Economics Group

Special Commentary

Do Emerging Market Economies Have Debt Problems?

Executive Summary
It appears that financial leverage has generally increased more in emerging market economies than in advanced economies since the advent of the global financial crisis. The sharp rise in debt in the Chinese non-financial corporate (NFC) sector has been especially noteworthy, but leverage has also increased in many other large emerging market economies in Asia.

The increase in NFC leverage in China is concerning but it does not necessarily imply that the Chinese economy is on the cusp of implosion. In our view, Chinese authorities have policy flexibility to respond to problems caused by excessive debt. However, we are becoming increasingly concerned that the Chinese economy may be headed for a prolonged period of disappointing economic growth if authorities misallocate capital via continued lending to the inefficient state-owned enterprise (SOE) sector.

Leverage certainly has risen in most other Asian economies, but debt generally appears to be widely dispersed in most of these economies. In sum, the increase in leverage in some large emerging market economies over the past seven years is noteworthy and bears watching. That said, debt issues in most of these economies likely are manageable.

Leverage in Emerging Market Economies Has Risen Markedly
In a series of four reports we wrote a few months ago, we analyzed debt issues in the household, business and public sectors in advanced economies. As shown in Figure 1, the aggregate debt-to-GDP ratio of the NFC, household and government sectors in 22 advanced economies rose from roughly 230 percent in Q1 2008 to 260 percent in Q3 2015 (latest available data). That said, much of the rise in the aggregate debt ratio for these 22 advanced economies occurred during 2008-2009 when nominal GDP growth came to a screeching halt in the aftermath of the global financial crisis. Subsequently, the aggregate debt ratio for these 22 economies has been more or less stable.

In contrast, the aggregate debt-to-GDP ratio for 19 emerging market economies has trended noticeably higher in recent years. Specifically, the aggregate debt-to-GDP ratio in these 19 countries has risen nearly 70 percentage points since early 2008. Although the ratio for emerging markets remains below the ratio of the advanced economies, these 19 emerging market economies clearly have become more levered during this decade. In the remainder of this report, we drill down further into financial leverage metrics in some of the largest emerging market economies in the world.

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1. Our series of four reports and the other Wells Fargo publications that are referenced herein are all available upon request.
2. These economies include Argentina, Brazil, China, the Czech Republic, Hong Kong, Hungary, Indonesia, Israel, India, Korea, Mexico, Malaysia, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey. Although reasonable people can argue whether or not some of these countries are emerging markets, we follow the classification of the Bank for International Settlements (BIS), our principal data source for this report.
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April 21, 2016

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Let us start by determining which emerging market economies have experienced the largest increases in financial leverage. As shown in Figure 2, the overall debt-to-GDP ratio in Hong Kong has risen by more than 100 percentage points since Q1 2008 with mainland China a close second. Moreover, the five countries with the largest percentage point increases in their overall debt-to-GDP ratios are in Asia (i.e., Hong Kong, China, Singapore, Malaysia and Thailand).

Not only have the largest increases in debt-to-GDP ratios occurred largely in Asia, but Asian countries tend to be the most levered economies as well. As shown in Figure 3, the overall debt-to-GDP ratio in Hong Kong approached 300 percent at the end of Q3 2015, roughly 100 percentage points above the aggregate ratio for the 19 emerging market economies considered in this report. Both Singapore and China have debt ratios equivalent to 250 percent of GDP. Korea’s ratio is roughly 230 percent and the debt ratio for Malaysia exceeds 190 percent of that country’s GDP.

Is this increase in debt broad based or is it concentrated in a specific sector? Figure 4 decomposes the aggregate debt-to-GDP ratio in our 19-country sample into three sectors: households, the NFC sector and the public sector. This decomposition shows that each individual sector has become more levered over the past seven years, with the debt-to-GDP ratio rising 7 percentage points in the public sector and 13 percentage points in the household sector. However, the lion’s share of the rise in the overall ratio reflects higher leverage in the NFC sector. At the beginning of 2008,
the aggregate debt ratio in the NFC sector stood below 60 percent. Over the intervening seven years, it swelled to 108 percent as the aggregate level of NFC debt surged.

So let us recap. Emerging Asia accounts for most of the increase in debt in large emerging market economies over the past seven years, and most of that increase in debt has occurred in the NFC sector. More specifically, more than one-half of the increase has occurred in the NFC sector in China. Between Q1 2008 and Q3 2015, the total amount of debt across all sectors in the 19 economies considered in this report rose by almost $25 trillion, with the NFC sector in China accounting for $13.5 trillion of this total increase. Given the centrality of China to the overall debt situation in emerging markets, we now turn our attention to that country before looking more closely at three other Asian economies.

The Problem in China is NFC Debt

The debt ratio in the Chinese NFC sector, which stood at 100 percent at the beginning of 2008, exceeded 165 percent in Q3 2015 (Figure 5). With a debt-to-GDP ratio of less than 40 percent, the household sector is not very levered. Likewise, the debt ratio of the general government, which includes the central government in Beijing as well as the debt of the local governments, is generally manageable at 44 percent of GDP. In other words, the debt issue in China today clearly resides in the NFC sector. Indeed, the run-up in NFC debt in China over the past few years has been staggering. At the beginning of 2008 there was about $4 trillion worth of outstanding NFC debt in China. It mushroomed to $17 trillion at the end of 2015.

In our view, the increase in NFC leverage in China is concerning, but it does not necessarily imply that the Chinese economy is on the cusp of implosion. As we have written previously, Chinese authorities have policy flexibility to respond to problems caused by excessive debt. For starters, the central bank’s main policy rate currently stands at 4.35 percent. Lower interest rates would help to ease the debt-servicing burdens of Chinese companies. Moreover, the low debt ratio of the Chinese government gives it the ability to recapitalize the banking system should the amount of non-performing loans become a problem.

Will capital in China become misallocated?

That said, we are becoming increasingly concerned that Chinese authorities may make the same mistake as their Japanese counterparts did two decades ago. That is, capital became misallocated in Japan as the government kept “zombie” companies afloat rather than allow them to go bankrupt. Similarly, we fear that the Chinese government may drag its feet in shrinking the inefficient, but politically powerful, SOE sector which accounts for nearly one-half of bank loans

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3 For example, see “Will Construction Take Down the Chinese Economy?” (August 27, 2015) and “China GDP: Slowdown or Deterioration?” (January 19, 2016).

4 See “Does China Face a Japanese-Like ‘Lost Decade’?” (March 15, 2016).
outstanding in China’s economy. China probably will not implode in the near term, but it could be headed for a prolonged period of disappointing economic growth à la Japan since the early 1990s.

**NFC Sector Even More Levered in Hong Kong than in China**

Hong Kong largely resembles mainland China in terms of the structure of its debt. That is, the NFC sector in Hong Kong accounts for the bulk of the economy’s overall debt ratio, not only in terms of its absolute level (more than 200 percent of GDP) but also in terms of changes over the past seven years (Figure 6). In that regard, the debt ratio in the Hong Kong NFC sector shot up by more than 80 percentage points between the beginning of 2008 and the end of last year.

Do authorities in Hong Kong have the same ability to respond to excessive NFC debt as their counterparts on the mainland? The overnight interbank rate in Hong Kong is essentially at zero percent, so the Hong Kong Monetary Authority does not have the same ability to ease debt servicing costs as the People’s Bank of China (the central bank on the mainland). However, Hong Kong banks are very well capitalized with common equity tier 1 (CET1) capital equivalent to 12.4 percent of the banking system’s risk-weighted assets as of the end of 2014.\(^5\) Furthermore, with its own debt ratio less than 5 percent of GDP at present, the Hong Kong government would have the resources to offer further financial support to the banking system, should that eventuality prove necessary.

**Debt Widely Dispersed in Singapore**

Unlike China or Hong Kong, where debt in each economy is concentrated largely in the NFC sector, debt in Singapore is more widely dispersed among the three sectors (Figure 7). Although all three sectors in Singapore experienced an increase in leverage over the past seven years, none, with the possible exception of the public sector, has a debt-to-GDP ratio that appears to be an outlier. Yes, the debt-to-GDP ratio in the NFC sector in the Lion City rose by 20 percentage points between 2008 and 2015, but it remains well below 100 percent, far below the comparable ratio in China, let alone in Hong Kong. With a debt-to-GDP ratio of only 60 percent, the household sector in Singapore is less levered than the country’s NFC sector.

If there is a problem with Singapore’s debt profile it is that the government’s debt ratio currently exceeds 100 percent. However, the government is incurring a sizeable fiscal surplus at present and the public sector debt-to-GDP ratio has receded somewhat since 2013. The International Monetary Fund projects that the government debt ratio in the Lion City will recede further over the next few years. Singapore’s government also has significant asset holdings in its sovereign wealth funds, suggesting that the net debt-to-GDP ratio is much lower.

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5 Under the terms of the third Basel Accord banks currently need to have a total CET1 capital ratio of at least 5.125 percent. This required minimum ratio is scheduled to rise to 7 percent by 2019.
Moreover, the overall debt ratio in Singapore, which is equivalent to 250 percent of GDP, should be put into perspective. Not only is it lower than the overall debt ratio in Hong Kong, but Singapore's overall debt ratio is more or less similar to comparable ratios in countries like Australia, Switzerland, the United Kingdom and the United States. Like their counterparts in Hong Kong, banks in Singapore are generally well capitalized, with the Monetary Authority of Singapore mandating that banks maintain a CET1 capital ratio of at least 9 percent.

**Manageable Government Debt in Korea**
The overall debt-to-GDP ratio in Korea currently exceeds 200 percent (Figure 8). The bad news is that the debt ratios for the NFC sector (106 percent of GDP) and the household sector (87 percent) may both be a bit elevated at present. That said, the NFC debt ratio in Korea is significantly below the comparable ratios in China (166 percent) and Hong Kong (218 percent). Although high by the standards of other emerging market economies in Asia, the household debt ratio in Korea is low when compared to some advanced economies such as Australia and Switzerland, where ratios exceed 120 percent, and in line with comparable ratios in the United States and the United Kingdom.

The good news is that the Korean government would have some policy flexibility, if needed, to counteract the effects of excessive debt. The Bank of Korea could ease interest rate burdens at the margin for the household and non-financial corporate sector by reducing its main policy rate, which currently stands at 1.50 percent. In addition, the debt ratio of the Korean government is low at only 36 percent, which would give it the ability to clean up a non-performing loan problem in the country's banking sector, should one transpire.

**Conclusion**
Our samples of 19 emerging market economies and 22 advanced economies are not entirely inclusive, but it appears that financial leverage has generally increased more in the former than in the latter since the advent of the global financial crisis. Although leverage has increased in most of the 19 emerging market economies in our sample, China has accounted for the vast majority of the increase in debt in these economies. Specifically, debt in the Chinese NFC sector has mushroomed by more than $13 trillion over the past seven years.

The increase in NFC leverage in China is concerning but it does not necessarily imply that the Chinese economy is on the cusp of implosion. In our view, Chinese authorities have policy flexibility to respond to problems caused by excessive debt. However, we are becoming increasingly concerned that the Chinese economy may be headed for a prolonged period of disappointing economic growth if authorities misallocate capital via continued lending to the inefficient SOE sector.

The NFC sector in Hong Kong is more levered at present than its counterpart on the mainland, but Hong Kong banks are well capitalized. The overall debt ratio in Singapore stands at 250 percent of GDP, but it is balanced across sectors and no individual sector appears to be overly levered. The overall debt-to-GDP ratio in Korea is not abnormally high, and debt appears to be widely dispersed across the household, NFC and public sectors. In sum, the increase in leverage in some large emerging market economies over the past seven years is noteworthy and bears watching. That said, debt issues in most of these economies likely are manageable.
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