

Macro
Asian Economics

Here we go

Europe's banking crunch may spill over to Asia

- ▶ **The crisis in Europe continues to escalate and poses growing risks to Asia's leverage cycle and domestic demand growth**
- ▶ **With a record amount of lending in the region, deleveraging by European banks could now start to disrupt local credit growth**
- ▶ **Still, Asia's financial systems are sufficiently robust and retain the capacity to fund further growth after the impending blow**

We're all in it

For a while, Asia was blissfully removed from the turmoil that engulfed Europe. Sure, exports took a knock in recent months and local asset markets sold off in response to global financial jitters. But, all considered, the region continued to hum along quite nicely, slowing just enough to take the sting out of inflation. As the crisis evolves, however, the risks for Asia are rising. Buckling European demand is one thing. The other, and more important, issue is the amount of lending by the continent's banks into Asia. If this gets withdrawn precipitously, the region will feel the pinch. This is all the more so since Asia's growth has become more credit intensive.

As our regular readers know, we highlighted the risk of European bank deleveraging for Asia some time ago (see *Will Asia Crack?*, October 2011). The issue has now become acute. First, the bushfire has jumped from Greece to Italy. Second, European officials, although making plenty of liquidity available through the ECB, are leaning on major banks to raise their capital ratios by next summer, which entails the risk of rapid deleveraging at least in the short term. We noted recently that, fundamentally, Asia's financial systems are in relatively better shape today than in 2008, and are certainly far less dependent on foreign capital than in the run-up to the 1997 regional currency crisis (see *Europeans and Asians*, October 2011).

That, of course, remains the case. But two other risks are becoming increasingly apparent. First, in Europe, deleveraging pressures may exceed those in 2008. Second, in Asia, growth is more credit dependent today than it was three years ago. Combined, these factors could certainly amount to a noticeable growth pinch. While the focus is all too often on the export exposure of Asia to European consumers, which is substantial, this credit channel matters at least as much and could weigh on local demand growth in the coming quarters. Much depends, of course, on the EU's policy response. As the crisis rumbles on, keep a watchful eye.

How will this play out for Asia? A short-term pinch, but still little risk of a broader financial crisis in the region. For now, Asia's financial systems have sufficient liquidity to finance more growth and, fundamentally, the region doesn't require capital inflows from the West. That, at least, is true in aggregate and the long-term, but as credit lines get cut, it'll get bumpy.

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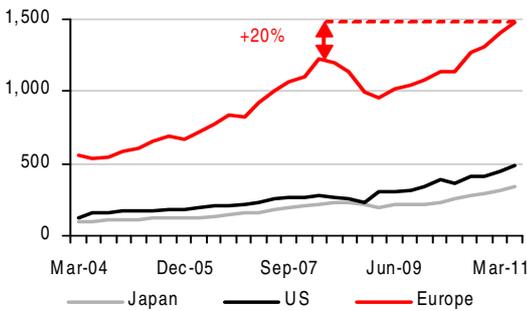
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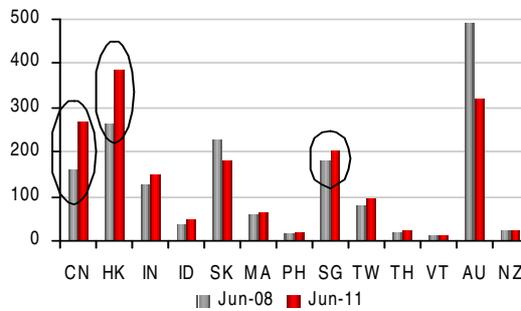
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1. European banks biggest lenders into Asia (USD bn)



Source: BIS, HSBC; NB: lending into Asia ex Japan, Australia, and New Zealand

2. European bank exposure today vs 3 years ago (USD bn)



Source: BIS, HSBC

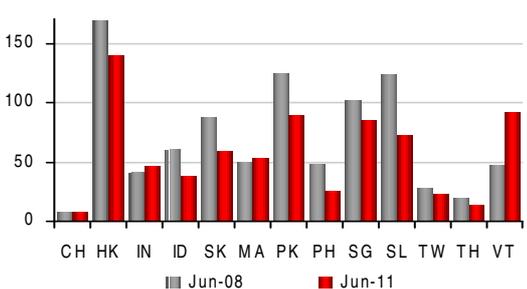
Credit all around

Let's put it all into context. Chart 1 shows the amount of bank lending into Asia from Europe, Japan and the US. A couple of things stand out. First, European banks lend about three times as much as US banks, a ratio that has roughly held steady over time. Second, bank lending into Asia, from all sources, is now well above its peak before the Global Financial Crisis. In Europe's case, total lending is currently 20% higher than in mid-2008 (almost USD1.5trn). Before panicking, consider a few nuances, however. Chart 2 shows that the increase in European bank lending is concentrated in China, Hong Kong, Singapore, and, to some extent, India. The other point is a little more technical, but equally important. Aggregate bank lending data includes both foreign and local currency exposure. A number of European institutions with a big retail presence in the region thus flatter the numbers. But much of this lending is locally funded through deposits and thus much less vulnerable to deleveraging pressures than traditional cross-border lending.

Historically, international bank lending has been seen through the lens of external solvency. In 1997, for example, a number of Asian economies funded their current account deficits through dollar borrowing. As international banks cut their exposure to the region, FX reserves proved insufficient to repay the loans and exchange rates took a dive. There is little risk of this happening now. As Chart 3 shows, obligations to EU banks (in both local currency and dollar terms) are easily covered by existing foreign exchange reserves. In fact, these ratios have generally improved further since 2008 (see also [Asian FX Dashboard](#), October 2011).

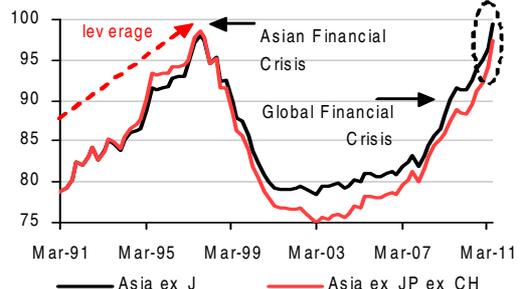
But, the surge in international bank lending is posing another risk as well. Even if external solvency is not a big concern, deleveraging pressures in one part of the world can affect credit availability elsewhere. That's

3. Lending by European banks (% of FX reserves)



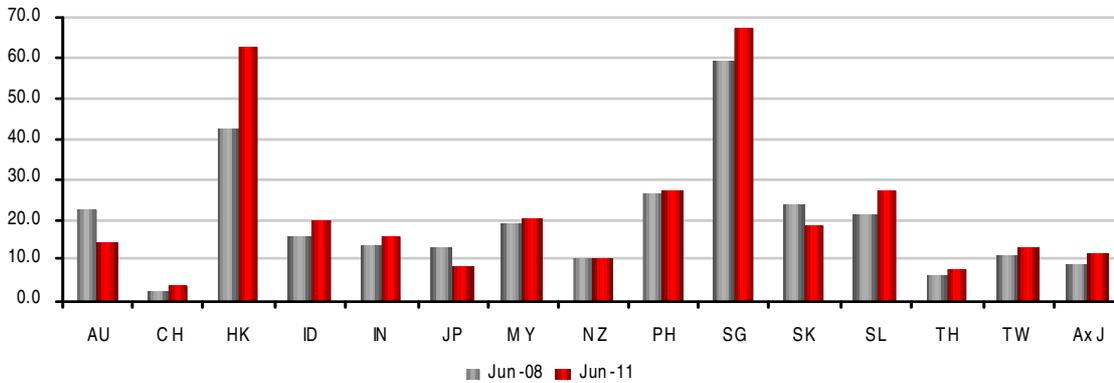
Source: BIS, CEIC, Bloomberg, HSBC

4. Bank credit to GDP ratio on a steep rise of late (%)



Source: CEIC, HSBC; NB: simple averages

5. Claims by European banks (% of local credit outstanding)



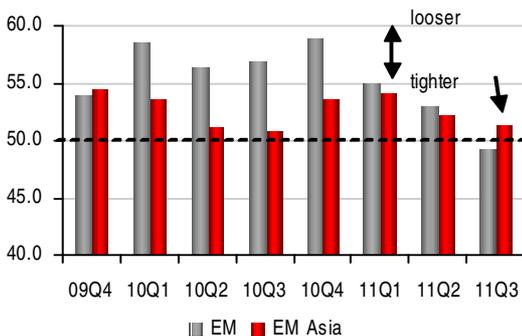
Source: BIS, HSBC

of concern for Asia. Take a look at Chart 4, which we have presented to you before. This shows Asia's Achilles' heel. Soaring local leverage, measured by the bank credit to GDP ratio, explains the resilience of local demand over the past several years; but aggressive deleveraging by European banks could disrupt this process and thus weigh on domestic demand growth.

To get a handle on the importance of European bank lending for local credit availability, consider our next chart. Here we show claims by European banks as a share of total local credit outstanding. With the exception of Australia, Korea, and Japan, this proportion has risen over the past three years. Hong Kong and Singapore stand out, although their status as global financial centres distorts the numbers considerably. Moreover, in both cases, lending by international lending is mostly funded through local deposits. Elsewhere the share is much smaller. This is especially true in China where lending by European banks accounts for only 3% by our calculation (though the number would rise to 5% if one assumes, somewhat improbably, that half of European bank lending in Hong Kong is actually channelled to the Mainland).

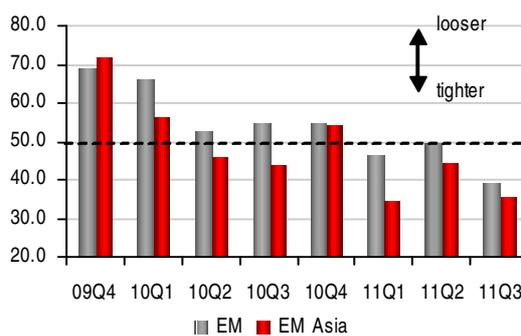
Elsewhere, the share of European bank lending in total credit is between 10 and 20%. Not an overwhelming number, but still quite sizeable. Assuming that half of this would be taken off the table due to a European bust, this would leave local financial systems short of credit: instead of continuing to rise, there would be a short, sharp dent in overall lending. For credit dependent economies, a pinch, to say the least.

6. Bank lending conditions (diffusion index around 50)



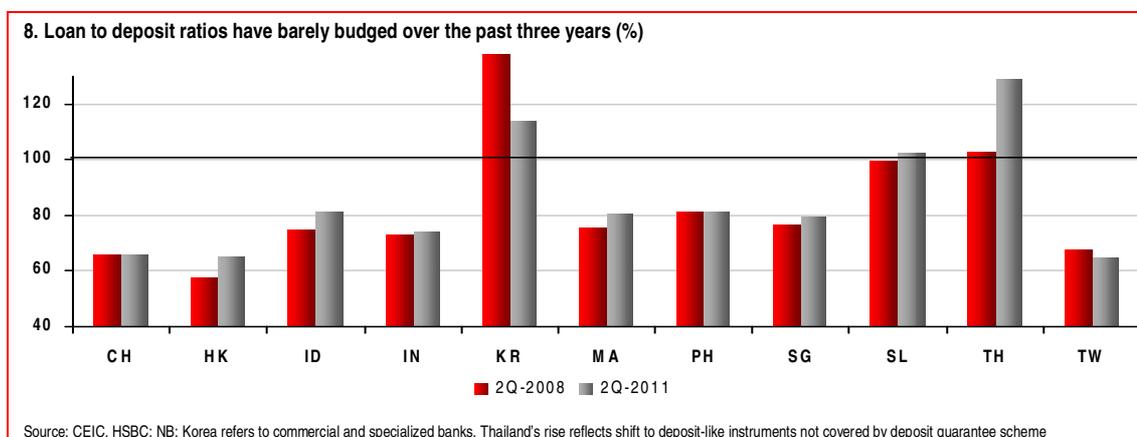
Source: IIF, HSBC; NB: statistical break from 1Q 2011

7. Bank funding conditions (diffusion index around 50)



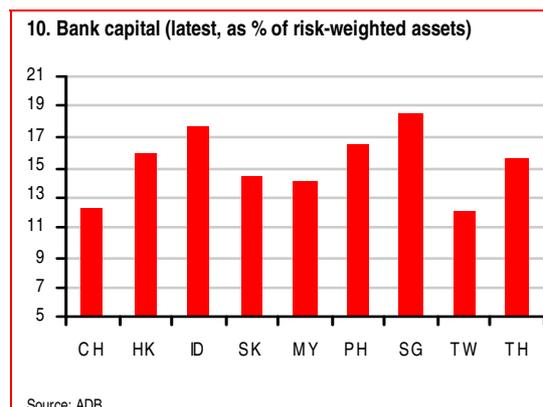
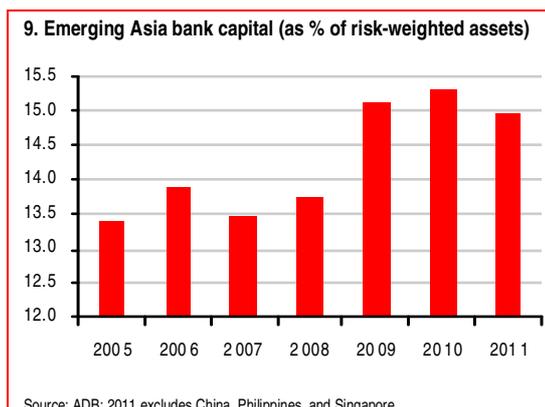
Source: IIF, HSBC; NB: statistical break from 1Q 2011

For now, Asian banks still appear happy to provide loans. A recent survey by the Institute for International Finance of loan officers in emerging markets, showed that lending conditions were still being eased in the third quarter, even if less aggressively than before. Crucially, in China, this may have continued well into this quarter, at least judging from selective easing measures applied by the government, which are in part designed to ease an incipient credit crunch among SMEs in the country. However, according to the same survey, funding conditions by local banks in Asia have deteriorated of late. This, in part, could reflect the withdrawal of European bank exposure to the region. Note that this measure tends to be volatile and stood higher in the third quarter of this year than in the first. Still, something that needs to be monitored closely.



Local capacity still there

Asia, obviously, is not immune should European banks start to deleverage aggressively in the coming months. As noted, this could disrupt credit availability in Asia, and thus weigh on demand, although the effect is likely to be uneven across Asia, with China less affected than, say, Malaysia, Indonesia, India, or Korea. But there is also reason to remain optimistic about the ability of local financial institutions to ultimately step into the breach and offset the withdrawal of European banks. There are a few points to make here. First, loan to deposit ratios point to comfortably levels of liquidity. Of course, caution is warranted on this front: while in aggregate these point to excess liquidity, some banks may be in a less robust position than others. Also, international deposits boost the ratio to some extent. As these get withdrawn, liquidity will appear a little less ample. Still, Asia on the whole isn't short of cash to be lent out for the time being.



Of course, liquidity is not the only constraint on lending. As European banks are finding out at the moment, capital matters just as much. In fact, since the introduction of capital adequacy requirements under the Basel rules, for most banks capital, rather than liquidity, has become the binding constraint on lending capacity. Here, too, Asia looks rather robust. Capital adequacy ratios, in fact, are substantially higher now than in the run-up to the Global Financial Crisis. Applying the new 9% standard that Europe is currently implementing to Asia would leave still plenty of room to expand balance sheets.

So?

Here, then, is the skinny. Aggressive deleveraging by European banks will interrupt credit growth in Asia and weigh on local consumption and investment. This could affect growth through the first half of 2012, possibly even plunging a number of Asian markets into a technical (with growth being negative sequentially for two quarters, though not necessarily in annual terms). But, fundamentally, Asia's financial systems have enough muscle to make up the shortfall, even if the adjustment will take some time. In the longer-run, of course, there is another problem to deal with: Asia can't grow forever by credit alone. But let's leave that for another time to worry about.

11. Asia's exposure in numbers

	AU	NZ	CH	HK	IN	ID	SK	MY	PH	SG	TW	TH
	<i>Claims of banks (USD bn)</i>											
EU	320	25	268	387	148	46	179	64	18	205	94	25
US	112	6	82	60	72	19	97	20	8	60	50	11
Japan	120	7	52	76	22	19	44	12	4	53	15	36
	<i>% of total local credit</i>											
EU	15	11	3	63	16	20	19	21	27	68	13	8
US	5	2	1	10	8	8	10	7	12	20	7	4
Japan	6	3	1	12	2	8	5	4	7	18	2	11

Source: BIS, CEIC, Datastream, HSBC

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