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How Vulnerable are Emerging Markets to Rising Interest Rates?

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The recent rise in global interest rates and increasing concern about future potential rises has prompted a number of commentators to focus on the debt levels in "emerging markets". Many have suggested that the rise in debt within these economies post the GFC makes them vulnerable to a further, or more rapid, rise in interest rates - particularly those in the US. By inference, it is suggested that emerging market debt is more risky than other asset classes should such events transpire.

Debt in the emerging markets (EM) has risen as a percent of GDP over the period since the GFC.[1] Specifically, based on the Bank for International Settlements (BIS) data, total non-financial sector debt as a percent of EM GDP has risen from 120% at the end of 2007, to approximately 190% in 2017. As a result, EM debt rose as a percentage of total world debt from 15% to 30% over the period. While notable, this increase is hardly surprising as the emerging markets were the dominant source of economic growth over that period. Their share of world GDP commensurately rose from just under 30% to approximately 40% in 2017. The rise in EM debt over that period has been broadly consistent with the credit demands associated with this economic expansion and the increasing access to credit that economic development brings. Unsurprisingly most of this increase was driven by the non-financial corporate sector, primarily in China. In contrast, debt in the "developed world" (DM) only rose by approximately 30% of GDP over the same period. Here the Government accounted for all of the increase, as non-financial corporate sector debt remained constant and household debt fell slightly as a percent of GDP. This more muted debt expansion however, took place against a much higher starting level of GDP and ended the period at approximately 275%. In summary, while EM debt has increased more than DM debt in the decade since the GFC, arguably this rise was consistent with economic fundamentals over the period, and EM debt levels remain notably below DM levels.

When assessing the rise in EM debt the impact of China needs to be isolated. Chinese economic growth over the past decade has been primarily fuelled by debt. Total non-financial sector debt in China increased from 145% to 266% of GDP over the period. Remarkably, China accounted for 43% of the increase in total world debt over the period. As a result, Chinese debt rose from approximately 5% of total world debt in 2007 to 18% in 2017. By way of comparison, the US share of total world debt remained essentially unchanged over the period; falling marginally from 29% to 28%. The debt build-up in China resulted in its share of EM debt effectively doubling over the period from 32% to 59%. This distorts the aggregate EM debt numbers discussed above as China accounted for nearly all of the 70% of GDP rise over the period. While non-Chinese EM debt rose from 10% to 12% of total world debt, the rise in EM GDP over the period offset this rise to essentially leave non-Chinese EM debt as a percent of GDP unchanged. In other words, China accounted for all of the rise in the aggregate EM debt numbers, while debt in the rest of the emerging world essentially remained unchanged as a percent of GDP. Absent China, hardly an explosion in EM debt.

Another commonly held belief is that a large proportion of EM debt is denominated in US dollars and is therefore more exposed to a rise in US interest rates. Whilst this may have been the case in the 1980's when both EM governments and corporations needed to borrow in offshore capital markets – primarily the US – this has changed over the past 20 to 30 years as EM countries have proactively developed deep and liquid local currency bond markets. This process was a direct result of the lessons learned from the balance of payments crises in the 1990's and earlier, where amongst the contributory factors was an excessive reliance on short term foreign capital, currency mismatches between assets and liabilities, and often, fixed exchange rates. Countries such as Mexico, Indonesia, Russia, Brazil and others, have all subsequently developed local financial markets, allowing them to issue local currency debt to domestic investors such as pension funds and banks. Not only is most government debt now issued in domestic currency (on average, around 80% across the EM world), so too is approximately 60% of non-financial corporate sector debt. In aggregate (including the financial sector), just over 70% of all debt is denominated in local currency[2]. In other words, only 30% of all EM debt is denominated in "hard" currency, predominately USD. It is likely that a significant proportion of this foreign currency denominated debt is held by entities exposed to "commodities". The correspondent Dollar income stream is therefore likely to provide a partial hedge against this debt exposure.

China again is particularly noteworthy as only 5% of its total debt stock is denominated in hard currency. Amounting to only 14% of GDP, this exposure is counter balanced by Chinese Government foreign reserves of over 25% of GDP. Only 5% of the non-financial corporate sector and 15% of the financial sector's debt is denominated in hard currency. While the size of China's debt stock may be a problem, its exposure to hard currency debt is probably not.

Finally, while there are some country and sectoral differences, EM borrowers do not appear overly stretched with respect to either the absolute level of debt, or their ability to service it. Specifically, at just under 50% of GDP, the current level of EM government debt is low (certainly when compared with the 110% in the DM world). That debt is mostly denominated in local currency, and the widespread adoption of orthodox macroeconomic policies and flexible exchange rates has significantly reduced economic volatility and lowered funding risks compared with the 1980's and early 1990's. In contrast, EM household and non- financial corporate sector debt at just over 140% of GDP is notably higher than that in the government sector, albeit still below the 166% in the DM world. This absolute level of debt suggests that the EM private sector is potentially more vulnerable than the government sector to an interest rate shock. Despite this, there is little to suggest that there has been a meaningful deterioration in this sector's ability to pay. Specifically, the EM non-financial sector debt service ratio has increased only slightly over the period from an average of 9.4% to 11.0% of income[3]. This contrasts with a slight decline from 19.6% to 18.5% in the comparable DM ratio. The EM private sector debt service ratio remains notably below DM levels and China again is an outlier. The Chinese private non-financial debt service ratio increased from 13.4% to 20% over the decade.

In summary, while EM debt has risen in the aftermath of the GFC, on average: -

(1) it started from a low base;

(2) still remains notably below debt levels in the "developed world";

(3) the primary source of that expansion has been China;

(4) outside of China, EM debt growth is more restrained;

(5) most debt is denominated in local currency, with less than a third of debt denominated in "hard currency" or US dollars;

(6) debt servicing costs remain constrained; and,

(7) prudent macro-economic policies and the adoption of flexible exchange regimes has reduced dislocation risks that have prompted emerging market "shocks" in the past.

On balance, this suggests that some of the alarmist predictions about the vulnerability of emerging markets to a further rise in interest rates may be overblown. On the contrary, the lower debt level, lower debt servicing ratio and stable macroeconomic conditions, suggest that they may be better placed to weather a further interest rise than some developed market economies. Nonetheless there remain differences across emerging markets and some countries with weaker stability and higher debt are more exposed than others. Such differences require constant monitoring if investors are to successfully navigate the changing economic and financial landscape.

[1] All data referenced has been sourced from the International Monetary Fund (IMF), Bank of International Settlements (BIS), Citibank and/or the Institute of International Finance (IIF). All data is latest available to end 2017, and is available upon request.

[2] The local/hard currency breakdown is provided by Citibank, based on Institute of International Finance (IIF) data. The EM data used here is an average of 21 countries, comprising, Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Hong Kong, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Thailand and Turkey.

[3] BIS data. The debt service ratio reflects the share of income used to service debt. The non-financial private sector includes the household and non-financial corporate sector The numbers reported for both the emerging and developed markets are an equally weighted average of countries reported in these categories by the BIS.

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