The Telegraph

Morgan Stanley warns on Asian debt shock as dollar soars

Foreign debt in emerging Asia has soared from $300bn to $2.5 trillion over the last decade

Morgan Stanley warned clients that local lenders in Asia have relied increasingly on the wholesale capital markets Photo: AP

By Ambrose Evans-Pritchard

5:00AM BST 29 Sep 2014

24 Comments

Debt ratios in developing Asia have surpassed extremes seen just before the East Asian financial crisis blew up in the late 1990s and companies have borrowed unprecedented sums in dollars, leaving the region highly vulnerable to US monetary tightening.

Morgan Stanley said foreign debt in emerging Asia has soared from $300bn to $2.5 trillion over the last decade, creating the risk of a currency shock as the dollar surges to a four-year high and threatens to smash through key technical resistance.

"High dollar liabilities do not bode well for emerging markets. In Asia (excluding Japan), the credit-to-GDP gap has reached levels higher than 1997," it said.

The US bank warned clients that local lenders in Asia have relied increasingly on the wholesale capital markets - a little like Northern Rock before 2007 -

allowing them to expand credit faster than deposit growth. This leaves them exposed if liquidity dries up.
Asia's credit-to-GDP gap measures how far loan expansion has pulled ahead of the underlying trend growth of the economy. It peaked at 10pc in 1997. This time a flood of cheap money from Western central banks and the Chinese authorities has pushed it to 15pc, clear evidence of credit exhaustion as productivity stalls and the region's economic model looses steam.
The bank's currency team said the region could be hit on two fronts at once: a credit squeeze as rising US rates push up borrowing costs across the world, combined with an exchange rate squeeze on "short" dollar positions. The response to one complicates the other.
Morgan Stanley's technical analysts say the dollar is poised to break its thirty-year downtrend as the Fed turns hawkish. It expects the dollar index - a broad gauge of the dollar exchange rate -- to surge towards 92 by next year if it breaks through resistance at 87. Such a move would be comparable to the global dollar shock that caused such strains twenty years ago.
The Asian Development Bank (ADB) warned last week that the area should brace for "tighter liquidity" and possible "capital outflows" as the US ends quantitative easing in October. "While the region’s bond markets have been calm in 2014, the risks are rising, including earlier than expected interest rate hikes by the Federal Reserve," it said.
The Fed was buying $85bn of bonds each month as recently as January. A fall to zero amounts to a major shift in global financial dynamics even before rates rise.
The ADB said in its Bond Monitor that emerging Asia issued a record $1.1 trillion of local currency bonds in the second quarter of 2014, pushing the total stock to $7.9 trillion. Most debt is at maturities below thee years, creating roll-over risk. This does not include $1.5 trillion of cross-border bank loans and over $1.2 trillion in foreign currency bonds on latest estimates, mostly in dollars and owed by companies.
Local bond issuance over the last year has jumped by 36pc in Vietnam, and 32pc in Hong Kong. China accounts for the lion's share of outstanding bonds. China Railway alone accounts for $975bn in yuan debt, and China State Grid a further $415bn.
The Bank for International Settlements devoted its latest quarterly report to mounting leverage and dollar debt in emerging markets, especially in Asia. It said cross-border loans to China had jumped by 49pc to $1 trillion in the year to March 2014.

The BIS said ultra-easy money had led to a "ubiquitous quest for yield", driving "huge investment flows" into emerging markets. "In many jurisdictions, corporates have opted to lock in low global interest rates and to sharply increase their international debt issuance. This could be a source of powerful feedback loops in response to exchange rate and/or interest rate shocks," it said.

"It all looks rather familiar. The dance continues until the music eventually stops. Markets will not be liquid when that liquidity is needed most. And yet the illusion of permanent liquidity is just as prevalent now as in the past," said Claudio Borio, the BIS's chief economist.

In stark contrast to the late 1990s, Asian states have borrowed in their own currencies and have little foreign debt. Most have large reserves. However, the BIS fears the region may be vulnerable through different channels, this time via private dollar debt and extreme sensitivity to rising rates on local debt.

Emerging markets have had time to adjust since the first "taper tantrum" in May-June last year when hints of Fed tightening triggered a sudden-stop in capital flows. Yet most continued to build up debt briskly afterwards, borrowing at record low rates averaging 1pc in real terms. The BIS is concerned that these rates could snap back suddenly.

The Fed signalled at its latest meeting that its benchmark rate will rise more steeply next year than markets had expected, setting off jitters worldwide. The great question is whether "rates rage" will prove as fleeting as the taper tantrum.