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The Lessons of the Asian and Latin American Financial Crises for Chinese Bond Markets

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Preface

In December 2003, the RAND Corporation co-sponsored a conference with the Institute of Finance and Banking of the Chinese Academy of Social Sciences on the prospects for China's bond markets. The conference attracted a large, enthusiastic audience of officials, scholars, and financial executives, and included presentations by China's central bank governor, the heads of major Chinese and foreign financial institutions, and numerous other officials and experts. The Chinese government is keen to expand the country's bond markets, as it has done with the stock markets, so that both the Chinese government and Chinese companies will have expanded and stable access to funding.

Our analysis, presented at the conference, used the lessons of the Asian crisis of 1997–1998 to highlight both the value of a more developed bond market and the prerequisites of sound bond market development.

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The Lessons of the Asian and Latin American Financial Crises for Chinese Bond Markets

Chinese capital markets have achieved outstanding successes since the first stock exchanges were founded in 1990. China's equity market is now the largest in Asia except for Tokyo and the Hong Kong Special Administrative Region. If we combine the mainland's markets with Hong Kong, China has one of the world's larger stock markets. Recent years have seen many reforms and the elimination of many abuses in China's markets. Although these financial markets still have serious problems, reform of China's markets has in fact moved much faster than in other key Asian countries.

Except for Japan, Asian nations have always focused on equity markets and bank loans at the expense of bond markets. But bond markets are at least as important as equity markets for the efficient allocation of a nation's resources. In highly developed countries, it is common for bond markets to be substantially larger than equity markets.

National Funding Strategies and Crisis Vulnerabilities

The Asian financial crisis of 1997–1998 demonstrated both the necessity and the vulnerability of regional bond markets. To understand this, it is useful to look at the patterns by which developing economies have funded themselves. Historically, most emerging economies have funded their foreign needs primarily through debt rather than equity. Most companies in those economies have funded themselves mainly through bank loans with a maturity of three years or so rather than through equity or bonds. These patterns create great dangers that can be offset by enhanced use of bond markets.

In Latin America, many governments have typically run large fiscal deficits, because politics has made it impossible to cut spending or raise taxes sufficiently. These governments then borrow abroad, either directly or through guarantees. In many cases, this borrowing becomes unsustainable, and they suffer a massive external financial crisis such as Argentina's recent debacle. Some countries experience such crises repeatedly every decade or two. East Asian governments other than the Philippines have mostly avoided this problem through greater fiscal responsibility. This pattern of tight fiscal control has been particularly true of the ethnic Chinese economies: Hong Kong, Taiwan, Singapore, and—at least through the

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mid-1990s—China proper. The Chinese government shared an aversion to funding itself through foreign loans.

China's strategy for avoiding the pattern of dependence on foreign borrowing has been more sophisticated than that of other emerging economies. Most third-world countries (along with Japan and South Korea) have a strong aversion to foreign ownership. They therefore welcome debt and refuse equity. This, combined with the earlier pattern of fixed exchange rates and high current-account deficits, is a principal reason there have been so many third-world financial crises. For the last decade, China, unlike most other emerging economies, has been a leader in balancing debt and equity. Since equity capital is longer-term money, this strategy has limited China's vulnerability to financial crises that result from an excessive accumulation of short-term obligations. The other important factor that protected China was the country's strong balance of payments, both on current and on capital accounts.

Nonetheless, China could have experienced a Latin American financial fate because of the problem of moral hazard. Moral hazard occurs when the party making a financial decision is relieved of the risks that result from that decision. For instance, when the U.S. government guarantees bank accounts, depositors become less concerned about depositing their money in well-managed banks, and when certain Asian governments guarantee that their banks will not go bankrupt, the banks' managements worry less about making risky loans. Through the mid-1990s, Chinese government-backed companies, most notably the international trust and investment companies or ITICs, were raising foreign funds by assuring banks verbally (but only verbally, except for the China International Trust and Investment Company [CITIC], and later even for CITIC) that either the central government or local governments would bail them out of any trouble. Foreign banks asked few questions about whether the funds were being used efficiently, because they thought the government would rescue these companies from any difficulties. The amounts borrowed were rising fast, and many large companies were wasting much of the borrowed money on speculative and corrupt activities.

This is a classic form of the problem of moral hazard. China was saved only when the central government, under the leadership of Premier Zhu Rongji, decided to let GITIC (Guangdong International Trust and Investment Company) go bankrupt and to explicitly limit government guarantees for most other companies. That painful but courageous decision cost China tens of billions of dollars of bank loans. But since much of those bank loans would have been wasted, it also saved China from the risk of a Latin American–type financial crisis.

Asia's Underdeveloped Bond Markets and China's Opportunity

The good news is that Asian, including Chinese, fiscal responsibility has limited the risks of Latin American–type international financial crises. The bad news is that, for many countries, including until recently China, limited government borrowing has inhibited the development of deep, liquid, sophisticated bond markets. A highly liquid government bond market usually sets the standards and the interest rate benchmarks for an economy's corporate bond market. The absence of such a government market has, for instance, inhibited the emergence of a sophisticated bond market in Hong Kong. Because China now has significant government debt, combined with a history of not letting that debt get out of control, it has the potential to develop a sophisticated government bond market that could become the foundation both for a large Chinese corporate bond market and, when the currency is fully convertible, for a regional bond market.

The 1990s restrictions of China's government guarantees, both explicit and implicit, mean that China's principal financial risks are focused on companies and banks, not the government, or at least not directly on the government, and on domestic loans rather than foreign loans. If not properly managed, those corporate risks could accumulate and lead to a crisis that, unlike the Asian financial crisis of 1997–1998, would probably be triggered by internal, not external, creditors.

The Asian Crisis and China

Most accounts of the Asian crisis refer to it as a "currency crisis," but this is a misnomer. At its most fundamental level, the Asian crisis was a credit crisis resulting from national misallocation of resources in a variety of Asian countries. Most Asian governments had channeled funds to favored sectors and companies. Eventually, except in Singapore, this led to financial overextension among many of the favored sectors and companies and thus to a wave of bankruptcies that threatened the banking system. In some economies, such as those of Japan, Taiwan, and China, the extension of credit was largely in local currency, so the stock market collapses of 1990 in Japan and Taiwan, the financial sector problems of the late 1990s in Japan and Taiwan, and the state enterprise and banking sector problems of China were all purely domestic. In other economies, such as those of Thailand, Indonesia, and South Korea, the credits extended relied heavily on foreign loans, particularly on short-term foreign loans, and in those economies the credit collapses were associated with massive default on foreign loans. As foreign banks called in credits or refused to roll them over, the currencies of those economies collapsed. The 1997–1998 crises of Thailand, Indonesia, and South Korea would have happened eventually under any circumstance given the extraordinary overextension of South Korea's chaebol, Thailand's property sector, and Indonesia's industrial sector, but the massive withdrawal of Japanese funds as a result of the Japanese banking crisis ensured the near-simultaneous bursting of bubbles across the region. In a fundamental sense, the Japanese part of the Asian crisis, which had nothing to do with currency exposure or currency volatility, ensured that the crisis of 1997–1998 would become a regional Asian crisis.

Because critical elements of the Asian crisis were not related to currency, the crisis has powerful lessons for other developing countries, including China, which are not particularly exposed to currency risk.

Corporate Bank Loans and the Asian Crisis

Typically, Asian companies have funded themselves with bank loans. Where banking systems are private, as in Thailand, companies have been able to obtain relatively cheap money by borrowing short-term—typically for about three years—and therefore at low short-term interest rates. When they have longer-term obligations, they roll over the loans. This puts them at risk if interest rates rise or if funding becomes unavailable at the time when they have to roll over their loans.

In the Asian crisis, interest rates rose and funding became unavailable, largely because the Japanese banking crisis led the Japanese banks to withdraw huge amounts of lending from the rest of Asia and to shorten maturities. This process was reinforced by a growing awareness that borrowing countries had huge current-account deficits and low reserves in relation to their short-term external debt. The restricted or expensive funding that resulted can occur for many reasons. It is always dangerous for companies to have long-term obligations and short-term funding. Had these companies matched ten-year obligations with ten-year bond issues instead of funding their ten-year obligations by trying to roll over three-year bank loans, the crisis might not have occurred and there would not have been such massive bankruptcies.

There is a prevalent belief that the lessons of the Asian crisis do not apply to countries that have not accumulated proportionately large foreign debt and particularly short-term foreign debt. But this is a myth. The risk that results from the need to roll over short-term bank loans in the face of credit crunches or high interest rates applies equally to domestic loans and foreign loans.

Why the Asian Crisis Did Not Stimulate Asian Corporate Bond Markets

The logical response to this painful lesson of the Asian crisis would be for Thai, Hong Kong, Indonesian, South Korean, and Malaysian companies to fund themselves through a bond market that would enable them to match the durations of their funding to the durations of their obligations. Although the average Asian bond market has roughly doubled in scale relative to gross domestic product (GDP) since the years immediately preceding the Asian crisis, the expansion has largely reflected larger government debts and large bank recapitalizations rather than extensive corporate use of bond markets. The deeper government bond and bank bond markets are beginning to solve the problem of inadequate liquidity for benchmark issues, but not the fundamental mismatch of corporate assets and liabilities.

Corporate bond markets have failed to expand appropriately because both the companies and the governments have resisted the reforms that would be necessary to make corporate bond markets work. The banks continue to make inexpensive three-year loans to companies that have risky longer-term obligations because they are relatively confident, except in Hong Kong, that the government will bail them out of any systemic crisis. This is another form of the moral hazard problem. Also, companies continue to fund themselves through three-year loans both because that money is cheaper than long-term bonds and because they resist the transparency and accounting standards necessary to get a credit rating and issue bonds. In following this pattern, both the companies and the countries incur potentially fatal risks.

China Faces a Similar Problem

In China, most companies would rely primarily on bank loans even if they had the option of a corporate bond market. They are able to borrow at low, government-determined interest rates that do not reflect the risk of the loans. Instead of paying high enough interest rates to cover their risk, these companies pay low interest rates and the government absorbs the cost of the extra risk by bailing out the banks' nonperforming loans. Companies generally do not worry about the risk of rolling over their loans, because they are confident that state-controlled banks will almost automatically roll them over at low rates. Again, these are classic moral hazard problems. The big banks absorb the cost of this system and ultimately pass it on to the government. Those costs, which accumulate as nonperforming loans that are now estimated by the International Monetary Fund (IMF) at 50–75 percent of GDP, are becoming unsustainably large.[1]

The Importance of a Chinese Corporate Bond Market

In China, a corporate bond market would serve several functions. First, it would enable companies to raise funds even if they are not favored customers of the banks. Today, China has one of the world's most entrepreneurial economies. New companies are formed, and many succeed and create jobs. However, they tend to stay small and do not expand rapidly, like McDonalds or Microsoft, because they lack appropriate funding. The stock and bond markets could potentially remove this constraint and enable China to create world-class companies and, even more important, jobs for tens of millions of people who need them.

Second, such markets would allow companies to match the durations of their assets with the maturity of their liabilities. China could thus avert the risk of an Asian-style crisis in its corporate world by ensuring that difficulties in obtaining bank funding would not simultaneously endanger most of the country's important companies.

Third, with the rise of pension funds, social security funds, and insurance funds, the bond markets are the key to ensuring that these funds can match their future payment obligations with assured future income. Without a long-term bond market, the nation's newly important pension funds, social security funds, and insurance companies will always be at risk.

The Asian Crisis and the Prerequisites for a Successful Corporate Bond Market

The Asian crisis has shown that there are important prerequisites for a successful bond market and that it takes determined, politically difficult reforms to fulfill those prerequisites.

In Thailand, when bond investors discovered in 1996 that there were no effective ways to enforce corporate guarantees, the multi-billion-dollar Bills of Exchange market collapsed overnight. In early 1997, when investors discovered that there were no effective bankruptcy procedures and that there was no way to foreclose on collateral from firms that defaulted, foreign and local investors abandoned the Thai bond market. All this occurred before the "currency crisis" of July 1, 1997. The lesson: Corporate bond markets will work only if there are effective bankruptcy laws, reliable courts implementing the laws objectively,

[1] See IMF, "China's fiscal challenges," Box 1.4, *World Economic Outlook*, Chapter 1 (April 2002).

effective procedures for foreclosure, and effective enforcement of court judgments. This is an important lesson for China.

In May 1997, investors in Thailand's most prestigious high-tech company, Alphatec, discovered that Thai accounting practices had allowed the company to turn the reality of a very large loss into the reporting of US$128 million in false profits. Confidence in the numbers they were being given by Thai companies collapsed, and investors withdrew from the Thai bond market. The lesson: Bond markets work effectively only if accounting standards and transparency are rigorously enforced.

In addition, these developments produced a loss of confidence in bank loans, which also depend on sound accounting and effective bankruptcy and foreclosure procedures, and this crisis of confidence caused a mass exodus from the market. The requirements of transparency and sound accounting are not cultural issues; they are universal.

The massive exodus of capital created a national economic crisis beginning two months later, in July 1997. The lesson: Although the imposition of rigorous accounting, legal, bankruptcy, and foreclosure rules is politically difficult, the consequences of not doing so include the risk of later national economic and political crisis. Once again, this risk arises regardless of whether the bonds are denominated in local currency or foreign currency, or whether they are held by locals or foreigners. It may be that foreigners will be quicker to analyze the situation and quicker to panic because they have superior analytic techniques, but the history of the Asian crisis does not support the view that foreigners were either particularly wise or particularly quick to understand the situation. Large, allegedly sophisticated foreign investors held large amounts of Thai paper for many years until the crisis was imminent.

The substantial presence of foreigners made a difference to the Asian crisis in three respects. First, a major reason for the sudden shortage of credit was the regional withdrawal of Japanese bank funding resulting from a banking squeeze in Japan. Second, once foreign investors realized the roots of their problems in Thailand, they quickly applied the same lessons elsewhere, most notably to South Korea and Indonesia, and withdrew their money hastily when they perceived similar problems. Third, for better or worse, the foreign presence facilitated large-scale IMF involvement.

Implications for China

None of these foreign aspects of the Asian financial crisis changes the implications for China. Domestic developments could cause a credit squeeze in China, and a financial market collapse could occur domestically without contagion from elsewhere. Chinese regulators will face the same hurdles in creating a sustainable bond market as other countries have. Success will require a combination of bank reform, legal reform, accounting reform, and bankruptcy and foreclosure modernization. This combination will challenge the determination of China's regulators and political leaders because the banks and companies will resist as vigorously in China as they do elsewhere.

A market for corporate bonds and for local government bonds requires a credit rating system similar to that provided by Western companies like Moody's and Standard & Poor's. China has the beginnings of a rating system, but domestic and foreign rating agencies can be effective only if the government rigorously enforces high standards of accounting and transparency. Also, they can be effective only if the rating agency is independent and has rigorous standards; the high proportion of Chinese companies that obtain the highest ratings from domestic rating systems currently diminishes the credibility of the ratings.

Finally, successful bond markets require liquid trading and relatively free interest rates. Economic conditions, government policies, and corporate risks change daily, and bond prices and interest rates must change with them if the market is to be successful. Otherwise, investors will lose money and become discouraged.

There is talk of a "bond market with Chinese characteristics." Of course, China has unique market conditions, and it is obviously true that no bond market can instantly achieve world-class transparency, accounting standards, legal standards, and bankruptcy and foreclosure practices. At the same time, one of the lessons of the Asian crisis is that certain structural truths are universal. If companies are allowed to report misleading financial information, they will do so. Investors will lose money and become disillusioned, and eventually there will be a market crisis. Thailand thought it had a bond market with Thai characteristics or with Asian characteristics; it turned out merely to have a market with fraudulent and unstable characteristics.

It is also true that recent U.S. experience has shown how even the seemingly rigorous accounting and transparency standards of New York are fallible. In the wake of frauds at WorldCom, Global Crossing, and others, Americans have had to become less arrogant on the subject of financial regulation. Each time we raise the standards of transparency and accounting, brilliant minds go to work inventing new ways to mislead investors. But the U.S. market bounces back precisely because companies that defraud investors suffer and sometimes go bankrupt, because corporate executives who mislead investors frequently lose their jobs and sometimes go to jail, because regulators work hard to keep ahead of the fraudsters even if they sometimes fail, and because regulation is strict enough that the vast majority of companies do in fact provide investors with a reasonably accurate view of their situation. So, while Americans need to be more humble about their own system, nobody, including China, can afford to neglect the universal lessons of the Asian crisis.

Now that there are serious worries about the future of Japan's bond market, given overwhelming debt on the government side and widespread problems on the corporate side, China has the potential liquidity to create Asia's greatest bond market. It has the momentum of fiscal discipline and financial reform to create a stable, confident government bond market. A well-regulated corporate bond market open to private companies can fund the jobs that China requires for social stability. Government and corporate bond markets together can stabilize the financial situations of the country's newly important pension, insurance, and social security systems by matching assets to liabilities. But the reforms required for success are numerous and politically strenuous. Before such reforms are completed, it is necessary that the market develop gradually to avoid grave risks to national economic health. Because Chinese investors dislike losing money as much as foreigners do, the risks are similar—regardless of whether the investors are predominantly domestic or predominantly foreign.