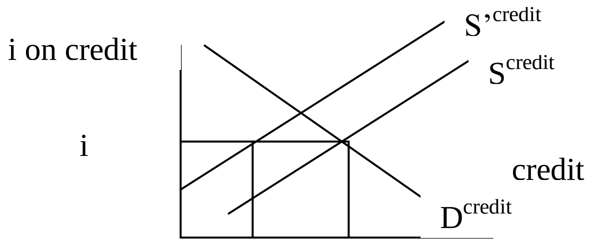
Lecture 14 : Credit crunch and financial disintermediation[1]

I. Credit crunch

Credit crunch : a situation in which the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects (the United States Council of Economic Advisors, 1991)



To put this simply: credit crunch is a 'disequilibrium' phenomenon where $S^{credit} < D^{credit}$ and credit (loans) is allocated via non-price mechanism. Tight monetary policy raised costs of funds for banks. In a recession, banks cannot pass on the higher costs of funds to higher interest rate on credit, therefore, they reduced the S^{credit} to S'^{credit} but i is not adjusted upwards.

Evidence on Thailand

The period right after the breakout of the crisis in 1997, the growth of credit dropped along with the real GDP growth. It is an intricate task to identify whether this decline is demand- or supply-driven. Dollar and Hallward-Driemeier (1998) found insiginificant degree of credit crunch in Thailand. On the other hand, Ito and Silva (1999), Domac and Ferri (1999), Ghosh and Ghosh (1999), Agenor, Aizenman and Hoffmaister (2000), Kotikula, Patrawimolpon and Pongsaparn (2001) and SiriPhothiprapan (2003) found econometric evidence of credit crunch, in particular, during the period right after the crisis.

The driving forces behind credit crunch

- The level of NPLs or fear of NPLs
- Asymmetric information
- Risks of a further fall in collateral values after the asset bubble bursted
- Impaired debt-servicing capacity, especially SMEs

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[1] Readings

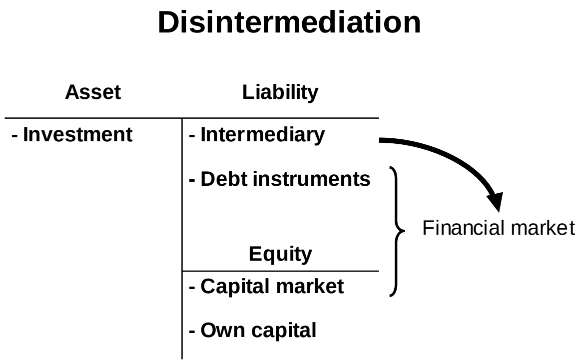
- Dollar, David, and Mary Hallward – Driemeier, "Crisis, Adjustment, and Reform in Thai Industry," the World Bank unpublished, the World Bank (November 1998)
- Ito, Takatoshi, and Luis Pereira da Silva, "New Evidence of Credit Crunch in Thailand and Indonesia and its policy Implications," (November 1999)
- Domac, Ilker, and Giovanni Ferri, "The Credit Crunch in East Asia: Evidence from Field Findings on Bank Behaviour and Policy Issues," (November 1999)
- Ghosh, Swati, and Atish Ghosh, "East Asia in the Aftermath - Was there a Crunch?," unpublished, the World Bank (October 1999b)
- Agenor, P, J. aizenman, and A. Hoffmaister, "The Credit Crunch in East Asia: What Can Bank Excess Liquid Assets Tell Us?", National Bureau of Economic Research (October 2000)
- Kotikula O, Patrawimolpon P and R Pongsaparn (2001), 'Mobilizing Domestic Finance for Development and Credit Crunches : Some Evidences from Thailand and other East Asian Countries', *DRPAD (UN ESCAP) Publications (Special Reports),* ESCAP-ADB joint workshop on mobilizing domestic finance for development
- Siriphotiprapan P (2003), 'Credit crunch after the financial crisis in Thailand', Thesis (Master of Economics), Thammasat University (in Thai language only)
- Oh J (1997), 'Financial Disintermediation and Monetary Policy', the SEACEN Centre

- Slow debt restructuring

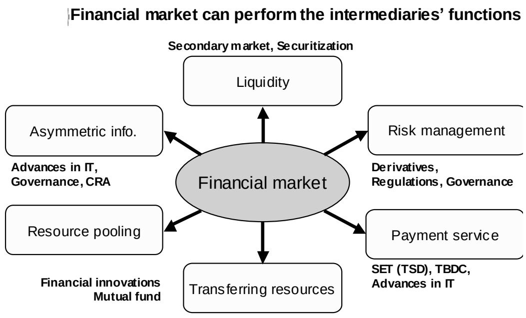
Way out

- Export credit (EXIM bank) and SME credits (state banks)
- Thai Asset Management Corporation (TAMC) starting in 2001 to conduct bond-for-discounted-NPLs swaps based on the underlying collateral values to be evaluated independently
- Credit bureau

II. Financial disintermediation



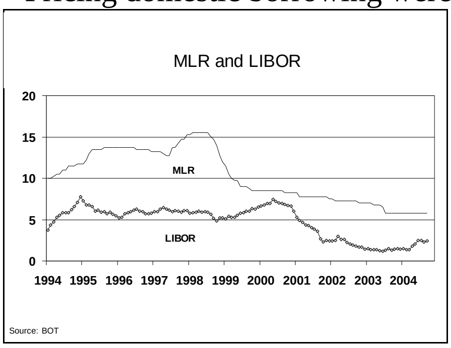
Financial disintermediation: the withdrawal of funds from an intermediary by ultimate lenders (savers) and the lending of those funds directly to ultimate borrowers. In other words, disintermediation involves the shifting of funds from indirect financing to direct financing. (Oh, 1997)

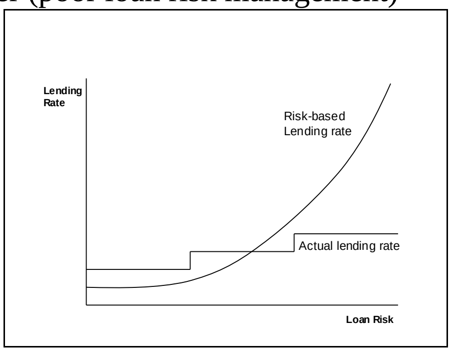


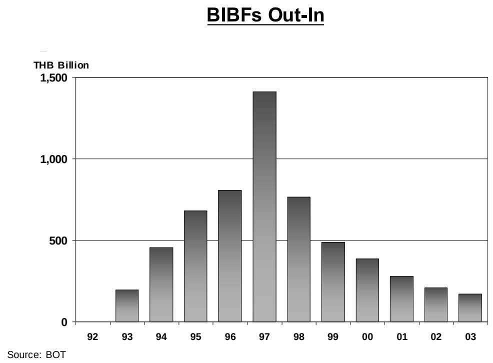
Evidence on Thailand

Pre-crisis

- Banking loans were the main sources of funds
- Development in the bond market
- Development in the capital market
- Capital inflows from abroad (disintermediation)
  - Foreign exchange policy makes costs of financing by domestic borrowing higher than borrowing from offshore market
  - Pricing domestic borrowing were higher (poor loan risk management)







As a result, domestic firms borrow directly from foreign creditors.

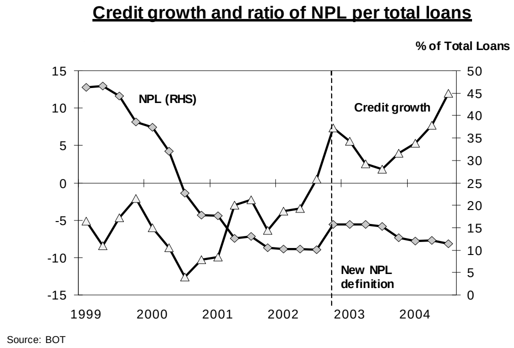
The Crisis

Float of the Baht on July 2, 1997

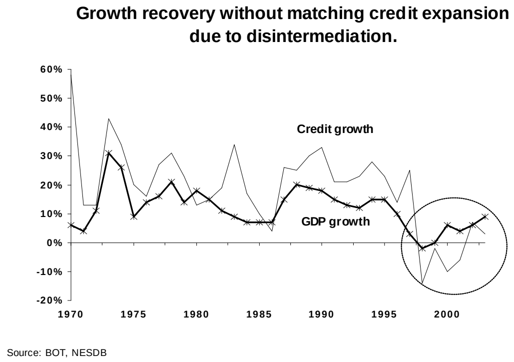
- Currency and maturity mismatch
- Credit crunch

Post-crisis

- Banking restructuring, cautious lending, and improved risk management slow down credit expansion
- Credit growth slows with declining NPLs



- Changes in corporate capital structure & financing
  - debt-equity ratio decreases
  - Issues of debentures and fund-raising in the stock market increase following the credit crunch



- Growth recovery without matching credit expansion clearly indicates disintermediation