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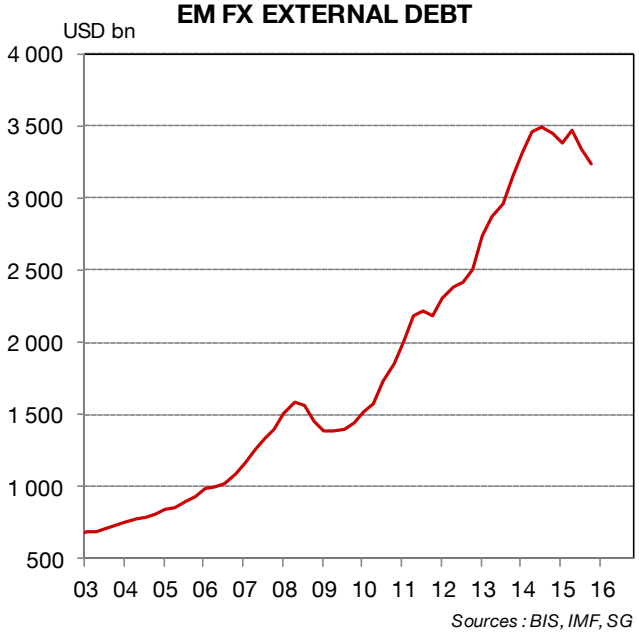
EMERGING MARKETS' EXTERNAL DEBT: IT'S THE SAME OLD SONG?

— The external debt in foreign currency of Emerging Market Economies (EMEs) has significantly increased over the last decade, supported by a low interest rates environment, emerging currencies appreciation, and rising commodity prices. Unlike previous episodes, this increase has mainly been driven by the non-financial private sector, rather than by governments and banks.

— The heightened volatility of financial markets, triggered by the prospect of a tightening in Fed monetary policy and the drop in commodity prices, has increased risks related to this debt. Indeed, financial crises in EMEs are generally preceded by episodes of rising external debt.

— However, a detailed analysis of the situation shows signs of financial strength at the macroeconomic level. External debt is concentrated in some sectors, notably in commodities. Thus, while potential growth is likely to fall, a balance of payments crisis should be avoided.

EM FX EXTERNAL DEBT



Sources : BIS, IMF, SG

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Since the US monetary policy normalization was announced in 2013, the volatility of currencies and capital flows to EMEs has significantly increased. This rise in volatility calls into question the "sustainability" of EMEs' foreign currency debt. Furthermore, this situation echoes previous episodes of EMEs crises, namely a surge in foreign currency debt against a backdrop of low commodity prices and weak growth. First, we will examine the reasons why EMEs borrow in foreign currencies, and the risks that this debt entails. Then, we will analyze the current debt episode, and will look at the various risks that this puts on EMEs.

CAUSES AND RISKS OF DEBT IN FOREIGN CURRENCIES

EMEs have a tendency to hold a significant part of their external debt denominated in foreign currency[1]. This is mainly due to difficulties that these countries face in issuing long-term debt in local currency, owing to the fact that their local financial markets are underdeveloped. This underdevelopment is often the result of a series of factors, such as a legacy of high inflation and a weak legal and institutional environment. This situation makes it almost impossible to obtain funding in local currency over the long term and at an affordable interest rate. This issue is overcome by borrowing on international financial markets in a hard currency where long-term financing is possible. It is this recourse to financing in foreign currency that economic literature calls "*original sin*"[2]. Nevertheless, this "original sin" increases EMEs' vulnerability to capital flows. Indeed, by introducing a balance sheet mismatch in foreign currency[3], i.e. a difference between liabilities in foreign currency and assets in local currency, the "*original sin*" increases financial vulnerability in the event of a sharp depreciation of their local currency.

EMEs have experienced several episodes of rapid rise in external debt denominated in foreign currency. These episodes are generally marked by prolonged periods of accommodative monetary policies in developed economies, and strong investment growth in EMEs. In fact, the drop in interest rates in the former generally leads to capital flows into the latter, where investors are seeking higher yields. This results in pressures on local currencies to appreciate and on borrowing costs to come down, prompting agents to borrow in foreign currencies. All these factors emerged during the debt crisis of the 1980s in Latin America, the Mexican crisis in 1995 and the Asian crisis at the end of the 1990s.

OVERVIEW OF EXTERNAL FOREIGN CURRENCY-DENOMINATED DEBT: AN INDEBTNESS THAT REFLECTS THE COMMODITIES CYCLE

Like these previous episodes, the accommodative monetary policies of developed economies and the "*super cycle*" of commodity prices, over the last decade, has resulted in significant increase in the external debt denominated in foreign currency of EMEs. Between 2008 and 2015, the external foreign currency-denominated debt of EMEs (which includes both bond denominated in foreign currency issued by a counterparty defined by its nationality, and international bank loans in foreign currency) rose by USD 1,100bn to nearly USD 3,400bn. The prolonged zero-rate monetary policies of developed economies, coupled with asset purchase programmes, have led to an increase in liquidity in the financial system and a compression of yields for assets of developed economies. This environment has prompted financial agents to invest in EMEs, where yields were higher.

The accommodative monetary policies of developed economies have coincided with higher interest rates in EMEs, a period of emerging currency appreciation and growing demand for investment related, to some extent, to the bull cycle of commodity prices. Meanwhile, this cycle has allowed relaxing debt constraints for EMEs, by increasing the value of their collateral. All these factors led to a rise in external foreign currency-denominated debt of EMEs.

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[1] *For certain countries, the dollarization of their domestic debt is significant.*

[2] *"The mystery of Original Sin"; Eichengreen, Hausmann, Panizza; 2003*

[3] *"Currency Mismatches, Debt Intolerance and Original Sin: Why they are not the same and why it matters"; Eichengreen, Hausmann, Panizza; 2007*

BOX 1 – WHAT IS EXTERNAL DEBT?

— By **external debt**, we mean all debt due by borrowers of a country (governments, banks, corporate) to external creditors (banks, investment funds, governments, international organizations). This debt may take the form of a bank loan or a bond.

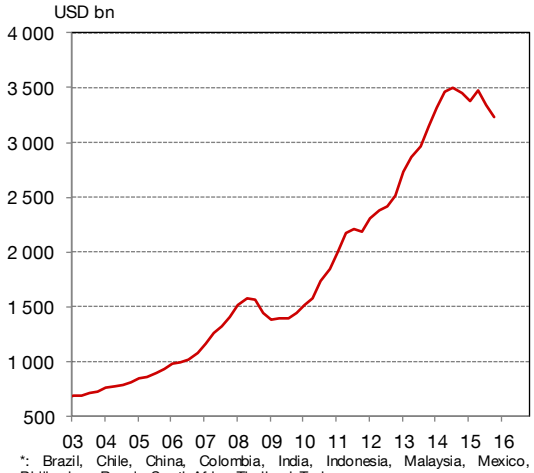
— External debt may be denominated in a currency other than that of the issuer's country. Generally, these are the most important currencies in terms of market depth, such as the dollar, the euro, and the yen. External debt may also be denominated in the currency of the issuer's country if local financial markets are open to foreign investors.

— **If the debt is denominated in a foreign currency**, the issuer faces a currency risk. If the currency of the issuer's country depreciates against the dollar, for instance, the debt burden would immediately increase, thereby increasing the risk of the borrower's default.

— **If the debt is denominated in local currency**, the borrower faces an interest rate risk. This is more manageable than the currency risk, which has an immediate impact on the service of the debt and the principal.

— In this note, we focus on **external debt denominated in foreign currency**.

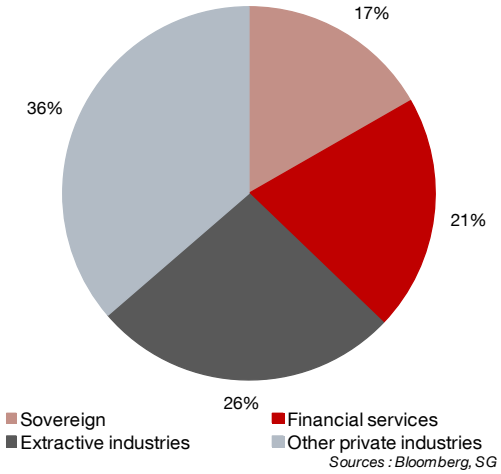
EM FX EXTERNAL DEBT*



*: Brazil, Chile, China, Colombia, India, Indonesia, Malaysia, Mexico, Philippines, Russia, South Africa, Thailand, Turkey

Sources : BIS, IMF, SG

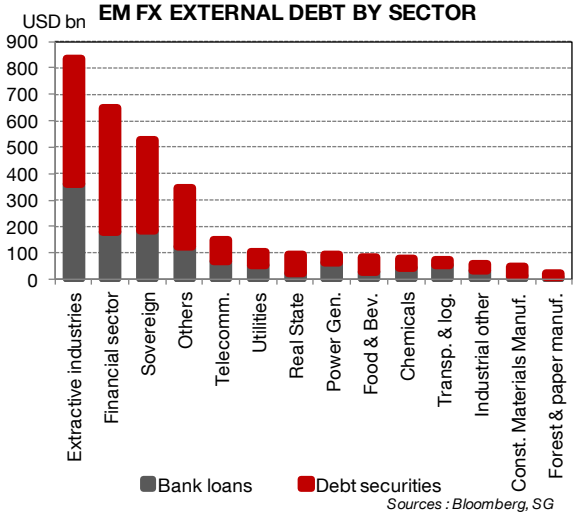
EM FX EXTERNAL DEBT (as % of total)



Sources : Bloomberg, SG

While the current foreign currency debt episode has the same "origins" than previous episodes, there are a number of differences, notably in its composition and nature. The first difference is related the borrowing counterparties. Indeed, this time, the sharp rise in external foreign currency-denominated debt of EMEs is mainly due to the non-financial private sector, unlike previous episodes, when the public and banking sectors were the main borrowers[4]. Within the non-financial private sector, the commodities sector accounts for half of the total debt. The external foreign currency-denominated debt of the oil and gas sector has risen to USD 563bn, and mining sector debt to USD 271bn. This is the case in most EMEs, with the exception of China and Turkey, where the bulk of the debt is contracted by the financial sector (USD 520bn and USD 128bn respectively).

EM FX EXTERNAL DEBT BY SECTOR



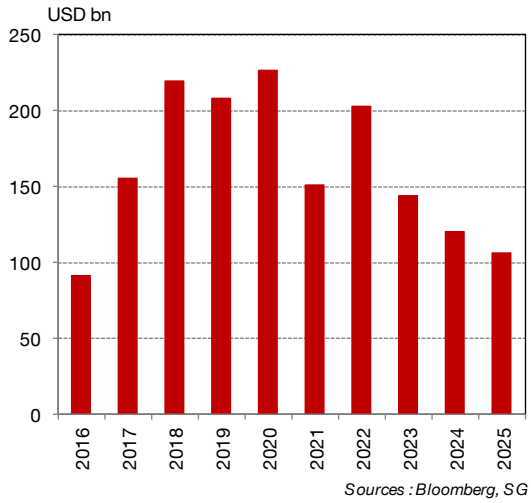
Sources : Bloomberg, SG

Another factor that makes the current episode different from past episodes is the maturity of the external debt, which has generally been extended. In fact, all sectors and countries together, 70% of the total of this debt is set to mature in five years or more. In the 1990s, this share was less than 50%. Hence, risks related to a more difficult market access and to higher interest

[4] The external debt in foreign currency of the non-financial private sector rose to USD 1,980bn at the end of 2015 (63% of the total), versus USD 646bn for the financial sector (20% of the total) and USD 521bn for the sovereign (17% of the total).

rates when rollovers occurred are less significant than in the 1990s.

EM FX EXTERNAL DEBT BY MATURITY



Sources : Bloomberg, SG

A final difference with the past is that the majority of the debt contracted has been in the form of bonds and not bank loans. In fact, at the end of 2015, bond issued in foreign currency totaled USD 1,930bn, versus USD 1,220bn for international bank loans denominated in foreign currency. This trend mainly reflects the financial disintermediation under way since 2009[5], with the gradual withdrawal of the banking sector from international financing at the benefit of investment funds. By country, Thailand, Turkey, India and Indonesia are the countries where bank loans continue to absorb the bulk of international financing, accounting for over 60% of the total of their external debt in foreign currency. Conversely, Mexico is the country most financed by bonds, which represents 70% of its debt in foreign currency.

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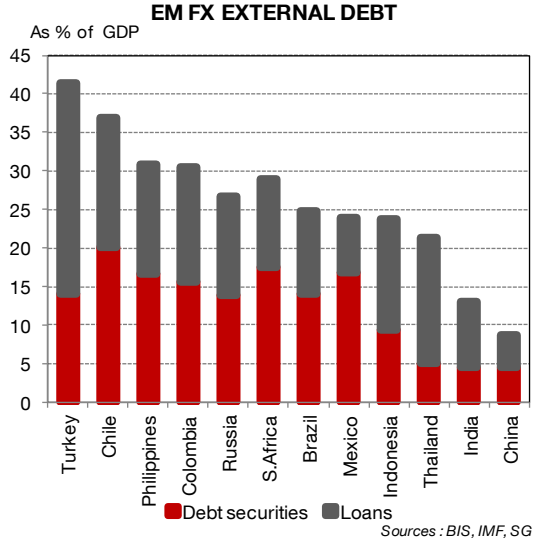
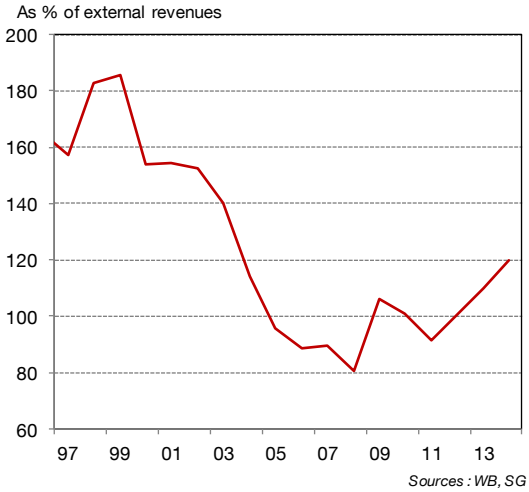


Sources : BIS, IMF, SG

RISKS OF SECTORAL OR GROWTH CRISIS RATHER THAN BALANCE OF PAYMENTS CRISIS

However, the risk that this new episode of a rise in external debt in foreign currency would lead to a systemic financial or balance of payments crisis seems, in our view, more limited than in the past, for several reasons. First, despite its rapid growth, the external debt in foreign currency as a percentage of GDP remains at relatively moderate levels: 28% of GDP in Brazil (versus 42% in 2002), 25% of GDP in Mexico (versus 50% in 1995) and 8% of GDP in China. Compared to external revenues[6], the ratio that measures a country's capacity to generate revenues in foreign currency to meet its foreign currency commitments, external debt in foreign currency is in most countries well below the levels of the 1990s and 2000s.

EM FX EXTERNAL DEBT AVERAGE

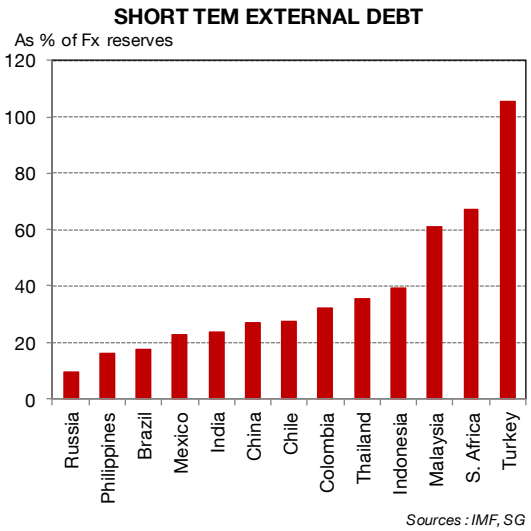


Sources : WB, SG

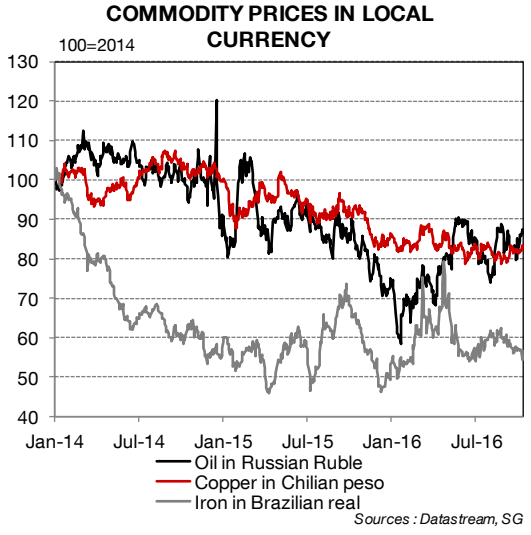
Second, most EMEs have solid macroeconomic fundamentals that enable them to cope with significant depreciations of their local currencies and increases in financing costs. In particular, most of them have substantial foreign exchange reserves that allow them to cover all their short-term external financing needs, in the event of significant stress and regardless of their exchange rate regime.

[5] *"Financial disintermediation in international markets and global banks funding model"; Serena Garralda; 2014*

[6] *Exports of goods and services, interest income and migrant worker remittances*



Third, the public and banking sectors have relatively low levels of debt in foreign currency, thereby reducing the probability of a systemic crisis associated with defaults of these sectors. In fact, sovereign debt has a domino effect on all sectors (banks holding government bonds, suppliers, public sector salaries and pensions, public investment). Likewise, a banking crisis by shutting off sources of financing, also leads to domino effect of defaults. In the 2000s, several emerging countries managed to issue long-term debt in local currency, thereby freeing them from the "*original sin*"[7]. Furthermore, most EMEs put in place various macro prudential measures, in order to reduce currency mismatch in the banking sector.



Finally, most external debt in foreign currency was contracted by the commodities sector. This sector is less vulnerable to foreign currency balance sheet mismatch as a significant part of its revenues is denominated in foreign currency. It is true that the drop of commodity prices was a shock for producing countries, but this was in part offset by the concomitant depreciation of their exchange rates, thereby supporting revenues expressed in local currency. This sector is rather facing with a common issue to all commodity-producing countries, whose investment and debt dynamics are based on expected prices that are much higher than current ones. From this viewpoint, investment in this sector may be impeded in the future.

The sectors that could be faced with difficulties owing to heightened volatility in exchange rates and financing costs are those that have little (or no) revenues in foreign currency, more specifically non-exporting sectors, such as telecommunications and utilities.

Taking into account the key role played by all these sectors in EMEs, their financing difficulties could lead to a prolonged period of lower investment and therefore weaker potential growth. In the end, the risk is therefore more a persistent weakening of potential growth in indebted emerging economies, rather than a sudden and systemic financial crisis.

[7] *Emerging Markets Local Currency Debt and Foreign Investors, World Bank Group, 2014*

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