Economist Insights

Easy come, easy go

For most emerging markets (EM), money was easy to come by in the wake of the financial crisis. Low global interest rates and quantitative easing programmes have created a heady mix of easy domestic money combined with easy foreign money. Easy money triggered a substantial rise in corporate EM debt. But, as the IMF recently highlighted, what if global financial conditions start to tighten? What then for the debt-laden EM corporates?

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It is called easy money for a reason. When interest rates are unusually low and credit easy to come by, you do not have to work very hard to justify your borrowing. So you will tend to borrow more. That is why central banks try to create 'easy money' conditions when the economy is weak. But what if the easy money comes from external, rather than domestic factors?

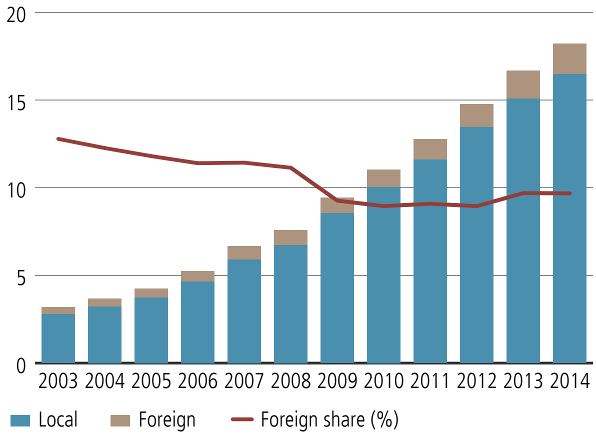
Plenty of emerging markets (EM) have experienced easy money in the wake of the financial crisis. With low interest rates in developed markets (DM) and quantitative easing (QE) programmes flooding the financial markets with cash in search of a home and a higher yield, a lot of that money inevitably headed towards emerging markets. All this money flowing into EM tended to put upward pressure on exchange rates, so many central banks kept their monetary policy loose to counter the upward pressure. But this added domestic easy money to foreign easy money, so whichever way EM corporates turned, cash was freely available. Sure enough, EM corporates increased their debt level, and EM corporate debt has tripled since the years preceding the financial crisis (chart 1).

The easy money from domestic sources has dominated, with the foreign currency denominated share of EM credit actually lower now than it was in the early 2000s. The fear would normally be that a rise in foreign currency borrowing would create a currency mismatch, so that as soon as the local currency depreciated, firms would be unable to service their debt. The absolute level of foreign debt is indeed higher, but with the lower share this is not so much of a concern.

But as the IMF points out in its biannual Global Financial Stability Report, since global monetary easing encouraged easier domestic financial conditions, a tightening of global financial conditions could be problematic for EM. The IMF finds that EM domestic macroeconomic conditions have deteriorated since the crisis. On top of this, firm-level fundamentals (such as profitability, liquidity and solvency) have also worsened. So that leaves global factors as the most likely explanation for the rapid growth in EM corporate debt.

Chart 1: Easy rider

Emerging market corporate debt (USD trillions) by local and foreign currency, and foreign currency share of the total



Source: IMF Global Financial Stability Report October 2015
Note: Data is for major economies only. Consists of loans and bonds. Loans from foreign banks are assumed to be foreign currency denominated.

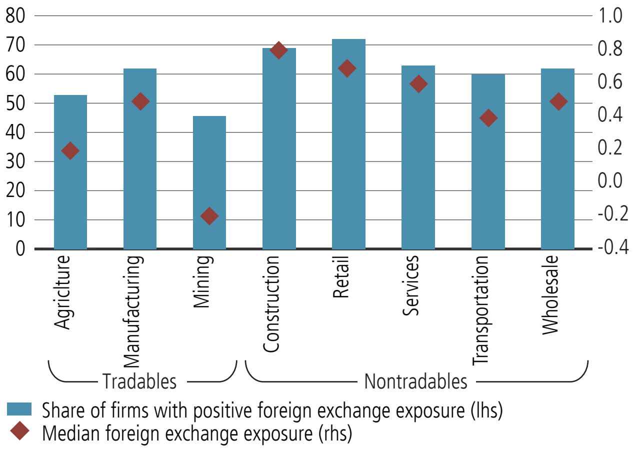
The IMF goes on to paint a rather unpleasant risk scenario. Suppose that global financial conditions tighten, for example because the Federal Reserve starts hiking rates. Domestic financial conditions could tighten as well, leading to corporate distress which leads to non-performing loans. This in turn has a knock-on effect on the financial sector, which leads banks to tighten credit conditions and you end up with a vicious downward spiral. This is hardly unprecedented: countries that experience rapid credit growth for several years are far more likely to experience a subsequent financial crisis.

But, you may ask, if there is actually less foreign currency borrowing nowadays, why should we be worried? And since there are many domestic-oriented firms that borrow domestically, are these corporates not safe from global gyrations? Not necessarily. Part of the problem is that many of the risks are concentrated.

Many firms that appear domestically oriented, such as retail or services, are actually quite exposed to movements in the currency even if they do not have foreign debt. In fact, many EM firms tend to see their stock market returns improve when the exchange rate is stronger, largely because of import costs (chart 2). For example, construction firms often import a lot of raw materials, so a stronger currency makes those cheaper. Similarly, a weaker currency would push up the cost of steel, concrete and such like.

Chart 2: Feeling exposed

Foreign exchange exposure by sector in emerging markets, 2001-2014, and the median sensitivity of firms' stock market returns to the exchange rate



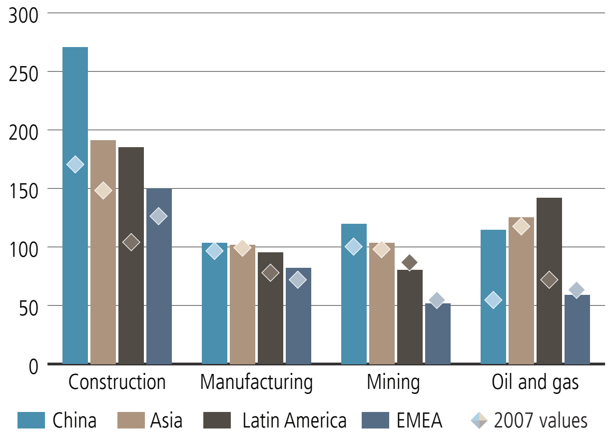
Note: When the exchange rate sensitivity is positive, stock market returns benefit (suffer) from a stronger (weaker) nominal trade weighted exchange rate. A level of 0.5 indicates a 1% strengthening of the exchange rate increases stock market returns by 0.5%.
Source: IMF Global Financial Stability Report October 2015

So corporates in certain sectors are exposed to an exchange rate depreciation. And an exchange rate depreciation is exactly what is likely to happen if DM central banks like the Fed raise rates while EM do not. This could hit the profitability of these sectors, but this is unlikely to be a problem unless the corporates have taken on a lot of debt. Unfortunately, they do have a lot of debt.

Construction is a good example. The sector is heavily exposed to a weaker exchange rate, but it also has the highest leverage across key sectors in all EM regions (chart 3). The Chinese construction sector in particular is highly leveraged. This conjunction of high leverage and high external exposure creates a weak point in the debt markets.

Chart 3: Building up problems

Corporate leverage by sector and EM region, (ratio of total liabilities to total equity), 2013 and 2007



Source: IMF Global Financial Stability Report October 2015

A weak point like this is dangerous. Just think back to the housing crisis in the US. There were plenty of mortgages, even amongst subprime, that were properly priced. This was particularly true of early vintages of mortgage, for example those that originated in 2003 or 2004, before lending standards deteriorated. Yet when the crisis hit, all mortgages suffered. Contagion in debt and lending markets tends to be swift and indiscriminate.

Beyond the sectoral split, there is also a worrying trend for EM corporate debt to be increasingly concentrated in firms that have low levels of solvency. Solvency in this case is measured by the ratio of earnings to interest payments: those with a low ratio could quickly run into trouble paying their debt if there is a drop in revenues. For example, if there is an economic downturn in emerging markets or more globally. However, these risks could be overstated where the firms are state-owned enterprises, since governments underwrite their solvency.

Risks are exactly that: risks. But it is hard to ignore the repetition of a very familiar pattern: rising debt, external exposure, concentrated risks and lower solvency. This mix has rarely (if ever) ended well.