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Emerging markets: Asian companies expected to consolidate their debt

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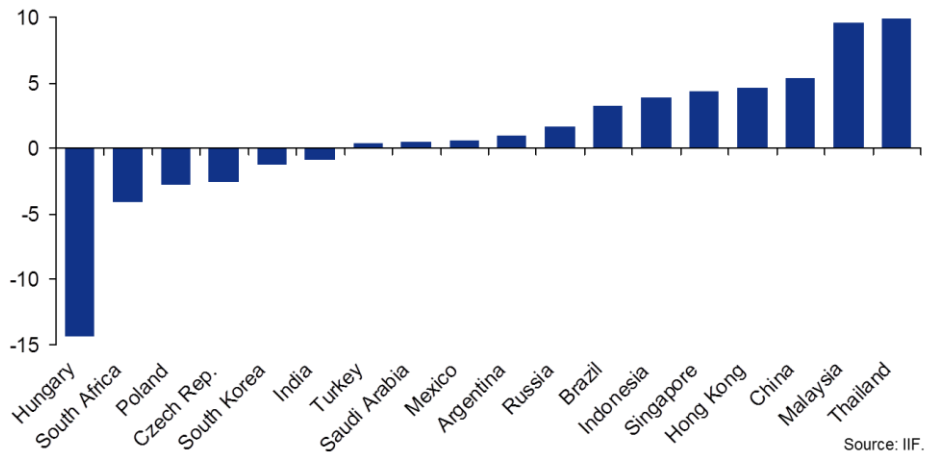
Emerging markets: Asian companies expected to consolidate their debt

The multitude of reasons behind the current growth slump that has afflicted the world's emerging markets makes it difficult to forecast the medium-term economic outlook for this group of countries, which is extremely heterogeneous to begin with. The rapid debt accumulation witnessed in recent years among both private households and the corporate sector in the emerging markets does not make this analysis any easier. The Institute of International Finance (IIF) estimates that global private household debt has risen by USD 7.7 trillion since 2007 to total USD 44 trillion in the first quarter of 2015. The IIF reports that households in the emerging markets are responsible for the lion's share of this increase, namely a good USD 6 trillion. Despite this rapid rise, however, debt levels remain moderate in relation to gross domestic product (GDP) and, at 32% of GDP, do not even correspond to half of the average figure for the developed countries. This would appear to suggest that there is not any fundamental debt problem among private households.

Averages, however, say nothing about developments in individual countries. Particularly in Asia, household debt has now reached a level that sets alarm bells ringing, especially given the stellar growth in property loans. If we look at the global ranking of countries with the biggest positive credit gap – i.e. the biggest positive deviation between lending and GDP trend growth – the first five places are all filled by Asian emerging markets. Thailand leads the field with a difference of 10 percentage points, followed by Malaysia, China, Singapore and Indonesia. It goes without saying that the credit gap is only one indicator of the debt problem. In South Korea, for example, while the credit gap was most recently negative, private household debt comes in at 84% of GDP or 165% of disposable income. The main risks lurking in the background relate to a marked interest rate hike or a sharp correction in property prices. According to the Bank of Korea's most recent "Financial Stability Report", for example, a rate hike of 300 basis points would push the proportion of at-risk households (households with a debt service ratio in excess of 40%) up from 10.3% at present to 14%. There is no doubt that this would not only drag down private consumption, but would also have negative implications for the banking sector.

Private households in Asian emerging markets with the largest positive credit-to-GDP gap

Household credit-to-GDP gap, percentage points, deviation from long-term trend

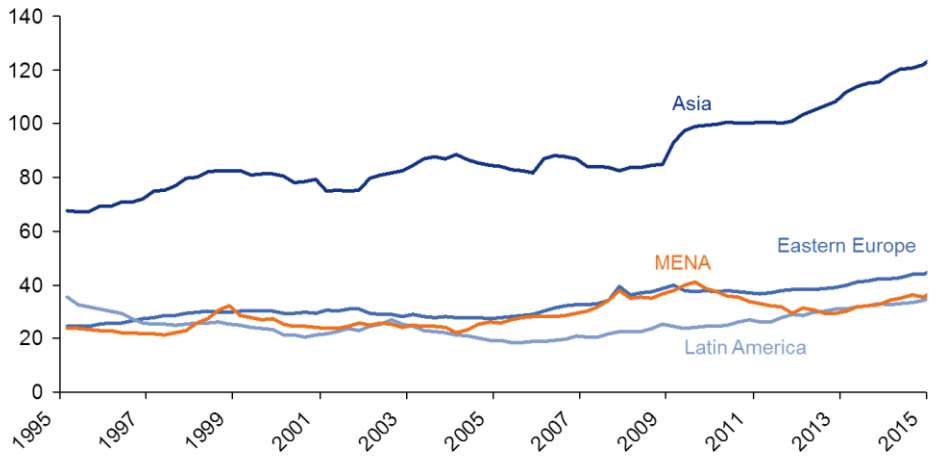


Source: IIF.

Nevertheless, overall the debt situation of private households in the emerging markets is still much more favorable than in the developed countries. This no longer applies to the debt levels of non-financial corporations. According to figures released by the IIF, the debt accumulated by non-financial companies in the emerging markets came to 89% of GDP in the first quarter of 2015, as against 90% in the industrialized countries. There is no sign of deleveraging; on the contrary: corporate debt has climbed by 28 percentage points since 2007. The increase in the advanced economies came to a mere 4 percentage points over the same period. A look at regional developments shows that – as with private household debt – the increase is concentrated primarily in Asia. China and Singapore top the list of emerging markets reporting the strongest increase in debt ratios. What is particularly striking within this context is that the most recent debt accumulation in these economies came from what was already a fairly high debt level, i.e. cannot be described as a catch-up effect. The debt accumulated by Chinese non-financial corporations, for instance, rose from just under 100% to 160% of GDP in the period between 2007 and the first quarter of 2015.

Heavy corporate debt burden in emerging Asia

Emerging markets: Non-financial corporate debt, as % of GDP



Source: IIF.

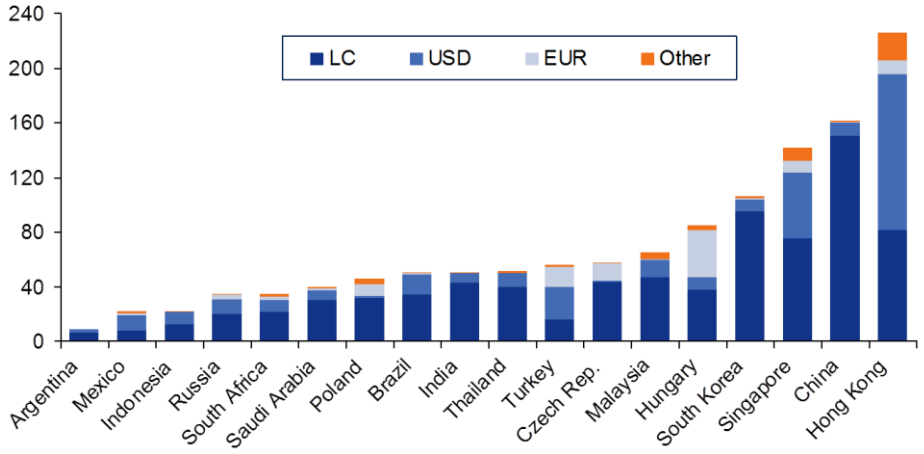
The changes in the structure of corporate debt in the emerging markets are also striking. Although bank loans continue to account for the lion's share, the proportion of bonds has risen sharply in recent years. According to the International Monetary Fund (IMF), bonds already accounted for 17% in 2014, almost double the 9% seen in 2004. Although a scenario in which companies make more use of the capital markets for corporate financing purposes is a welcome development in general – not just from a diversification perspective, but also because capital market financing tends to have a longer term than bank loans – this increasing recourse to the capital markets also makes companies more vulnerable to what are sometimes very volatile capital market developments.

Both the rapid debt accumulation and the trend towards using the capital markets more, and the credit markets less, for financing purposes are developments that have been helped along by the many years of very expansive monetary policy in the developed countries, which has had a decisive impact on financing conditions not only in the developed world but also, and to a considerable degree, in the up-and-coming economies. Changes in global financing conditions like those currently emerging in the US pose a risk to the corporate sector in the emerging markets. The interest rate risk sits alongside a currency risk as well: if rising interest rates in the developed countries, for example, result in the depreciation of local currencies, companies will have a harder

time servicing their debt denominated in foreign currencies – unless they have made appropriate hedging arrangements. Currently, around 18% of the total debt of non-financial corporations is denominated in a foreign currency, with stark differences from country to country. The country with the highest proportion of foreign currency debt among all major emerging markets is Turkey, with this debt accounting for a share of more than 70%. This sort of debt accounts for around 9% in China (including Hong Kong). This relatively small percentage, however, corresponds to an absolute amount of USD 1000 billion.

Emerging markets: Close to 18% of all non-financial corporate debt is foreign currency-denominated

Emerging markets: Non-financial corporate debt, Q1 2015, as % of GDP



Source: IIF.

It is impossible to give a blanket answer to the question as to how corporate sector debt in the emerging markets will develop in the future, because the situation varies considerably from country to country. Without wanting to downplay what is certainly a difficult debt situation in other emerging markets, such as Brazil and Turkey, the main debt problem lies in Asia. The fact that the Asian corporate sector has the biggest debt mountain out of all of the emerging market regions comes as little surprise: the Asian growth model, which is based on exports and investment, has been financed increasingly by debt. Given the level of debt already reached, this model is edging ever closer to its limits and we have to expect the growth slowdown in Asia to continue over the next few years.

We cannot rule out the possibility that the high corporate debt level has created a lending bubble that could set a crisis in motion. It is, however, virtually impossible to accurately forecast this sort of credit crunch. As long as growth in the Asian economic region remains, as we expect, in a range of between 5 and 6% (for comparison: annual average growth 2002-2011: 8.3%), corporate lending growth could well match, or even exceed, this figure. And as long as interest rates remain relatively low, companies will be spared any sharp increase in their interest burdens. A lot ultimately depends on whether economic policy can gradually slow the pace of lending growth by imposing regulatory measures, i.e. by putting an end to the tax incentives that debt financing enjoys compared with equity financing in the corporate sector. All of these factors will play an important role in determining how intensive the adjustment process will be and, as a result, also how much wind can be taken out of the growth sails. Developments in China's non-financial corporate sector will also prove decisive within this context. Due to

the adverse effects on the financial system and business activity well beyond China's borders, a debt crisis in China would have significant knock-on effects.

In recent years, Chinese growth has been fueled largely by credit-financed investment. Particularly since the global financial crisis, non-financial corporations have been accumulating debt at a staggering rate. In absolute terms, these companies had racked up debt of around EUR 13,000 billion by the spring of 2015. Just under 9% of this debt related to foreign currency liabilities, with the vast majority denominated in US dollars. The striking divergence between listed private companies and state-owned enterprises (SOEs) really stands out. Whereas private companies steadily whittled down their debt ratios in the period between 2006 and 2013, debt levels at those SOEs that already had a very high debt level, in particular, continued to soar. This trend was driven primarily by SOEs in the construction and real estate sectors, as well as in mining and energy. Debt ratios in these sectors come in at over 350% in some cases. The increasing concentration of debt in the hands of a relatively small number of companies is another eye-catching development Around 60 highly-indebted companies are responsible for more than two-thirds of total debt in the construction and real estate sector. There is no doubt that this makes the Chinese corporate sector extremely susceptible to any marked slowdown in construction and real estate. Any such slowdown would certainly also hit other sectors of the economy like the manufacturing industry and transport sector, both of which enjoy close links to construction and real estate. In a sensitivity analysis, the IMF concludes that if corporate profits in the construction and real estate sector were to fall by, say, 20%, the proportion of liabilities in danger of default (liabilities where operating corporate earnings are not sufficient to cover interest expenditure) would rise from the current level of around 8% to just shy of 25% of the total corporate sector debt.

In the short and medium term, however, we believe that the risks emanating from the Chinese corporate sector are manageable, mainly because the biggest debt problem affects companies that are in the state's hands. The Chinese government still has enough fiscal leeway in order to stave off a systemic crisis among SOEs. Since China still has very generous currency reserves, this also applies to the foreign currency liability of the SOEs. In general, however, there will be no getting round the need for write-downs, the restructuring of viable companies and the closure of unprofitable SOEs. This will also, however, require greater tolerance with regard to payment defaults and insolvencies among non-viable companies.

Literature

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