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Reversal of fortune

By Matt Miller

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A financial meltdown scorched Asian economies a decade ago. Easy money, bad loans, real estate bubbles, poor savings rates, overpriced currencies and inadequate current-account reserves ignited a devastating crisis of confidence.

Sound familiar? What happened next doesn't.

Thailand, Indonesia, South Korea and others sought economic lifelines. International Monetary Fund bureaucrats, Washington regulators, even many Wall Street bankers demanded a kind of Faustian bargain in return for bailout loans: Let economies contract and banks fail. Don't print more money. Don't descend into deeper deficits. Don't impede trade flows. Don't bail out. Privatize. Don't hinder acquisitions of assets by foreign bargain hunters. Above all, let the markets sort themselves out.

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Now comes the reversal of fortune. The know-it-all doctor has become the wounded patient, unable or unwilling to submit to the same medicine and rehabilitation it once prescribed. Over the past decade, the patient has become healthy, strong and fiscally responsible.

Role reversal is tempting in various Asian capitals these days, but it hasn't happened for good reason. America's banking collapse has weakened capital markets around the globe. Without overstating the obvious, the crisis is global.

"Is there resentment? So far, no," says Linda Lim, a professor at the University of Michigan's Ross School of Business and a Singapore native. In the current crisis, "Americans are much more focused on greed and lack of regulation. Asians are more concerned with the impact on themselves, that their major market is going into a recession."

Longer term, however, Asian economic planners, regulators and investors will almost certainly see the current financial wreckage as an inflection point. Everything from monetary policy to investment flows could be reassessed and affected. "The credibility of the U.S. model as a guide for much of Asia is lost," says Brad Setser, fellow at the Council on Foreign Relations' Greenberg Center for Geoeconomic Studies. "Fewer will emulate the U.S. model in the near future."

"Any kind of regulatory proposal of the U.S. government is going to get laughed right out of the room," adds Marcus Noland, senior fellow at the Peterson Institute for International Economics in Washington. "If the [United States Trade Representative] or Treasury wants to change, say, an insurance regulation ... or any micro-level regulation to the advantage of a U.S. service provider, it will be tough sledding."

While some now worry that liberal macroeconomic policies in Asia could suffer, changes will more likely reflect less ideological decisions than pragmatic ones. But the current crisis could become an excuse for moderating or peeling back everything from takeover regulations to exotic financial instruments. Leveraged buyouts will be viewed more critically. Asia's own appetite for U.S. debt is bound to get a rethink. Perhaps most importantly for the global system, over time, the enormous trade surplus of China and other Asian nations will be recycled less into U.S. financials and more into Europe. That process began before the crisis and reflects the growing importance to China and the rest of Asia of the European market. No one is predicting a sudden, wholesale selloff of U.S. financial assets, which would cripple Asian economies as much as America's. A gradual diminution, however, will continue.

"From Asia's point of view, Europe displaced the U.S. as its main export market. China's surplus with the EU is now larger than

with the U.S.," says Setser. "That shift will have a big impact."

Right now, Asian central banks have their hands full trying to contain the current mess. Unlike in the U.S. or Europe, no major Asian financial institution has needed a rescue package -- at least so far. However, throughout Asia, credit has tightened and the liquidity tap is being ratcheted down. Growing concerns that a deep U.S. recession could infect the rest of the world has caused local banks and businesses to dump local currencies. Stock markets throughout Asia are in freefall. Asian equities have already suffered because foreign investors have been pulling out. After years of foreign net buying of Asian equities, **Fitch Ratings** estimated foreign net selling totaled $13.7 billion during the first half of this year. That pullout will continue.

"Risk aversion" is the mantra of the day.

To counter, central banks from Taiwan to Indonesia are buying local currencies and cutting interest rates. Japan's central bank pumped $200 billion into the country's money markets in September. Expect more to follow. The latest action came Oct. 8, when China's central bank cut interest rates by 0.27 percentage points.

According to James Seward, who works on financial-sector issues related to Asia for the World Bank, a number of Asian governments have considered in recent months the type of stock market stabilization fund that Hong Kong established during the Asian crisis. That hasn't happened yet. However, the Chinese government has directly intervened in the stock market. After markets plummeted in the week of the **Lehman Brothers Holdings Inc.** bankruptcy, **Merrill Lynch & Co.'s** sale to **Bank of America Corp.** and the **American International Group Inc.** bailout, Beijing ordered **China Investment Corp.**, the country's sovereign wealth fund, to shore up the country's three largest publicly traded, but state-owned, banks. CIC bought 2 million shares in each of the banks, whose share prices had been tumbling even before last month's crisis struck.

Because they are state-controlled and have relatively conservative capital requirements, no one is talking about the need for a major government bailout. But the Chinese banks aren't immune, either. Like their European counterparts, they fell prey to the siren call of U.S. asset-backed securities linked to subprime loans. According to a January Congressional Research Service study, the largest of the three, **Bank of China Ltd.**, reported $15 billion in U.S. asset-backed securities in mid-2006. Bank of China held $7.5 billion in subprime mortgage-backed securities in September 2007, the study said.

Even India, which was largely insulated from last decade's Asian crisis, has witnessed steep equities selloffs and panicked bank withdrawals. Immediately after the Lehman bankruptcy, the Reserve Bank of India said it would pump money into the system if necessary. Two weeks later, the RBI announced it would provide **ICICI Bank Ltd.** with cash after the beginnings of a run on India's largest private bank. Last week, the central bank said it would relax cash-reserve ratios for commercial banks.

With few exceptions, Asian economic planners maintain their countries are fundamentally strong. Thailand, for example, triggered the financial crisis in 1997 with a run on its currency, which the government unsuccessfully countered by spending its precious reserves on propping up the baht. Now the baht is strong. Thailand's nonperforming loans stood at a scant 3% in August, according to the country's central bank governor, Tarisa Watanagase. Local lending actually increased in August, she told local reporters.

That doesn't mean there's complacency or a belief that Asia is somehow immune to events now taking place in the U.S. and Europe. "I just returned from a two-week trip in Asia," explains Noland. "When I first got there, it was schadenfreude. Over time, that was replaced by fear."

For a few antagonistic or nationalistic commentators in Asia, today's crisis provides added impetus for pushback. There's an undercurrent -- how strong is a matter of dispute -- that wants to sweep away dependence of Asian economies on the U.S. and Western Europe. This notion of economic decoupling promotes "Asia First." The model isn't new; it became a popular rallying cry after the Asian crisis. But it's getting another showing thanks to the current mess.

An emphasis on regional trade is difficult to envision. "Uncoupling is a myth," said Ifzal Ali, chief economist of the Asian Development Bank, in a September press statement that came just before the financial meltdown. "The region still depends on industrial countries to fuel its growth."

Calls have been renewed to stimulate domestic economies and no longer focus only on exports and trade. Some, such as longtime Asia commentator Philip Bowring, suggest regional cooperation in this stimulus effort, including a regional market in local currency government bonds.

A program that allows swaps between Asian central banks is developing and now totals some $80 billion, according to Noland. If the crisis picks up in Asia, as now seems certain, its smaller countries could avail themselves of this facility even further and test this regime.

But other forms of regional monetary cooperation are difficult to see. The problem is that in Asia, economic development and exports remain practically synonymous. Policies that favor domestic consumption over the reliance on exports are often bandied about, and necessary in the long term, but so far rarely acted upon.

Since almost all Asian countries remain tightly tethered to high investments and exports for growth, they compete for business rather than complement each other. Selling to each other has increased over time, but it's never been a substitute for the American and European markets. Even Japan has proved incapable of providing a robust Asian destination for goods and services.

More so than investments in risky U.S. securities, that's why Asia is so troubled by what's happened on Wall Street. A U.S. recession will most certainly batter Asian shores. Asian economic planners also understand how devastating and long-lasting such a situation can be. "Right now, there's a discordant disconnect between a booming Asia and a slowing U.S.," says Setser.

Today's financial crisis has some important antecedents in the disaster of the late 1990s. One of these is the uncertainty of its extent.

As the Asian crisis moved from country to country, as corporations and banks failed, nations were terrified to realize that even regulators couldn't determine the level of bad debt. (In late 1997, during the summit of Asia-Pacific leaders, I challenged a top-ranking Korean official in a televised press conference that the actual total of his country's bad debt was at twice what was being made public; he couldn't refute me.)

There was no question that the region's economies were seriously out of whack. Banks were undercapitalized, reckless and, often, corrupt. Reform was necessary. Asia needed help.

What happened, however, was the kind of devastating economic correction American officials and Wall Street now are desperately attempting to prevent. Known as the "Washington consensus," the American-backed, IMF dicta demanded shock treatment in return for assistance. (Even then, American aid was parsimonious. Japan provided the bulk of the necessary loans.) Looking back, just about everyone admits that while the banking system in Asia strengthened, the "Washington consensus" contained elements that were, at best, ill-conceived and, at worst, socially disastrous.

High interest rates and stiff monetary policies exacerbated an already steep recession. Poorer countries such as Indonesia and Thailand couldn't pump money into their economies to stave off widespread joblessness, economic contraction and even food shortages. Longtime Indonesian dictator Suharto fell as economy-related protests turned political. As Shawn Crispin, Asia Times' Southeast Asia editor, recently pointed out, one of the most dramatic images of the era was IMF head Michel Camdessus, arms crossed, looming over Suharto as he signed a bailout agreement.

It took years to recover. Even now, some Southeast Asian officials bristle about its effects. During a workshop in Malaysia last month, Rizal Ramli, a former Indonesian economic minister, slammed IMF policies and warned that continued liberalization was responsible for stock market and real estate bubbles in his country. "The more hot money flows into Indonesia, the more vulnerable the economy becomes," he warned, according to press reports.

As a result of the crisis, most Asian currencies sharply devalued, making exports far more attractive to American and European consumers. At the same time, Asian savings rates rose steadily. Current accounts moved firmly into surplus.

In one respect, however, most Asian nations held firm. Rather than allow their currencies to freely float as Western regulators demanded, most Asian nations maintained a peg, usually to a basket of currencies that included the U.S. dollar, euro and yen. That insured export competitiveness wouldn't suffer when economic recovery led to rapidly appreciating exchange rates.

These countries -- most notably China -- built up huge foreign exchange reserves in the process. Trade surpluses underwrote the effort, as did foreign direct investment. China's central bank kept purchasing dollars in a deliberate effort to keep the value of the renminbi low.

China's foreign exchange reserves last year topped $1.5 trillion, a more than fivefold increase from 2002 and more than double 2004. But it isn't the only country with bulging coffers. Singapore, a city-state of 4.5 million, held foreign exchange reserves of $141 billion. Through the first half of last year, foreign exchange reserves in all Asian countries eclipsed $3 trillion. Asia has not only the largest international reserves in the world, but the highest savings rates. Debt levels are way down. Current accounts are now in surplus, not in deficit.

Governments have to recycle mammoth dollar holdings some way. Recent attention has focused on various sovereign wealth funds and their estimated $3 trillion in capital. Especially in the case of China, however, the state itself poured far more surpluses into U.S. Treasuries, corporate debt and securities than into its $200 billion sovereign wealth fund. In July, China held some $518.7 billion in Treasury securities, an 8% gain over a year earlier and more than 5 times what it was in July 2002.

"More than 25% of China's GDP went to the U.S. government unconditionally and at very low rates," says Setser.

The Congressional Research Service study estimates total Chinese holdings in all forms of U.S. securities may have eclipsed $1 trillion last year.

As Lim points out, then-Princeton University economics professor Ben Bernanke suggested a few years back that foreign capital,

created by a "global savings glut," could finance U.S. government deficits for years to come.

That dollar recycling is one of the biggest reasons why liquidity in the U.S. skyrocketed beginning in 2003. It also helps to explain why, for example, Chinese banks earlier this year held more than $20 billion in debt issued or guaranteed by **Fannie Mae** and **Freddie Mac**. (The Bank of China, which held $17.2 billion on June 30, sold off $4.5 billion in the two months that followed.)

American securitization was peddled offshore. New types of instruments -- including some that proved poisonous -- wound their way from the U.S. to Asia. Lehman Brothers, for example, pedaled some of its structured products to retail markets in Hong Kong, Taiwan and Singapore. These so-called mini-bonds were structured notes in which corporate debt was tied to currency fluctuation, stock movements or interest rates and usually involved swaps. Lehman issued a total of more than $11 billion of these structured notes in private placement, according to a London-based structured products data provider, **Mtn-i**. Asian retail customers hold as much as $3 billion in these notes, according to estimates, including more than 50,000 in Taiwan and 10,000 in Hong Kong.

The market for Lehman-issued structured
notes indicates a return of pennies on the dollar. Officials in Hong Kong and Singapore have been swamped with requests for help. Both the Hong Kong Securities and Futures Commission and the Monetary Authority of Singapore have said they will investigate and punish any offenders who misled investors, according to wire reports.

This certainly will give pause to further embracing exotic derivatives. "It is very likely that Asian financial regulators will now be extremely cautious in approving any new forms of securitization and structured financial products," believes Seward, writing in a blog.

Adds the University of Michigan's Lim: "There will definitely be a step back from the view of U.S. i-bankers' [words] as the gospel."

The crisis will also reinforce views long held in many Asian countries that unfettered exchange rates and money movements are not necessarily beneficial. "For China, the whole case of [capital liberalization and reform] has gone down the tubes," Lim believes. "They will be less willing to embrace globalization of capital flows."

Individual Asian institutions have displayed no hesitation in picking over the wounded. Most notably Japan's **Nomura Holdings Inc.** grabbed Lehman Brother's Asian, European and Mideast equities and investment banking operations.

During the current crisis, however, sovereign wealth funds have been conspicuously absent. That isn't at all surprising, given some previous investments -- including CIC's $5 billion stake in **Morgan Stanley** in December and a $6.88 billion bet on **Citigroup Inc.** a month later by the **Government of Singapore Investment Corp.** -- didn't exactly turn into financial blockbusters. (Singapore's other SWF, **Temasek Holdings Pte. Ltd.**, fared far better, however. It made more than $1 billion from its $6.6 billion January investment in Merrill Lynch, which was sold to Bank of America last month. That profit stemmed from a reset payment Temasek received from earlier losses in Merrill, which it used to make further investments.)

More to the point, these are investment vehicles, not government-sanctioned largess. Tony Tan, the GIC executive director and a former finance minister, hinted to reporters earlier this month that his fund wouldn't be averse to further investments in the U.S. but for the time being sees more opportunities closer to home.

More likely, it's all part of a deliberate go-slow policy until Asian regulators get a better handle on just what's going on.

"There's a holding pattern on everything, including policy," concludes Lim.

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