

»» Keeping a watch on emerging market corporate debt



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A deeper financial system – measured by the ratio of debt to GDP – generally fosters economic growth. But a strong rise in corporate and household debt often precedes banking crises. It usually takes an economy several years to recover from systemic banking crises. According to scientific studies, per-capita incomes on average take eight years to return to their pre-crisis levels.

Debt level of private non-financial sector is considerable

The level of corporate debt in emerging market economies analysed by the Bank for International Settlements (BIS) has grown considerably since the economic and financial crisis of 2008/2009. By the end of 2015, debt levels of non-financial enterprises climbed to around 104 % of GDP, much higher than in industrialised countries, where the ratio is 86 %. Private households in industrialised countries, on the other hand, accumulated significantly higher levels of debt (75 % of GDP as opposed to 33 %). The range of private sector debt ranges from 41 % of GDP in Mexico to 210 % in China.

Private sector debt as an early warning indicator of banking crises

Debt dynamics are a measure often used to determine whether indebtedness constitutes a problem for the domestic banking sector. A rule of

thumb says that a banking crisis becomes more likely when the ratio of private sector debt to GDP increases by more than 30 percentage points within 10 years. China, Brazil, Russia and Turkey are among the countries that have passed this threshold.

The more elaborate system of early warning indicators which the BIS applies to the banking sector includes the development of private sector debt to GDP in comparison with its long-term trend. According to Basel III, anti-cyclical capital buffers for banks are recommended when the difference rises above two percentage points. A difference of more than ten percentage points is regarded as a critical threshold above which the debt dynamics can point to a banking crisis. While China is clearly and increasingly crossing over both threshold values, Brazil and Turkey are in the process of slowing down their credit growth. These three countries and Mexico would also have reason to check their banks' anti-cyclical capital buffers.

Corporate debt in US dollars adds exchange rate risk

After the economic crisis of 2009, issuing debt on the international capital markets was attractive for enterprises in emerging markets because of the low interest rates, risk premiums and US dollar exchange rate expectations.

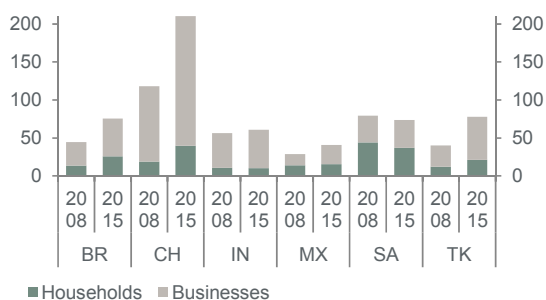
Between 2009 and 2013, private enterprises (excluding banks) from emerging market economies issued some USD 554 billion in international debt instruments. The depreciation of emerging market currencies against the US dollar, especially between mid-2014 and early 2016, then weighed on corporate balance sheets – as opposed to any effect it had to support export revenues – and put increased pressure on companies to reduce these debt levels. The fact that these enterprises – particularly in the commodities sector – receive their earnings in US dollars as well, their corresponding securities tend to have longer maturities and the countries have substantial currency reserves provides some relief.

No perfect early indicator

As an early warning indicator of banking crises, private-sector debt is useful but not perfect, especially not in emerging market economies. Other indicators such as the debt service ratio or real estate prices can point to vulnerabilities in the banking system as well. In China, Brazil and Turkey the debt service ratio indicators in the private non-financial sector also exhibit unusual values. These countries in particular should examine whether their banking system is equipped to handle these risks. ■

Figure 1: Private sector debt by country

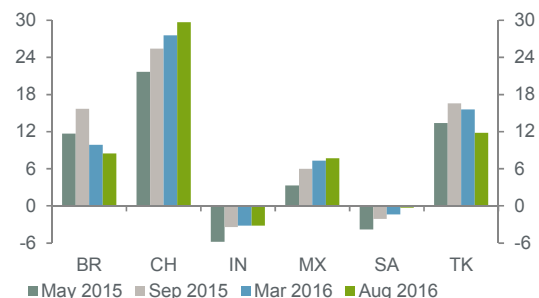
(in per cent of GDP)



Source: BIS statistics (total credit to the non-financial sector).

Figure 2: Private sector debt / GDP gap

(Deviation from the long-term trend in percentage points)



Source: BIS Quarterly Review; the date of publication is shown.