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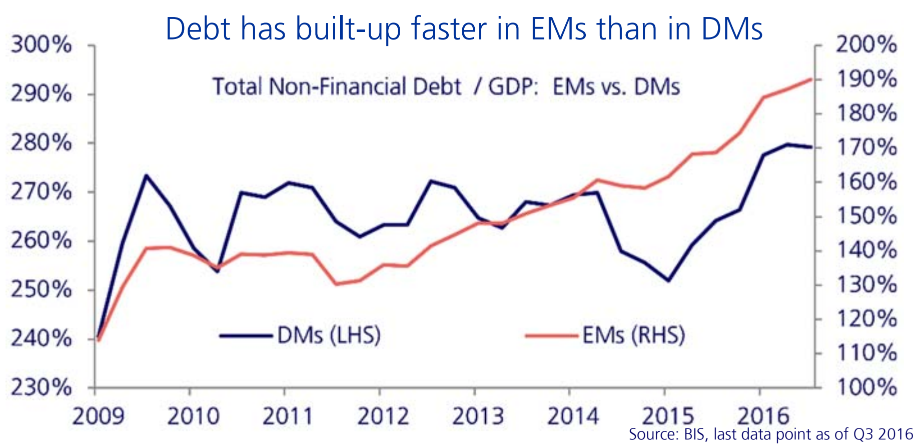
Emerging Markets: Lighter debt burden ahead

The recent economic rebound is helping debt levels to stabilise

Malaysia has seen its ratio of household debt-to-GDP fall for the first time in years. China is tackling its shadow banking excesses. Policy action, along with better nominal GDP growth, are powerful forces that should bring debt levels down. Although risks persist in Hong Kong and China, we see sustainable improvements in the rest of Asia.

Debt has built-up faster in EMs than in DMs

The issue of excessive debt has long been associated with developed markets (DMs). Even today, total non-financial debt-to-GDP in DMs stands at a hefty 279%, ~39ppts more than in 2009. Looking at emerging markets (EMs), the ratio is smaller, at 190%, but it has grown twice as fast, jumping by 76ppts from 2009 to 2016. EMs now account for 28% of the global USD 166tn debt pool, up from 17% in 2009. While credit growth in DMs has followed the fluctuations of nominal GDP growth, credit growth in EMs has been steady post-2009, even after GDP growth decelerated in 2012 and 2014. This has contributed to a stronger credit numerator and weaker GDP denominator. Additional debt failed to revive economic growth because of a decreasing multiplier effect, especially in China. Liquidity was channelled to sectors with weak productivity, such as the Chinese mining sector, or to the real estate sector in many Asian countries.



Source: BIS, last data point as of Q3 2016

In this topical paper, we start exploring the potential drivers of debt and subsequently look at EM debt by country and by category to identify the areas of risk. As the debt issue mainly affects Asian countries, we focus on EM Asia. We argue that the risk of a systemic debt crisis is low, although the situation in China and Hong Kong bears monitoring. The debt burden has weighed on demand growth, especially in Asia, but there are very encouraging signs that the situation is improving.

Foreign currency-denominated debt is no longer an issue in EMs

First, we want to highlight that EM, and especially EM Asia, has a domestic debt issue, not a foreign debt one. This contrasts with the situation of some Asian countries in the run-up to the 1997 crisis. US dollar credit to the EM non-financial sector equalled USD 3.6tn in 3Q16 compared to 47.1tn for domestic credit. In Asia, Malaysia

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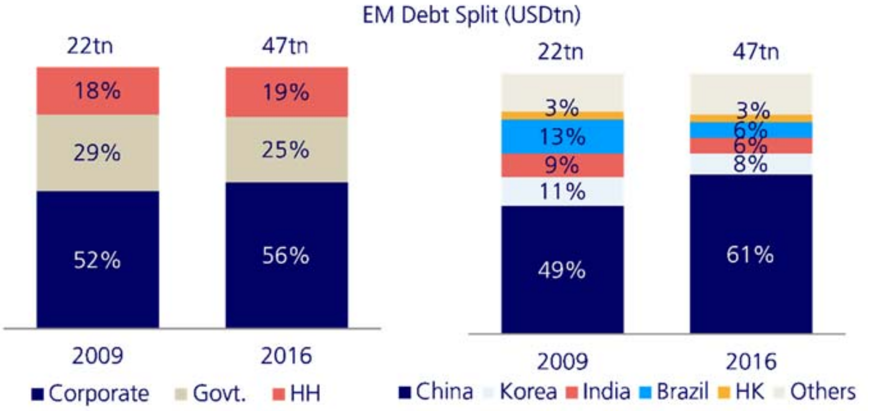
The share of corporate debt, mainly from China, has surged



Source: Source: BIS, last data point as of Q3 2016

stands out for weaker external debt coverage metrics than its peers: the ratio of FX reserves to short-term external debt is below 1 and the share of foreign ownership in sovereign bonds is ~38% vs. 28% for the average EM. For the other EM countries, external fundamentals have improved in the last two years, as reflected in the reduction of current account deficits and stabilisation of local currencies against the dollar.

Over half of EM debt is corporate debt

Corporate debtors represent the lion's share of the EM domestic debt pool: 56% vs. 25% for governments and 19% for households, which translates to debt-to-GDP ratios of 106%, 48%, and 37%, respectively. Between 2009 and 2013, absolute levels of corporate and household debt increased by a steady 13% average annual rate, faster than government debt at 9%. We do not view the levels of government debt as excessive. Singapore, Hong Kong, and India are the only Asian countries above the EM average: for the first two, assets and excess fiscal buffers compensate for liabilities. In India, the government's commitment to tighter fiscal policy, along with the better growth outlook, should help to contain debt.

Asian countries have the highest debt-to-GDP ratios in the EM world

Turning to a country-wide distribution of debt, China has clearly outpaced all its peers: 61% of total EM debt is now China's, up from 49% in 2009. Reviewing the national credit-to-GDP ratios allows us to single out other countries. Hong Kong tops the list (373%), followed by Singapore (295%), China again (256%), Korea (238%), and Malaysia (191%). We would also add Thailand (153%) to the list although it lies below the EM average of 190%.

Better prospects for ASEAN mortgage debt

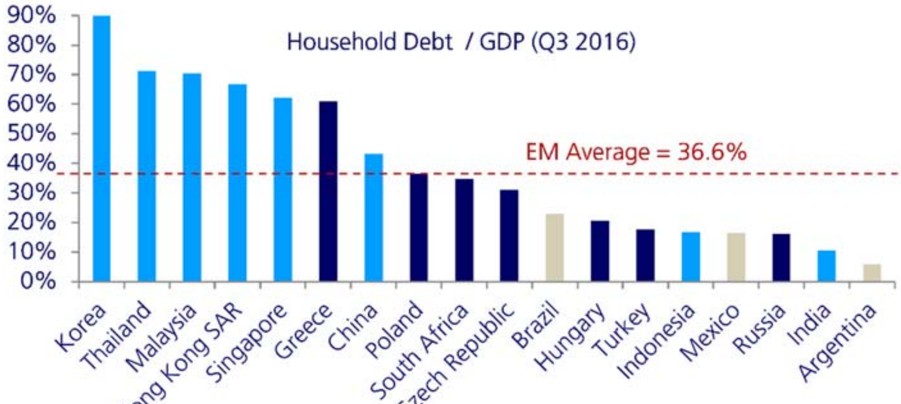
By crossing debtor and country categories, we are able to refine the picture further and identify potential areas of risk. Starting with household debt, we single out Korea (92%), Thailand (72%), Malaysia (70%), Hong Kong (67%), Singapore (62%), and China (43%) as above the EM mean (37%). Most of those countries have seen household debt growth decelerate recently, with the exceptions of Hong Kong and China. In Asia, mortgage debt is responsible for ~60% to 80% of household debt. In ASEAN, the real estate market does not appear to be a systemic risk, in our view. Governments have enacted a series of macro-prudential regulations from 2010 to 2016. Singapore started to tighten regulations around the housing market in 2010, and, as a result, triggered a multi-year decline in property prices. The Thai and Malaysian governments also introduced macro-prudential measures, although less strict than in Singapore. As a consequence, housing price growth peaked around 2012 in Malaysia, and weakened considerably after 2014 in Thailand. Given that property price growth has slowed in those countries, we do not expect further negative effects on wealth to unravel.

In Korea, property price growth remained brisk until H2 last year, when mortgage rules were tightened. We expect the new Korean government to push further prudential measures, which means that housing price growth has likely passed its peak.

In China, household debt has not reached alarming levels yet, especially when compared to the strong savings rate of 47%. However, the pace of Chinese mortgage growth has accelerated, forcing the authorities to implement investment restrictions in tier 1 and tier 2 cities.

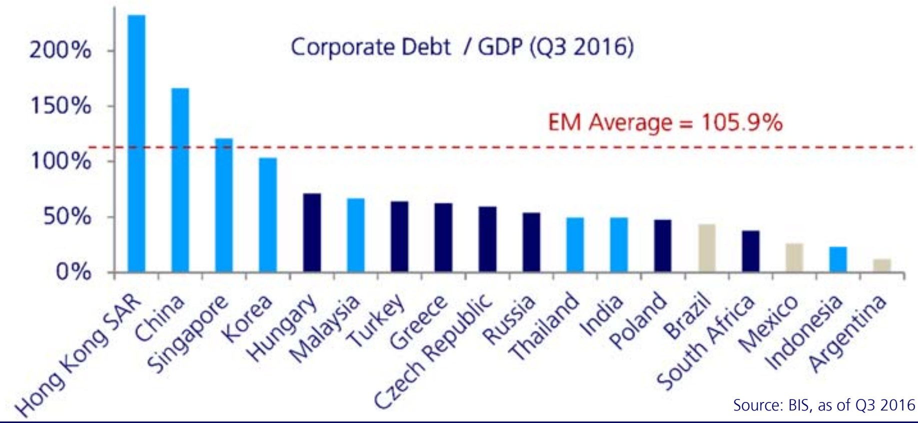
Thanks to the intervention of the respective Asian governments, the risk of systemic household debt crisis has been considerably reduced. The ratio of non-performing loans (NPL) to gross loans has been trending down. Additionally, Asian banks have built up strong capital and provision buffers, and are now seeing credit costs stabilising. In ASEAN and Korea, we are seeing debt service levels decrease, which is also encouraging.

Six Asian countries have above-average household debt



Source: BIS, as of Q3 2016

HK, China, Singapore have corporate debt ratios > 100% of GDP



Source: BIS, as of Q3 2016

The Hong Kong property market is especially exposed to the Fed rate hikes

Hong Kong deserves a special mention because it ranks high in terms of both the level and the speed of household debt accumulation. Hong Kong has seen property prices rise this year from already high levels. Income gearing is now at ~60%, still far below the 92% that preceded the Asian financial crisis, but moving upwards. Also, Hong Kong banks' exposure to the real estate sector as a whole (developer loans and mortgages) represents half of total loans. This situation is the result of abundant liquidity, very strong demand from Mainland China, and a delayed ramp-up of apartment supply. Currently, the NPL ratio stands below 1%, and banks have solid capital positions. However, the special HKD peg regime makes the HIBOR dependent on US Federal Reserve policy. According to the IMF, a 100bps rise in Hong Kong mortgage rates would reduce household consumption by 2% to 2.5%. The Hong Kong property market is thus dependent on the pace of normalisation of US monetary policy. This is also true in other Asian countries, to a lesser extent.

We note two contrarian drivers, though. First, Asian nominal income growth picked up in Q2 last year and has surpassed loan growth for the first time in countries such as Malaysia. A continuation of this economic recovery would mean a healthy resolution of the household debt issue. Second, were rising rate pressures to become too strong, Asian governments could still retract part of the cooling measures implemented earlier. This has been the case for Singapore, which has recently unwound part of the rules around property stamp duties.

The balance sheet of Singaporean corporates should improve

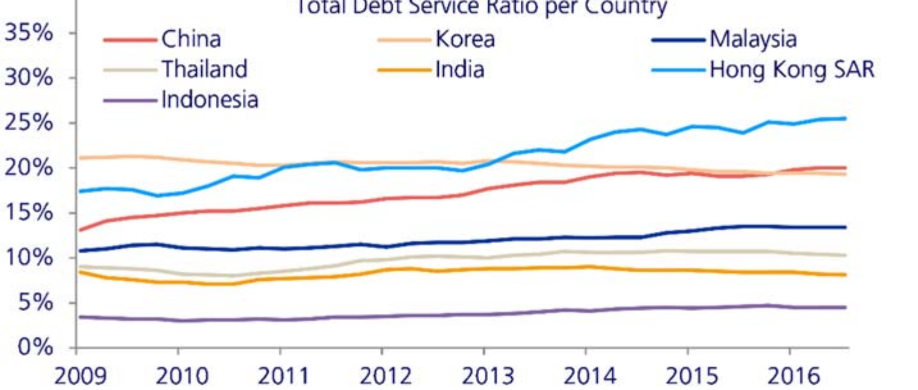
When it comes to corporate debt-to-the non-financial sector, Hong Kong (232%), China (166%) and Singapore (121%) have debt-to-GDP ratios above the EM average of 106%. In Hong Kong, as mentioned earlier, most corporate debt is tied to real estate developers. In Singapore, corporate NPLs have edged up to 2.1% of gross loans in Q3 2016 from 1.5% a year ago. Firms in the offshore and marine services sector have come under particular stress following the oil price decrease prior to February 2016. However, according to the latest quarterly results of Singaporean banks, NPL formation is peaking. Additionally, capital buffers and provisioning are at very robust levels. The recent recovery in Asian trade and manufacturing activity has also helped corporate balance sheets.

China's corporate debt is an outlier

China strikes us as the largest outlier. As of Q3 2016, its non-financial corporate debt amounts to USD 18tn, or 38% of the total EM debt pool. This is the consequence of steady growth in lending even when GDP growth slowed in 2014-15. As a result, excessive liquidity was injected into the so-called "old economy" sectors (mining, transport, etc.), which led to a build-up of excess capacity before 2015. The main liquidity recipients were state-owned enterprises (SOEs).

The picture of Chinese debt is not so simple, though. Banking loans to SOEs are the measurable piece. Borrowing by local government funding vehicles (LGFVs) increased considerably in 2015-16 and has been in the form of bond issuance. Bond issuance is linked to shadow banking instruments, which are often used as liquidity sources and / or collateral. Shadow banking involves small and medium Chinese banks, asset managers, and trusts. Some of the most successful instruments have been the wealth management products (WMPs). WMPs are savings products, issued by banks or other financial institutions, which offer higher returns than traditional bank deposits. Most of the WMPs appear off-balance sheet and bear no explicit guarantee by the issuer, although this is often not clear to investors.

Debt service is high and rising in HK and China



Source: BIS, last point as of Q3 2016, debt service for total domestic household + corporate debt

Since 2016, though, Chinese regulators have stepped up their fight against shadow banking. The banking regulator, the China Banking Regulatory Commission (CBRC), is tightening disclosure rules on WMPs: their on-balance sheet reporting will become compulsory so that financial institutions will have to post additional capital. In parallel, the rules of the interbank lending market are also being reinforced. We believe that the Chinese authorities are committed to tackling the debt issue. The nomination of allies of Xi Jinping at the helm of key regulatory institutions should reinforce a collaborative approach. China has also made significant progress in cutting excess capacity, mainly in the coal and steel sectors. The positive effects of supply reduction policies are already visible in the strong pickup of margins growth for the materials sector in Q1 2017. Other solutions contemplated by China include pushing for a mixed public-private ownership of SOEs and driving supply-cuts via M&A. China also aims at exporting parts of its excess capacity abroad, by pushing Chinese SOEs to lead infrastructure projects globally. The ´Belt and Road´ project is an illustration of this initiative. Finally, to attract foreign capital, China is using and liberalising equity and bond ´connect´ channels.

The effectiveness of these solutions is uncertain: even if China is moving in the right direction to solve its debt issue, execution risks persist.

To conclude, we identify two main potential areas of risks: China corporate and shadow banking debt, and the Hong Kong property market. Indeed, Hong Kong and China are the only Asian countries that have seen debt service growth accelerate in the last two years. Currently, the prudential safety nets appear relatively solid for both. The Chinese government controls the monetary/fiscal – exchange rate – capital flow trinity, and the prudential metrics of the Hong Kong banks and debtors are robust. However, the situation could deteriorate if the Fed normalises its monetary policy faster than expected and/or China commits an execution faux-pas in its reforms.

Korea’s household debt is the third vulnerable area and bears monitoring, despite the recent decrease in Korea’s debt service ratio.

In the rest of Asia, we do not see debt as a source of systemic risk. Debt has historically been a burden to consumption and investment, but the recent rebound in nominal GDP growth should help. We are very encouraged by the pickup in the return on equity (RoE) of Asian corporates. We see Asia at a turning point where nominal income is likely to outpace lending growth. The recent recovery in manufacturing activity and fixed asset investment are signs that the region is shifting its focus from the liability to the asset side.

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