal system that allows such assets to be used as real collateral.

*BUY Korean
restructuring successes*

Within the umbrella of the South Korean market, as certain of the chaebol restructure, some companies with attractive revenue prospects should quickly emerge. It is too early to identify which pieces of the chaebol will be most attractive, because the restructuring plans as yet are not that detailed. But restructuring stories should be the most attractive theme later in 1999. Also, BUY the chaebol most likely to reform and recapitalise and simultaneously SELL the others short. Within each of the really troubled markets, it makes sense to BUY sector or category leaders and simultaneously SELL short laggards, since a protracted squeeze will usually differentiate leaders and laggards to an extreme degree that is not reflected in current earnings or valuations.

*BUY HK companies
with businesses outside
the SAR*

In the Hong Kong market, we recommend that investors dig for those few companies that are not property companies or banks and that serve strong markets outside Hong Kong. Legend, a company that sells computers to China, is our current favourite.

*BUY Korea,
SELL Thailand*

In such uncertain local, regional, global and liquidity conditions, another attractive strategy is to neutralise some of those "environmental" risks by pursuing arbitrage tactics. BUY the South Korean equity index and simultaneously SELL the Thai index short — so long as South Korea is attacking its chaebol problem and Thailand is fudging its foreclosure problem. Perhaps most importantly, BUY the Singapore equity index and SELL Hong Kong short, because Singapore is adjusting so much more rapidly than Hong Kong. So long as Hong Kong has a pegged currency and slow adjustment, it can be expected to have extremely high real interest rates; these in turn are deadly to a market dominated by property and bank shares. Singapore's rapid adjustment and flexible currency point to relatively low real interest rates; for market index appreciation we believe these are more important than Hong Kong's advantage of a strong back yard.

*BUY Singapore,
SELL Hong Kong*

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