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Emerging-market debt: China must manage credit bubble to avoid new crisis

by Michael Heise

Among the many uncertainties that have spooked stock markets in early 2016 – from power rivalries in the Middle East to Europe's unabated refugee crisis – the most unsettling has been the slowdown in emerging markets, as signaled by a collapsing oil price.

Until 2015, emerging markets were the engines of global growth. Now Brazil and Russia are in recession, while China and other Asian economies are losing momentum. Among a myriad of factors that are weighing emerging markets down, the growing burden of private debt has received most attention recently. And rightly so.

Debt of households and non-financial companies in emerging markets has increased strongly since 2007, from around 80 percent to 120 percent of GDP.

Concurrently, at least since 2010, much of the industrialized world has been deleveraging.

This is why some observers are talking about private-sector debt in emerging markets being the third stage of the global debt crisis – from mortgages in the US to sovereign debt in the eurozone and now to private-sector debt in emerging countries.

More important than labels is the question: Where do we go from here? Will private-sector debt in emerging markets continue to increase in relation to GDP?

Continued credit growth would stimulate growth in the short term but it would also increase the risk that the bubble bursts at one point, with severe implications for financial stability. In a second scenario, successful policy changes, together with capital outflows, curb the credit boom and to allow for a gradual adjustment. This would imply somewhat lower, but hopefully more stable growth in emerging economies.

A closer look at the numbers show that the situation differs from country to country and from sector to sector. On the whole, the increase of private sector debt in emerging markets has been driven mainly by non-financial companies.

True, households have increased their debt by more than $6 trillion since 2007. But the average level of household debt remains moderate, at about a third of GDP, which is less than half of the industrialized-country average.

These averages mask big differences between countries.In Thailand, Malaysia, China and Hong Kong, for example, household debt dynamics are worrying. Nevertheless, the biggest threat to emerging market growth stems from corporate debt.

On average, corporate debt now stands at about 90 percent of GDP in emerging markets.

That level is similar in industrialized countries but the latter usually boast more reliable legal systems, sound property rights and a relatively larger capital stock. Therefore, investors will tolerate a higher debt level than in emerging markets.

The fastest increase in corporate debt has been recorded in Asia, where it has risen from 80 percent of GDP in 2007 to about 125 percent today.

While the bulk of corporate debt still consists of bank loans and is denominated in local currency, the issuance of corporate bonds and foreign currency exposure have both increased rapidly in recent years. Today, an estimated 14 percent of non-financial corporate debt in Asian emerging markets is denominated in foreign currencies, especially the U.S. dollar. This exposure leaves borrowing countries vulnerable to sudden capital outflows and currency devaluations vis-a-vis the dollar.

Within Asia, the debt bubble is mainly a Chinese phenomenon.

In 2015 alone, Chinese non-financial companies took on an additional $1.2 trillion in debt, which lifted the corporate debt-to-GDP ratio to more than 180 percent. The biggest borrowers have been state-owned enterprises in construction, real estate, mining and energy.

So the adjustment path of the emerging market debt bubble mainly hinges on what happens in the state-controlled part of the Chinese economy.

At the moment, the Chinese authorities are trying to stem large capital outflows that have reduced liquidity in the market. They are grappling with the dilemma of how to keep growth close to target while stopping further inflation of the credit bubble.

They will be able to reconcile these objectives only if the allocation of capital improves. Money that is currently being absorbed by unprofitable state-owned behemoths should be freed up to finance the growth of new and innovative firms in manufacturing and services.

So far, the Chinese government seems unwilling to allow large-scale losses on the debt of state-owned enterprises, for fear of spreading panic among investors. Such interventions only make sense if they are accompanied by efforts to unwind excess production capacity and curtail the flow of capital to bloated state-controlled sectors. Otherwise there will be continued extension of credit to these companies that exacerbate the problems in the future.

Even if China manages to re-allocate capital in this way, it will not avoid a slowdown of the economy – which would also impact on the rest of the region.

For emerging Asia as a whole, we expect growth to slow down moderately to around 5 percent in 2016-17. But a gradual slowdown would still be much preferable to an unabated credit-fueled expansion, with the accompanying risk of a hard landing at a later point in time.

If policymakers act decisively, the third stage of the global debt crisis can be avoided. The odds are that they will.

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