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After the Asian Financial Crisis: Can Rapid Credit Expansion Sustain Growth?

In the years following the Asian financial crisis of 1997–1998, the governments of South Korea and Thailand each have sought to generate economic recovery by expanding domestic credit. The rapid credit expansion in both countries has created concerns about the extent to which their economies can channel these funds efficiently and sustain economic growth. In particular, if banks are unable to supervise the allocation of resources effectively, there is a risk of widespread bankruptcies and a financial system crisis. Previous experience shows that these Asian economies indeed may be at risk of a credit boom and bust cycle.

This *Letter* discusses the sustainability of the credit-led economic expansions in South Korea and Thailand. First, it discusses the experiences of South Korea and Thailand as they attempted to recover from the 1997–1998 crisis and boost domestic demand through credit expansion. Then, it assesses the risks that these two countries may face if their credit-led expansions collapse and discusses steps they are taking to reduce exposure to these risks.

Boom and bust

In the decades before the Asian financial crisis, South Korea and Thailand experienced sustained economic growth based largely on export-oriented policies, productivity gains, and investment growth, which was financed by relatively high levels of private saving as well as by foreign borrowing.

The rapid expansion of foreign borrowing is seen by many as the primary cause of the Asian financial crisis. Because the financial sectors of the affected countries proved to be too weak to monitor the effective investment of foreign credit, funds were directed to unproductive projects. Consequently, international creditors lost confidence, prompting

higher costs of borrowing, and leading to a wave of bankruptcies among many seemingly sound firms. This further undermined international investor confidence, and led to a rapid outflow of short-term capital and a sharp depreciation of domestic currencies. The ensuing crises led to the collapse of the financial sector and of economic activity.

During the Asian crisis, South Korea and Thailand were hit very hard, as their economies experienced large and prolonged output collapses: In South Korea, output fell by 8% between 1997:Q4 and 1998:Q2 and did not return to its pre-crisis level until 1999:Q2; in Thailand, total output fell by 14% between 1997:Q3 and 1998:Q3 and did not return to its pre-crisis level until the end of 2000. In addition, consumption and investment contracted sharply in both countries. The International Monetary Fund (IMF) implemented severe austerity packages as part of bailout programs that reduced government outlays and severely curtailed social programs. The long-term cost of the bailout of the financial sector amounted to an estimated 30%–40% of output in both countries.

Government-encouraged credit expansion to pump economy

Output was slow to pick up in the aftermath of the crisis. Because of the rapid outflow of foreign funds and the collapse of the financial system in both South Korea and Thailand, the effect of a large currency depreciation was not sufficient to boost output. Furthermore, the global slowdown of 2000–2002 restrained export growth and limited the amount of foreign funds available to these countries. Finally, to limit further vulnerability to capital flow reversals, South Korea and Thailand became reluctant to rely on foreign funds. In fact, Thailand rapidly reduced its stock of foreign debt even though the interest rates charged to many



emerging markets were down to pre-crisis levels. Thailand went so far as to pay off the IMF early for the debt it incurred during its restructuring program.

With foreign financing precluded, both countries sought economic growth by stimulating domestic demand. However, the governments faced restraints in using fiscal policy stimulus because of IMF-recommended policies that called for greater fiscal austerity. Consequently, Thai and South Korean policymakers stimulated domestic demand by increasing public credit and by encouraging commercial banks to increase credit to private firms and domestic consumers. One such program in South Korea involved giving tax breaks for consumers for payments by credit cards. The result: between 1999 and 2002, the number of credit cards doubled to four per every adult and credit card use increased sixfold to 114% of GDP; by 2002, household debt rose to over 70% of output, a stark contrast to the pre-crisis period when South Korea enjoyed a very high saving rate and household debt of only about 40% of output.

Getting banks to extend credit rapidly was hampered by the large amount of nonperforming loans (NPLs) on commercial banks' books that remained from the aftermath of the Asian crisis. To address this problem, both countries set up government-run asset management companies to buy NPLs and recapitalize the banks. The experience of one government-owned commercial bank in Thailand is illustrative. Krung Thai Bank received large injections from the government to clean up its balance sheet after the Asian crisis. After the transfer of assets to a government asset-management company, Krung Thai's NPLs decreased from 50% to less than 10% of deposits. This provided Krung Thai a competitive advantage over other private-owned and foreign-owned commercial banks. Krung Thai was encouraged by the government to increase credit to individuals with credit problems and unable to borrow from other banks, and it now controls about 20% of the Thai commercial bank market.

The domestic credit expansion policies worked in both countries. Led by private consumption, both economies expanded. In South Korea, output grew by over 6% in 2002, and consumption grew by 6.7%. In Thailand, output grew by 5.4% in 2002 and by 6.7% in 2003, and consumption grew by 4.9% and 6.2%, respectively.

What are the risks of a credit-led output expansion?

A study by the IMF (2004), examining historical evidence on the cost of deflating credit expansions in emerging markets, finds that, if private credit booms too rapidly above a historical trend, the expansion usually deflates under its own weight, just as stock market bubbles eventually burst. For example, if capital inflows are attracted by expected returns, and if expectations are not met or there are large negative shocks to the economy, the financial flows may reverse. The highly leveraged financial systems in emerging markets are usually particularly vulnerable to such developments because of poor risk management and implicit government bailout guarantees. As investors realize that a financial system is deteriorating, financial outflows accelerate, leading to a credit bust. The IMF study finds that private credit booms in emerging markets are associated with consumption and investment booms (70% probability) followed by banking crises (75% probability) and currency crises (85% probability).

In the cases of South Korea and Thailand, the recent credit expansions could be a threat to fiscal health because much of the new loan activity represents increased implicit fiscal liabilities. If the economy slows, leading to an increase in NPLs and a simultaneous fall in tax receipts, the governments may be forced to bail out the banks again.

Are South Korea and Thailand in a credit boom?

The answer to this question is not so simple. In South Korea, real private credit grew by 11% in 2002 and by about 10% in 2003. While this may seem like fast growth, in fact it does not meet the benchmark of a "credit boom" as defined in the IMF (2004) study, which compares credit growth to a measure of its long-term trend growth. Thailand's credit was almost 8.3% above trend in the fourth quarter of 2003, which does come close to qualifying as a credit boom by the IMF benchmark.

One caveat to these calculations is that it is hard to know with certainty the trend level of real credit. Another caveat to note is that aggregate credit data may be misleading. Government actions may have led to a shift towards riskier forms of credit, even if the aggregate numbers do not indicate that the country is experiencing a credit boom. In South Korea, most of the credit expansion was in the form of increased credit card use. In 2003, 8% of the population was delinquent on credit card payments. By 2003, 34% of the assets of credit card

companies (about 3% of GDP) were impaired, up from 11% of assets in 2002. LG Card, the largest credit card issuer, had to be rescued from insolvency with a \$3.9 billion package from the government at the beginning of 2004.

In Thailand, Krung Thai Bank's NPLs have almost doubled since 2000 and represent about 18% of its deposits; foreign creditors suspect that the true level may be closer to 36%. Also, the Thai government has made a large number of direct loans to consumers and firms, making it hard to ascertain their quality. In 2002 and 2003, while credit by commercial banks (including Krung Thai) increased by 7% and 2%, respectively, credit by three large government-controlled banks (the Government Savings Bank, the Government Housing Bank, and the Bank for Agriculture and Agriculture Cooperatives) grew by about 10% each year.

Policy options for South Korea and Thailand

Both countries have taken measures to avoid a credit bust. South Korea has taken some steps to curb its rapidly expanding credit card business to avoid a hard landing. In fact, the problems created by the credit card boom have led to an extended period of slow economic growth, mainly due to falling private consumption. Thailand's central bank, the Bank of Thailand, has also taken some steps to rein in the growth in consumer debt by increasing the interest rate and pressuring commercial banks to take a more aggressive stance towards improving the quality of their loan portfolios.

Two factors favor the success of government actions in South Korea and Thailand in avoiding a crisis and limiting its effect should it occur. First, the

current expansions in South Korea and Thailand are mostly financed by domestic residents in the form of debt denominated in domestic currency. Thus, these countries are not as vulnerable to a rapid depreciation of the exchange rate that would inflate the real cost of making debt payments. Second, the currencies of Thailand and Korea have tended to appreciate against the dollar, and their current accounts have recorded large surpluses. Thus, South Korea and Thailand have accumulated foreign assets to pay off debts and recapitalize the banks in the event of a crisis.

Conclusion

In the aftermath of the 1997–1998 Asian financial crisis, the governments of South Korea and Thailand took steps to encourage demand in their countries by increasing domestic credit. However, they do face some risk that the credit expansion may turn into a credit boom, which could cause output and consumption to contract yet again, if the boom later ends and a financial or banking crisis ensues. Although the governments of these countries have taken steps to cool the credit expansion, the risks of a credit bust still linger.

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