Are We Headed for a Global Debt Crisis?

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THE WORLD HAS BECOME A SCARIER PLACE IN THE PAST year. Asia has slid into a deep recession. Japan is stuck in the muck and can't help. World economic growth is slowing, and there is even early talk of a possible global recession.

The waves of deflation coming out of Asia are hitting debtors hard, nowhere more than in Asia itself. Companies who took advantage of low US interest rates to borrow in US dollars have seen their liabilities skyrocket, even while deflation reduces their revenue stream. To make matters worse, many Asian loans are secured with real estate, where prices have fallen by roughly 50%.

And then there are the innocent bystanders. Since the onset of the Asian crisis in mid-1997, commodity prices have fallen by an average of 30%. This has pushed a number of non-Asian countries to the edge, including most notably Russia, Brazil, Argentina, Chile, South Africa, Venezuela and other oil-exporting nations. Among the major economies, Canada, Australia and New Zealand are taking it on the chin.

These stresses will not soon go away. When the Asian crisis began there was widespread complacency about its implications for other countries. Even now, many are still pinning their hopes on a fast recovery for Asia, similar to that of Mexico in 1995 after its financial crisis. But Mexico had the benefit of a roaring US economy to help pull it out of the morass. What does developing Asia have by comparison? Japan is trapped in the quicksand of deflation with a banking system on the edge of collapse, and China's growth has slowed to well below the level needed just to absorb her growing labour force, let alone to be a locomotive for the region.

The world is awash in non-performing loans as a result of these stresses. In Japan, acknowledged non-performing domestic loans amount to around $600 billion, or nearly 15% of GDP, and another $600 billion is classified as "questionable". In China, roughly 25% of all outstanding loans are believed to be non-performing. Elsewhere in troubled Asia, central banks have just begun to add up the losses, which are staggering. Russia has hard-currency debts amounting to around $140 billion. They negotiated an IMF-sponsored line of credit of over $22 billion just to help pay the interest, and a few weeks later were forced to devalue and impose a partial debt moratorium.

This all adds up to well over $1 trillion in bad debt, or more than 5% of world GDP. Were the bad loans mostly domestic, they could be liquidated by each local central bank using newly printed money. However, the situation is not that simple. The major international banks have some $900 billion in cross-border loans outstanding in the developing world. More than half of this exposure is in the troubled parts of Asia and Eastern Europe. Although banks' capital exceeds these exposures (unlike the situation in the early 1980s when Latin America defaulted), there is no doubt that a loss of 25% of the outstanding loans would put a major dent in that capital. European banks have been the most aggressive lenders, and such a write-down could wipe out as much as a quarter of their capital. The prospect that a major bank will run into trouble and put the world financial system at risk of an ugly chain reaction cannot be dismissed. The debt-rating institutions are busy downgrading countries and banks or putting them on special watches.

There are clear signs that policymakers are taking this risk even more seriously than are financial markets. This is not necessarily good news. When the IMF reached an agreement with Russia in July, global markets heaved a collective sigh of relief. But the policymakers' frantic response to Russia's travails, which included accessing the IMF's rarely used General Arrangements to Borrow, should be taken as a very worrying sign. Not only did it underscore the extreme fragility of the world financial system, but it made it clear that the IMF's cupboard is bare. With outstanding commitments of about $54 billion before the Asian crisis, and new commitments to Asia of about $36 billion, the IMF has used up the bulk of its loanable funds. There is currently only about $20 billion available for new lending.

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Is that enough? Perhaps, if nothing else goes wrong. Even if the IMF is given the capital boost it is demanding, they will only be able to deal with one more "crisis" about as big as the one Asia went through in late 1997 before hitting the wall again. If Asia can blow up and fall into a depression, commodity prices can plunge and bring Russia, Ukraine, Pakistan and others to the wall of debt default, all while the US economy is booming, what will happen when the US economy starts to slow?

Investors should be wary of taking on more risk in this environment. Portfolios should be weighted toward bonds and defensive stocks until Asia shows signs of bottoming and tensions in Latin America, China and Eastern Europe begin to ease. ◆

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