The views and writings of DSG*Asia* before and during the Asian Crisis – 1996-98

Pre-amble

The following are some snippets from my writings over the period mid-1996 to early-1998. Obviously, I would not claim to have got everything right – indeed a file of wrong calls would be equally easy to fill. No commentator or administrator can claim perfect foresight (although many seem to be blessed with twenty-twenty hindsight!). Indeed, as Hayek has argued, such a belief was the erroneous basis for the failed socialist experiments of this century and is thus ‘the fatal conceit’. However, I would like to think that I am one of those commentators who has been right (or wrong) more often than not for at least this affords one the ability to consistently trade on (or against) the views on offer. After all, the economist with a fifty-fifty record – normally the result of slavishly hugging consensus – is about as much use as an ejector seat on a helicopter.

So how callable was the Asian crisis? Well, many of Asia’s problems – falling profitability, eroding competitiveness, over-investment, external debt currency mismatches, and excessive lending to property and share markets – were apparent back in 1996 (and even earlier) and therefore contrary to popular perception, I believe many of the region’s troubles *were* predictable. Moreover, many of these problems were common to a range of countries with close linkages so the contagion jumping from one to another should not have come as such a surprise.

What was impossible to forecast *as a base case* back in the early days of the crisis was the extent to which poor policy responses – both IMF-dictated and far more crucially at a domestic level – and a shared sense of denial, would contribute to the complete collapse of confidence that pervaded the region by late 1997. Nevertheless, this extreme chain of events was always a possibility, albeit one with a low probability at the outset. This should not have precluded scenario planning though and indeed as the crisis progressed, so the probabilities rose.

One final observation. As an employee of an investment bank with a range of corporate and government relationships around the region, I was somewhat constrained in what I could say in print. My verbal comments tended to be less censored but you will just have to take my word for it! Or alternatively, see some of the kind comments made by clients about my work. And I didn’t even have to pay for some of them….

Simon Ogus

The Myth of Asian Profitability – May 1996

Intuitively, if consumer prices are rising faster than unit labour costs, then income is being redistributed from the consumer to the producer and the corporate profit share should be rising. Unfortunately, the experience of much of Asia has tended towards the opposite.

It can be argued that many of the asset price movements seen in recent years that have boosted headline EPS growth in Asia are not sustainable. They have been in part a function of the Fed's exceptionally loose monetary policy from 1989-93 conducted in order to recapitalise the US banking system. The result has been structurally low or even negative real interest rates which have changed corporate and household portfolio preferences towards consumption of assets rather than goods….[T]his should net out in terms of GNP-based savings shares but the structure of the listed economy in Asia has probably served, perhaps near term, to magnify the headline quoted profit share of GNP.

The ASEAN economies (ex-Singapore) and China probably face the greatest challenge though. Most are for the moment choosing to maintain their 'cheap' currency policies since in a number of cases, the ability of their industries to deliver the productivity gains required by a stronger currency still appears limited, or the political environment does not allow the economy to enter a period of weaker growth that the transition requires. However, especially in those economies where the labour market for even semi-skilled workers is tight, the offset is that unit labour cost pressures are building strongly. Moreover, they are in a number of cases rising relative to consumer prices (which in turn have a tendency to be constrained artificially). As a result, the corporate profit share in GNP is probably falling and could further hamper the ability of the corporate sector to deliver profit growth in line with economic growth.

Asian Adviser – October 1996

Year-on-year prices of a number of key processed commodities are down sharply.... much of the blame can be placed at the door of the Koreans although to be fair, they have been ably abetted by the Taiwanese, Japanese and Thais amongst others. Capacity expansions seem to have been predicated by a 'market-share-at-all-costs' strategy of trying to be the last one standing no matter what the short-term pain. Some might argue that they have been watching too many Rocky movies.

This is all great news if you are a consumer getting a better deal on a PC, a producer seeing lower prices on key inputs, or even Al Greenspan trying to walk the monetary policy tightrope in election year….It's just not so great if you are an Asian corporate that makes its living from shipping the stuff out of the door.

If, and admittedly it might be a big if, the Koreans *et al* resist the temptation to bring on even more capacity at the first whiff of higher prices/stronger demand, we should be in a position by the end of Q1 1997, where the negative price component drops out of the figures [and better exports should come through]….[T]he major wild card remains certain unnamed countries' tendencies to over-expand capacity. This would serve to prolong the pricing pain…. then the risk is of a much harder landing in ASEAN *à la* Thailand this year. This would create air-pockets both in terms of growth and earnings expectations.

[With the JPY/USD at 110], Asia as a whole does not [seem to] have a competitiveness problem. There are two exceptions though, Thailand and Malaysia, where labour cost pressures now resemble trends seen in Korea and Taiwan in the mid-1980s, and Japan in the early 1970s.

Asian Adviser – November 1996

Most of the region's central banks are relying on the current [export] slowdown reversing itself into 1997 Q2. What if conditions do not go Asia's way though? Specifically, what if we get an extension of weak global demand and a strong USD which is a pretty nasty cocktail…. [this] combination…. precipitated the ASEAN recession of 1985-86….Current accounts will widen further and sentiment towards ASEAN currencies will deteriorate leading to an involuntary squeeze. Asset quality will subsequently be called into question; especially in those markets where real estate and stock market speculation [has been excessive] in recent years.

A further complicating factor this time round is the accumulation of net foreign liabilities in…. banking systems as a result of global appetite for high yield. This is all fine and dandy while expectations are that the domestic currency will remain stable, or will even appreciate….if the system's currency mismatch becomes significant and suddenly attitudes towards the currency reverse, immense strain can be placed on financial balance sheets as the currency weakens and/or the risk premium adjusts sharply upward.

Asian Adviser – March 1997

What are the implications for Asia of a JPY above 120? [T]he region will be starting to be feeling the pain….is in terms of its competitiveness. More so, if one looks at labour cost-adjusted exchange rates.

If the Thai situation were unique in the region we would of course be a lot more sanguine about Asia's prospects this year. However, because many of the excesses of Thailand (over-investment, external debt currency mismatches, financial sector exposure to property with dubious collateral value, etc.) are evident elsewhere in Asia, the contamination risk from a forced THB devaluation [is high]….[T]he countries most in the immediate line of fire, Philippines, Indonesia and Malaysia, can only sit there and hope that there is not a spill over.

Asian Adviser – April 1997

Thailand's excesses may have been worse than many but are far from isolated…. the endgame must surely be a weaker THB. The choice [in Malaysia] appears to be between slower growth and a weaker currency. We suspect the latter route will be chosen.

Allowing Korean corporates to go out and borrow even more overseas (instead of exhorting them to cut investment) is akin to giving a pyromaniac a flame thrower as soon as he has used up his last match.

Region on a Knife Edge – 29th August 1997

We have probably been amongst the most pessimistic on ASEAN all year but we are now are getting progressively more bearish on the region…. we believe that the risks are currently rising of outright recession in places other than Thailand as well.

The reason is the lack of, or the crass policies that are being pursued…. [there seems to be] no response apart from jawboning and reactive mini controls/measures. Currencies and other local assets have all confidence destroyed and we get to serious overshoot levels – 3.50 MYR, 4,000 IDR?

In addition, with moves like this, banking sector stability is compromised and even large cushions of collateral can disappear.

The conclusion is that unless we see meaningful policy responses from the various ASEAN countries in the near future, the risks are:

- Outright recession - i.e. zero growth or below throughout SE Asia
- Full Blown Banking Crises in Indonesia and Malaysia, big problems elsewhere
- Knock on effects in Singapore, Japan and Korea (bank exposure and demand collapse), and in HK (more pressure on HKD, rates up, assets down). In addition, funds will be forced to raise cash and HK is the only avenue currently.

We think these will also catalyse a stronger USD/JPY. New range would be 120-130 with upward bias reached quickly. External demand has been all that is keeping the Japanese economy afloat.

The probabilities of this disaster scenario are rising by the day and some contingency planning should be considered. The knock-on effects would likely be felt beyond the region. At the moment, we put the chances at evens.

Regional: Region on a Knife Edge – Toppling into the Abyss? – 3rd October 1997

That Thailand is near absolute recession, has a full-blown banking crisis, and is going to need radical surgery is unchallenged now. However, Thailand has ceased to price the region and attention has switched to the actions of Malaysia. The other regional economies still have time to pull back from the abyss even as the temperature in the kitchen continues to rise but despite the best efforts of countries like Indonesia and the Philippines, they appear unable to distance themselves from others seemingly intent on economic *hara-kiri*. Last month, we put the probability of a number of others going the same way as Thailand as fifty-fifty and unfortunately, we see little reason to significantly lengthen the odds on the apocalyptic scenario. True, a few sops have been thrown to the markets but these have been viewed insufficient, as we stand today, to radically alter investor perceptions either at home or abroad.

Exchange rate forecasts, of course, are a moving target currently; our base assumption, and therefore our forecast profile, remains that policy makers are going to wake up in the near future and start to act more rationally. However, as the days go by, we start to wonder whether this is just a forlorn hope and whether our base case should switch to our doomsday scenario. When we floated extremes of USD/MYR at 4.00 and USD/IDR at 4,000 a couple of months ago, we did not realistically expect to see them go anywhere near this far.

Last Chance for Asia – 17th October 1997

As you are aware, we have been running two sets of growth forecasts. Our core numbers in the *Asian Adviser* have been based on them "doing the right things" sooner rather than later, 1998 being slow but not recession (ex-Thailand which is there already – witness yesterday's downgrade of 1997 GDP growth to "around 1%" from 2.5%), 1999 being slightly better, and ASEAN contagion to North Asia and beyond being limited. This probability has been around 50%.

We have also been running parallel numbers which have been circulated regularly over the last couple of months, which assume zero growth throughout ASEAN in 1998 and 3% or so off other growth rates in the region. Currencies would be all the 4s (4 or *sei* is also death in Chinese by the way) i.e. MYR4, IDR4,000, THB44 and PHP40.

Region on a Knife Edge: The Gloves Come Off – 20th October 1997

We have been running with the assumption that when push came to shove, the region's leaders would act in a statesmanlike manner and do what was best for their countries, rather than for their own bank accounts and those of their friends, acolytes and cronies. We held the view that it would take a few months for the message to sink in – hence our near-term bearish views on all asset classes – but by now, we would be seeing signs of policy responses improving.

Well at this stage, we are throwing in the towel and pushing the disaster scenario we first pushed three months ago to our base case scenario with a 75% probability. Why? Because events of the last few days – be they disappointing Malaysian budgets, Thai finance ministers resigning, etc., all suggest that the region remains in a state of denial, and is unwilling to pursue policies that come anywhere near to addressing the problems to be tackled….In reality austerity involves the equivalent of a 250lb person going into MacDonalds, asking for 5 Big Macs, and then deciding to have a Diet Coke.

The bottom line is that the welfare loss is already there. How it is shared out and worked through the system is the key though and the policies being pursued suggest that the burden will fall, as ever, disproportionately on those who are least able to protect themselves. In effect, they will involve a massive transfer from the poor to the rich and the well connected. This is the path cynically being pursued in a number of countries and invokes memories of the late years of the Weimar Republic, the KMT-led Chinese Government, and the Sukarno administration in Indonesia. The potential social risks are also building as a result.

We believe that we will see outright recession and full-blown banking crises throughout much of ASEAN next year, and attendant knock-on effects to North Asia and beyond. Rather than giving these administrations the benefit of the doubt, it is now up to them to prove us wrong. We reproduce a table of our disaster scenario GDP forecasts below. These are initial stabs and we will furnish greater detail in the coming days. As for forex, we refer you to our "Last chance for Asia" note in Friday's Asian Adviser Daily. All the 4's - MYR4, IDR4,000, THB40 and PHP40 are on the cards not too far down the line. JPY, KRW and TWD also appear vulnerable.

Korea: 'Thar She Blows' – Is it Going Global? – 10th November 1997

As many of you will be aware, we have been sounding the possibility of ASEAN infecting Korea and then the world for some time now. The direct result of the ASEAN economies refusing to put their houses into order has led to the contagion spreading and we believe now that Korea is mortally wounded, and has attendant global consequences. Of course, if the rest of the world was in pristine health the worries would be less, but valuations globally appear stretched and have been fuelled by easy money policies from all the world's major monetary authorities. Korea could therefore be the catalyst that starts the revolution.

The [debt] numbers for Korea are horrible. In short 220% of GDP (GDP=USD500 bn) of which foreign equals USD160 bn and domestic 850 bn. Of the foreign, 80-90 is short term, 30 is due before December 31st and none is hedged. The BOK officially has 30bn of reserves but like their Thai counterparts before them, they are intervening in the forward markets to support the KRW. We believe that net reserves could now be below 10bn of less than one-month's import cover. Domestic debt is equally a concern as perhaps 25% is sour. In short, this is a banking system that makes Japan's look healthy.

Moreover, Korea matters. It is a member of the OECD, the 8th largest trading nation in the world and has a fractious neighbour to the north. The US may not care that much about Thailand but it does about Korea. And to top this off, the Koreans have been huge buyers of other countries' emerging market paper. For example, we understand that they hold 20% of Russia and sizeable chunks of Latin America debt. Korean banks have been riding the credit yield curve, with leverage, over the last couple of years but with a difference – borrowing at Korean spreads and on-lending to lesser credits! However, now they are now being forced to liquidate this as the BOK instructs firms and banks to remit as many funds as is possible. Hence the knock-on impact elsewhere.

Discussions with our economists elsewhere lead us to the conclusion that Latin America and perhaps Eastern Europe could be taken down on the back of this. We continue to recommend clients to be short on a trading view and pulling back exposure wherever possible. The outlook for emerging market spreads and global equities looks horrific from here. It also potentially reverses our US view in that the Fed will be cutting in order to offset this potentially huge cash call on global liquidity.

What is the timing? The Presidential election is 18th December and we think Korea will mobilise every last cent before then. They have no external reserves left except for those owned by the corporates and financial institutions. We expect repatriations, at any price to accelerate. After then, the most benign interpretation would be that they declare bankruptcy, go to the IMF, and we get a debt restructuring. Growth collapses and probably contracts. And remember that domestic demand, excluding inventories, was only 2.7% yoy in Q2, the lowest level for 15 years.

The potential for global knock-on would have been raised. We think that an USD60-100 bn bailout for Korea alone, as a first tranche, could be required. Recall that ASEAN's cash calls are already USD47 bn to date and will rise much further.

We believe that the Korean economy could limp along till the end of the year with the KRW being defended around 1,000 (it is currently at 999 which as all our British readers will know is the number you dial to call the emergency services). However, we would not be trying to finesse this and stress that any dips are huge opportunities to buy dollars and/or hedge exposure. The chances of them holding on till December are perhaps 50-50 at best. We then think, that KRW is allowed to collapse and see 1,200 very quickly - mid January perhaps. This has knock back effects onto JPY, TWD and HKD, and then back into ASEAN again.

There is potential for Japan to slow much further on the back of this perhaps nearing recession with USD/JPY flying to 140 and beyond. Especially, given the weakness of the Nikkei and the impact that has on the Japanese banking system. We may see an emergency fiscal package which could give temporary support to the JPY but pumping up public works has done little good in the past while a tax cut is likely to be saved in such circumstances. More so since most Japanese consumers would believe the cut to be temporary. Accordingly, the strain will again fall on monetary policy with the BoJ further stepping up its JGB purchases.

Intuitively, such a scenario favours USD, DEM and core Europe and perhaps the Skandies. USD bonds could sell off on the back of forced liquidations but the prospects of yields at 5% or lower next year could be very real. Keep smiling......

Regional: On the Brink of Hyperinflation? – 8th January 1998

Many readers may recall that when we first started discussing endgames for what was happening in the region around the middle of last year, we raised the ultimate disaster scenario of hyperinflation (technically this is 50% per month price rises). Unfortunately, we are getting nearer and nearer to this catastrophe at this stage in a couple of countries, namely Indonesia and Malaysia. What has driven this view is that it is not hedging or speculative demand for USD we are seeing, but genuine capital flight by ordinary people who have lost complete confidence in their leadership.

First the IDR. A complete loss of confidence domestically is leading to the currency gapping down while the political class remains fixated on their own narrow interests. We see the potential for an IDR15,000 level within a few days and then on to 25,000. Perhaps this will catalyse full blown currency reform, debt restructuring and political change(?). However, the print money to keep the masses happy route cannot be ruled out. If so, we are on the road to hyperinflation as people will quote prices either in USD or in terms of (spiralling) forward currency expectations.

Malaysia is a bit further behind but the road map is clear. The yield curve remains positive and BNM is now using its reserves to defend 4.60. They will run out pretty quickly and then currency free fall and inflation will follow. They can pull back by jacking up rates but will they?

Will others follow? Korea most likely not as we are seeing some genuine improvements [in policy] there now. This is still the key for the broader world as in truth, ASEAN does not matter very much in the big scheme of things. The Greater Chinese economies will probably also be able to hold together as we expect should Korea pull through. Thailand is perhaps more vulnerable but could hitch a ride on the Korean debt restructuring model as and when it is worked out fully since the new government seems more willing to bow to the inevitable. Ditto the Philippines which has nowhere near the fundamental problems of the others but is being dragged down by association.

Final Comment

Fortunately, at this stage, most of the governments in the region looked into the abyss and pulled back, though Indonesia's flirtation with hyperinflation lasted longer than most and was a major cause in the change of regime there. Korea got its act together and thus Greater China was able to pull through. It had been a tortuous wait though and the damage that had been caused by the delay, denial and obfuscation was immense. Happily though, the recovery has been much faster than most (including it should be stressed myself) expected….