Asian Credit Outlook”

By Clifford Griep

I appreciate the opportunity to be with you today and share our outlook for creditworthiness in Asia. My brief discussion will cover several developments, each underpinning, in part, our current ratings and largely stable outlooks in the sovereign sector. Collectively these developments evidence considerable change, some might say transformation, in risk factors and analytical emphasis that has occurred since the crisis. They also reflect the challenges of improving creditworthiness from current levels.

First, continuing a trend we highlighted at last years ADB meeting, Asian sovereigns, corporates, and banks have reduced dependence on foreign borrowing. For sovereigns, external positions have improved, reserve levels strengthened, short-term debt reduced, and reserve coverage of external financing gaps, that is reserve coverage of current account deficits, external short-term debt and amortizing long-term debt, bolstered. The four largest investments grade sovereigns, Japan and Taipei,China, with negative outlooks, and the PRC and the Republic of Korea, with stable outlooks, are all external net credits when the public and private sectors are combined. While these changes have been largely managed through trade, and in the PRC through capital controls, strong saving rates and emergent local capital markets have supported local funding. These changes have reduced regional vulnerability to the discipline of external shocks, volatility of capital flows, and contagion. These strong external positions are a positive factor in recent improvements in creditworthiness in the Republic of Korea, and in other countries support creditworthiness at current or higher levels as other risk factors are mitigated. But for smaller countries this strengthening of external position represents a necessary, even if somewhat defensive credit consideration in the context of potential volatility of global capital flows.

Second, fiscal positions have weakened, largely reflecting fiscal stimulus taken to offset economic slowdown. Debt levels have increased, reflecting higher general government deficits as well as the realized burden of bank bailouts. For some countries, fiscal prudence has limited the debt burden to tolerable levels, like the Republic of Korea and Malaysia, where we anticipate that more modest increases in debt levels from expansionary policies and public sector support can be worked down as growth accelerates. The fiscal flexibility retained is a positive credit factor and in the case of Malaysia, contributes meaningfully to our current positive outlook. In contrast, the negative outlooks on Japan; Taipei,China; and India each reflect weak and less flexible fiscal positions, albeit to varying degrees. More meaningful perhaps is that the erosion of fiscal position and rising debt levels has in many countries highlighted the burden of unreformed public sectors and hobbled banking systems.

Third, Asia’s fundamental strengths, highly skilled and increasingly flexible labor force, strong and improving education will become an increasingly valuable resource as global competition intensifies. The recent real economic impact in the region’s export oriented economies from the global economic slowdown also revealed potential vulnerabilities in the export base. Rapid changes and discontinuities in the competitive and market environment of key corporate sectors, including technology and telecommunications, contributed to the highest global corporate default and broadest erosion of corporate creditworthiness in the last 20 years. While these sectors will recover, albeit slowly, and the regions export based economies will benefit from the improvement in the U.S. and European economies, the challenges of maintaining global competitiveness have intensified.

Fourth, for most countries ongoing structural reform, combined with macroeconomic stabilization, is the most meaningful opportunity for sustained improvement in creditworthiness. For others, the absence of reform weighs heavily in our negative outlooks.

Banking systems in most Asian countries remain burdened by the legacy of state directed, state influenced or simply poor allocation of credit. While the contingent and in some cases realized costs of restoring banking systems is reflected in current sovereign ratings, lack of progress in some countries retards the effectiveness of monetary policy and the availability of capital, delaying economic recovery. Contrast for example, the relative pace and progress of bank and corporate sector restructuring in the Republic of Korea or Malaysia to that of Japan. The former has taken decisive and aggressive action, restoring growth and improving creditworthiness. Japan has languished still the amount of debt assumed by governments from financial and corporate sector bailouts during the crisis remain a burden and rating constraint in the Republic of Korea, while the orientation toward intervention of the governments of Malaysia and Taipei,China is still regarded as a meaningful contingent liability and negative credit factor.

Japan, however remains a critical credit issue for the region, and for the world. Ten years after the collapse of the bubble economy, Japan's economic stagnation has evolved into a worrisome deflationary recession with only faint signs of an upturn and increasingly limited and risky monetary policy options to resuscitate the economy. Our negative outlook on the sovereign, most recently lowered to AA- in April reflects the unconvincing political commitment to, and consequent slow pace of structural reform. We now expect Japan's general government deficit to remain at 8% for several years, swelling gross general government debt to 200% of GDP, without some partial monetization of fiscal debt through inflation. The banking system remains vulnerable, burdened by impaired or problem assets that are understated by a factor of three. The modest rise in loss provisioning required by the FSA (Financial Services Agency) leaves the stock of loss provisions at a still inadequate one third of reported impaired assets. The weakness of the banking system will continue to blunt monetary policy, and without significant recapitalization, will continue to constrain prospects for recovery. The emergent burden of pension and health entitlements, unlikely to be trimmed by political continuity and a strong social contract, may also constrain creditworthiness given Japan's demographics.

With the government seemingly unable to rein in its fiscal deficits or to effect structural reform to boost medium-term growth prospects, there remains one avenue left to policymakers to curb the government's debt trajectory: monetary policy. A prolonged period of negative real interest rates could stabilize Japan's debt levels. This third avenue, by far the least attractive on the three, could be achieved through the Bank of Japan's revised policy of greater monetary easing, as seen by it raising its quota for monthly purchases of Japan Government Bonds (JGBs) to ¥1trillion from ¥800 billion. The Bank of Japan, on current trends, is slated to monetize more than 40% of the government's fiscal deficit in the year ending March 31, 2003. Such monetization could change price expectations and, coupled with the strong home market bias of Japanese investors and depositors, could set the conditions for modest real losses on financial fixed-income and banking assets. Such a strategy—shifting the burden of adjustment from the special interests that benefit from Japan's current pattern of public expenditure to its beleaguered savers—carries risk: to political consensus, to capital account stability, to maintaining Japan’s historic high savings rates. Above all, it carries the risk that price expectations simply will not change. However, with fiscal and structural adjustments excluded, it might be the sole remaining strategy to keep Japan’s credit standing at the current level.

Despite an accommodating interest rate environment and considerable forbearance on the part of banks, credit pressures are expected to persist in Japan’s corporate sector concentrated particularly in high tech, retail, general trading, and construction industries. Recent downgrade to upgrade ratio of 8 to 1 in the first Q 2002, up from 5 to 1 in last years 1st Q, but 18 to 1 for the full year in 2001. Nearly half of rated credits in Japan currently have negative outlooks, reflecting the expectation that credit pressures will likely persist in the intermediate term.

The flow-on effect of the U.S. economic rebound on Asia's economies, many of which are export-oriented and sensitive to foreign investment inflows, is positive for Asia's banks. Those banking systems and banks that have undertaken earnest reform since the Asian financial crisis of 1997 and 1998 are in the best position to reap the benefits of the economic upturn. However, banks, governments, and regulators that which have avoided making difficult choices are likely to see their banking systems continue to struggle with asset quality problems into the medium term.

While the outlook on Japan's banks remains negative, for the leading banks in the Republic of Korea it is positive. Although the ratings on major Japanese banks incorporate the likelihood of the Japanese government infusing additional funds into the banks, the negative outlooks on these banks reflect concerns that the banks' asset quality will deteriorate further amid an entrenched recession in Japan. As market participants become more sensitive to credit risks, it is becoming increasingly difficult for financially weak companies to get funding, which could increase the number of corporate failures. Efforts by Japan's banks to improve earnings and capital may not be sufficient to offset the negative impact from the adverse environment.

The recent announcement by the Japanese government's banking sector watchdog, the Financial Services Agency (FSA), that, following a special inspection, the major Japanese banks will have to incur additional loan loss expenses, is a welcome step toward obtaining a more realistic picture of the banks' bad loan problems. Nevertheless, the reported amount falls short of Standard & Poor's own estimates and is based on only a fraction of the banks' total bad loans. Standard & Poor's estimates that the total credit costs for the 12 major banks are 50% higher than those stemming from the FSA inspections. In Standard & Poor's view, some of the highly indebted corporations rated in the 'B' category or lower will need to make additional provisioning or write-offs, given the prolonged stagnation of the economy and asset deflation.

The inspections by the FSA were limited to 149 large borrowers, which account for only 4% of the banks' total loans. While the failure of large borrowers will seriously affect the banks' financial performance, the impact of deterioration in the financial performances of small and midsize enterprises (SMEs) will have more significant repercussions. Credit extended to SMEs represents more than 60% of the major banks' lending, and the financial performance of this sector is likely to be more seriously damaged by the stagnant economy than the performances of larger corporations, particularly in view of the fact that the amount of borrowings compared with cash flow has been growing at a more rapid pace for SMEs than for large corporations.

In contrast, banks in the Republic of Korea are making some progress in dealing with their nonperforming loan problems. While the legacy of problem debts extended to the country's leading conglomerates and large companies, such as Hynix Semiconductor Inc., remain in place, the Republic of Korea's leading banks are successfully remaking themselves. Standard & Poor's recently upgraded the ratings on Kookmin Bank (BBB-/Positive/A-3) and Korea Exchange Bank (BB-/Stable/B), while changing the outlooks on Shinhan Bank (BBB-/Positive/A-3), Korea First Bank (BB+/Positive/B), and Chohung Bank (BB/Positive/B) to positive from stable. While Standard & Poor's is concerned about the build up of consumer loans in recent years, the positive trend for the Republic of Korea's banks should continue in 2002, especially if the economic recovery in the U.S. helps the country's export industries.

The outlooks for banks in the mainland People's Republic of China (PRC) and Hong Kong, China are stable although for different reasons. The accession of the PRC into the World Trade Organization has helped speed up the transformation of banks of mainland PRC into viable commercial entities. Mainland Chinese banks are grappling with two major hurdles—their massive residual nonperforming loans, which Standard & Poor's estimates amount to at least half of total system loans, and the massive task of overhauling their archaic risk management systems. Recent disclosures of misconduct at Bank of China reflect previous risk management malpractice. In consideration of mainland PRC's still high, although likely slowing, economic growth rate, the rating outlook on the country's banks is stable.

The recent economic recession has caught banks in Hong Kong, China off guard. Higher credit card defaults stemming from rising unemployment, while unlikely to reach a degree that would significantly weaken the banking sector, are symptomatic of the challenges facing banks in Hong Kong, China that are in a low-growth environment. While the U.S. economic rebound is likely to help the flow of exports through Hong Kong, China, a major world port, the property dependent economy will continue to be impacted by property prices that are substantially below their mid-1990s peak. Nevertheless, banks in Hong Kong, China are well capitalized, prudently managed, and able to absorb the higher level of problem assets likely in early 2002 supporting a stable outlook for the sector.

Although a potential revival of U.S. demand for microchips should assist Taipei,China's economy, the benefits are unlikely to flow through to the banking sector over the near-term. The major corporates involved in this sector tend not to borrow much. Instead it is the other depressed sectors of Taipei,China's economy that continue to contribute to the asset quality problems besieging Taipei,China banks, many of which have below-average profiles. Standard & Poor's estimates that gross problematic assets-to-loans for the sector will rise to 18% in 2002 from about 15% at end-2001. Hence the sector has a negative outlook. Nevertheless, the formation of financial groups following the enactment of the Financial Holdings Companies Act in 2001 is seeing a realignment within the financial services industry. This may well lead to rating changes that reflect this newly competitive environment.

Malaysia's economy appears to be moving ahead faster than Thailand's and is bringing some of its banks with it. The rejuvenation of the Malaysian government's Corporate Debt Restructuring Committee in 2001 is seeing the logjam of corporate debt restructuring start to disentangle. This hurdle has been a key impediment for Malaysia's banks. The bottoming out of the slowdown in Malaysia's export-dependent economy is also an encouraging development for the banks' earnings prospects. Standard & Poor's recently revised its outlook on Malaysia's leading bank, Malayan Banking Berhad (BBB-/Positive/A-3), to positive from stable, based on the assessment that it has taken sufficient action to address its nonperforming loans and is better poised to benefit from the improvement in Malaysia's economy. While the outlook for the banking sector is generally positive, not all Malaysian banks have improved on their nonperforming loans and indeed some are reporting higher ratios.

Thailand's banks had a more difficult road to run than Malaysia's following the Asian crisis of 1997-1998. More critically, progress has been disappointing and compares unfavorably with that of the Republic of Korea. Standard & Poor's remains pessimistic about the willingness of the authorities and banks to truly confront the issue of nonperforming loans, which are estimated to amount to one-third of total loans. The effectiveness of the recently formed Thai Asset Management Co. has been curtailed by both its late formation (four years after the crisis began) and the absence of special legal powers to swiftly foreclose and dispose of loan collateral, powers similar to those that Malaysia's National Asset Management Co. possesses. Not surprisingly the sector's outlook remains negative.

Despite a decline in the capitalization of Singapore's domestic banks in recent years, following acquisitions and efforts to improve shareholder returns, the country's banks are well placed to absorb higher problem assets. A slight increase in problem assets is likely in early 2002, being a lag effect from the downturn. This year Singapore's three remaining domestic banks will be busy consolidating a number of last year's mergers and acquisitions. With no danger on the horizon, the rating outlook for the Singapore banking sector is stable.

While the banking system in the Philippines remains something of a hard luck story, the banks' attempts to control their asset quality problems remain protracted. Nonperforming assets, including restructured loans, are estimated to account for about 25%-30% of the banking sector's gross loan book. Although the weakened position of the country's banks continues to support the view that the outlook for the sector remains negative, there are signs that better prospects for the economy may see the banks' financial profiles bottoming out towards end-2002.

Banks in Indonesia face the most difficult task of all. The country is still beset by economic distress and political uncertainty, even though these pressures may have eased, it is still difficult for banks to reconstruct their balance sheets. The banks need to replace existing low-yielding government paper with higher-yielding commercial loans. Standard & Poor's continues to stand by its 1999 prediction that it may take Indonesia's banking sector a decade to fully recover. Nevertheless, it should be said that while external factors dictate a negative outlook for the country's banks, several Indonesian banks, including P.T. Bank Mandiri (Persero) (B-/Negative/C), have been steadily rebuilding themselves.

Compared with the rest of Asia, India's banking system is relatively calm. The industry, however, remains weak by international standards and the credit profiles of most banks continue to be negatively impaired by longstanding levels of nonperforming assets, which have suffered from high information risk and historically weak credit underwriting standards. Progress on the resolution of asset quality problems remains hampered by the lack of structural reform in key industry sectors in the economy and the lack of progress on much needed regulatory and legal reforms. Nonperforming loans are estimated to represent nearly 25% of total loans. The deceleration of GDP growth in recent years to 4%-5% per year places further strains on the banking system while fierce resistance from public sector unions has pushed bank privatization off the political agenda. The high degree of government ownership in the banking system is an important rating factor. Consequently, the outlook for many of the country's banks is negative, in line with the outlook on India's sovereign rating.