3 december 2018

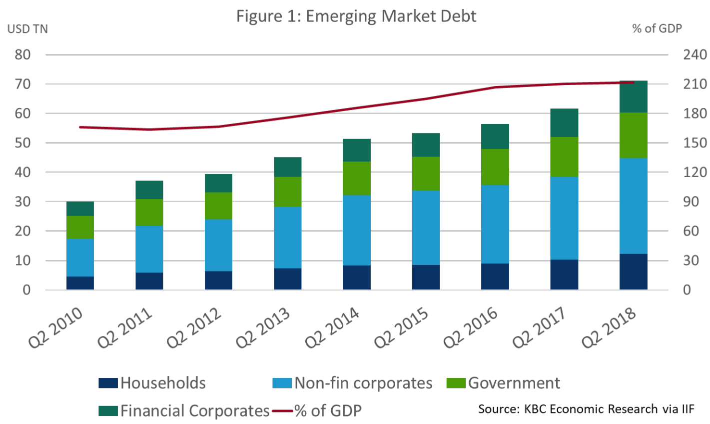
"Emerging Market Debt Mountain nears boiling point"

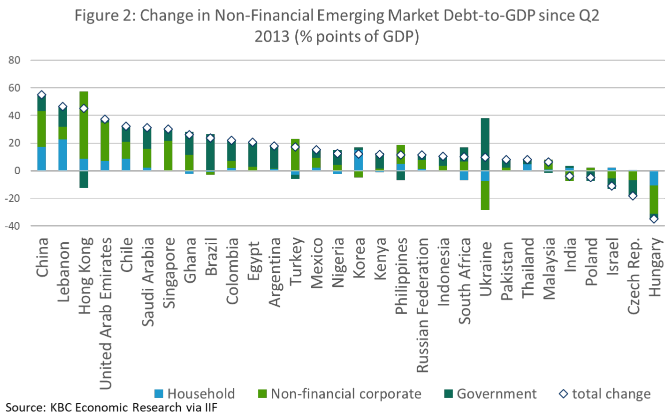
"Government and corporate debt in dollars, of many emerging economies, amount to more than 20% of GDP. China, too, is full of debt, which carries risks."

2018 has been a turbulent year for many emerging market assets as rising interest rates in the US triggered worries about macroeconomic vulnerabilities in those markets. And yet, emerging market debt continues to climb higher, reaching $71 trillion in Q2 2018 (212% of GDP). That is almost $10 trillion higher than Q2 2017 (figure 1).

Excluding financial corporations, China has led the way in debt buildup over the past five years, with significant growth in both corporate and household debt (figure 2).

The Chinese authorities should be able to avoid any major debt-related crisis in the short-to-medium term, but the debt pile in China does pose significant risks to the global economy in the long run. Furthermore, several other emerging markets have also increased their debt burdens in recent years. Those countries with especially high vulnerabilities, such as significant levels of debt denominated in USD, or a steep debt redemption schedule over the next two years, are particularly at risk for further market turbulence.

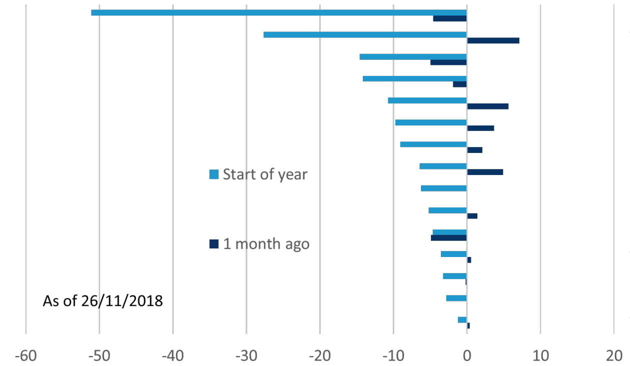




The substantial debt burden and other vulnerabilities faced by several emerging markets are no surprise to investors. Emerging market assets faced significant bouts of volatility over the past year as the Federal Reserve continued its rate hiking cycle. With interest rates in the US rising and expected to rise further, certain emerging markets will find it more difficult to secure financing or refinancing from international markets. Tighter financial conditions often force countries with large macroeconomic imbalances to introduce abrupt, and sometimes painful, adjustments.

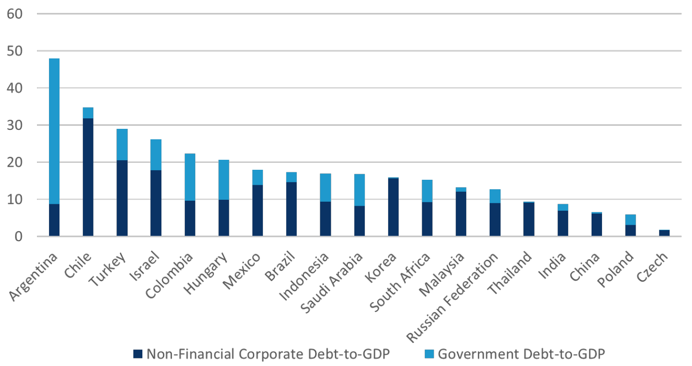
As such, it is not surprising that the currencies of those emerging markets with the largest imbalances generally came under the most pressure this year. Argentina and Turkey, suffered the most, with their currencies depreciating roughly 50% and 28% respectively against the USD since the beginning of the year. They were not alone, however. The Brazilian real, Russian ruble, South African rand, Indian rupee and Chilean peso have all depreciated more than 9% against the USD this year (Figure 3). With reports of investors pouring back into emerging market stocks in recent weeks, one might wonder whether the worst is over for emerging markets. Given the current global environment however, with the Fed still hiking, the ECB expected to start raising rates in 2019, and mounting concerns that trade tensions could disrupt currently strong global growth, bumpy waters may still lie ahead.

Figure 3: Percent change in emerging market currencies vs USD



Source: KBC Economic Research via Macrobond

Figure 4: USD denominated debt (% of GDP)

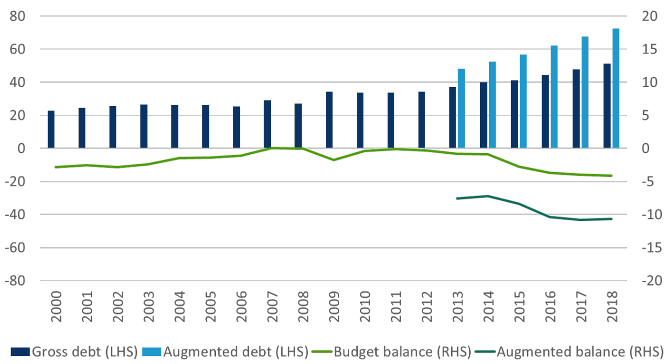


Source: KBC Economic Research via IIF

This is especially true for countries with high vulnerabilities, such as significant debt levels, and particularly USD denominated debt. Brazil's government debt has reached 85% of GDP, for example, and reining in the government's fiscal accounts requires surmounting steep political battles. Government debt-to-GDP ratios also remain substantial in India (69%), Argentina (58%) and South Africa (55%) among others. Meanwhile, Argentina, Chile, Turkey, Israel, Colombia and Hungary all have USD denominated government and non-financial corporate debt amounting to over 20% of GDP (figure 4). In total, just under one-third of emerging market debt maturing through 2020 is USD denominated, and for several countries, more than half their public, financial, and non-financial corporate debt coming due through 2020 is USD denominated.

On the other hand, China, which has contributed significantly to the buildup in emerging market debt, has very low levels of non-local currency denominated debt. Indeed, China's debt situation is rather unique, though still worrisome in the long-run. Given the high degree of government control over the economy, the Chinese authorities have both the will and the means to avoid a significant debt crisis or hard landing of the Chinese economy.

Figure 5: China's Public Debt (% of GDP)



Source: KBC Economic Research via IMF

However, China's debt burden is significant, and government debt in particular is much larger when contingent liabilities are taken into account (figure 5). The authorities have acknowledged the need to put debt on a sustainable path, but are, at the same time, fully committed to supporting economic and social stability. China's growing debt burden, along with slowing growth, however, will continue to make the balancing act between supporting both financial stability and social stability more difficult. As China becomes more open and integrated into the global economy, China's debt mountain, therefore, becomes a greater risk.

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