Peru's banking system faces imminent crash

by Manuel Hidalgo

Peru is poised on the verge of a generalized bankruptcy of its national banking system, the result of incompetent hyperinflationary policies which were adopted following the Asian eruption of the global financial crisis last fall.

During the first quarter of 1998, one could observe "the gestation of a crisis in the financial system," due to huge short-term private foreign debt and the recession, just as occurred in Chile in 1982, explained the Lima magazine *Sí* of March 30. Economists interviewed by *Sí* warned that the short-term foreign debt of Peru's private banks had reached $3.2 billion as of Feb. 22, or 150% of the capital of the domestic banking system. The short-term debt of one bank, *Sí* says—implying that it could be Wiesse Bank, the country's second largest—is 300-400% of its total capital! *Sí* warns that the bank in question reported fourth-quarter 1997 losses, and reduced its profits last year by 23%, compared to 1996.

This is a formula for insolvency, because a major devaluation of the sol, the Peruvian currency, is highly likely during the second quarter. This means that the banks—which have indebted themselves in short-term dollars, while lending out long-term sols—will not be able to meet their foreign obligations. This payments "scissors" is precisely what happened to Mexico's banks in December 1994, which led to the bankruptcy of approximately 75% of that national banking system.

The case of Wiesse Bank is not an isolated one, since, according to *Sí,* there is a significant number of banks which "have either suffered losses, or have substantially reduced their profits at the close of 1997, and this tendency has apparently increased in the first 45 days of this year," a period in which the delinquency (non-payment on loans) index rose by 29%. Delinquency, not counting hidden non-performance, is approximately 6%, and it is expected that it will rise another three points, or $400 million.

One sign of the times is the practice of buying up non-performing loan portfolios, a form of "grave-robbing." Economist Juan José Marthans explained that certain banks "are negotiating problem portfolios; some of them are selling problem portfolios to their subsidiaries, as a way of underestimating the delinquency problems they actually have. Others still have the luxury of buying up problem portfolios from other commercial banks. . . . This strikes me as horrible."

On March 25, the bankers met with Peru's Bank and Securities Superintendent (SBS), to ask—in vain—for a suspension of new higher reserve requirements for bad debts and publication of risk classification. On March 31, the new requirements went into effect and, according to *Sí,* one-third of Peru's 25 domestic banks will face serious difficulties as a result.

More foreign takeovers

According to *Sí,* the crisis means that "a large part of the system" is going to collapse, and will be "concentrated in a few hands, which will not exactly be Peruvian." In late March, the press announced that four local banks—including Wiesse—are seeking a buyer, that is, a majority, or "strategic," partner. Among the most talked-about buyers are Banco Santander (which could become the country's number-one bank, if it buys out Wiesse), Sudameris, and HSBC-Banco Central Hispano. The managing director of the Spanish Banco Bilbao Vizcaya in Peru announced that the process of "natural selection" would last less than three years.

The combination of the banking crisis, deterioration in the current-accounts deficit, and devaluation could melt down the system. This year, Peru is expecting the largest current-account deficit in its history, according to the Association of Exporters, and the largest in proportion to GNP in the region. Former central bank president Julio Velarde estimates that the current account deficit will run 8% of GNP, more than Mexico's 7% in 1994. This is due in large part to the collapse in price of Peru's leading mineral exports (copper fell 28.1%, zinc 27.5%, lead 16.9%), and to reduced export production and reduced domestic consumption in fish, agriculture, and industry, because of the destruction wrought by El Niño.

In January, the trade deficit grew 61.6%, and in the first two months of the year, exports plummeted 28%. The collapse of minerals prices has forced the postponement or cancellation of various "mining megaprojects," which were to have provided a flow of capital, and later of foreign exchange, to balance the current-account deficit.

Although Peru has not suffered devaluations like those of Chile (which has already devalued up to 12%) and Ecuador (which recently devalued 7.5%, because of the fall in oil prices), the sol has experienced a 7% devaluation since the "Asian crisis" began, and faced a critical moment in late February when a run on the sol by certain banks threatened to unleash further devaluation. The danger was halted only after the central bank backed the sol with tens of millions of dollars, while drastically cutting liquidity in sols, at the cost of accentuating the recession. The banks made futures contracts on the dollar, to the tune of $400 million in March alone, compared with an average of $180-280 million per month during 1997. A devaluation would be a death warrant for many banks, since the banking system has 75% of its holdings in dollars, and a large part of its borrowers have their income in sols. The "exchange risk" has thus become a "banking risk."