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Emerging markets: Deeper into the red

By Jonathan Wheatley and James Kynge

Companies from Brazil to China are finding it harder to repay loans and raise fresh cash, hampering growth

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EM central bankers have been concerned that inflows of cash will inflate their currencies

When China Shanshui Cement embarked on a borrowing spree in 2011, its managers could not have known that they had set in motion a chain of events that would lead to the company's default last week on Rmb2bn ($315m) of short-term bonds, in all likelihood setting off a cross-default affecting debts totalling $3bn.

With hindsight it seems inevitable. Shanshui's borrowing had been encouraged by a massive stimulus that Beijing unleashed after the global financial crisis of 2008-09. But borrowing in China and around the emerging world was also turbocharged by funds that were born in the US Federal Reserve's quantitative easing programme.

Those funds, designed to stimulate a recovery in the US, were also leveraged into many multiples of their original value and invested in businesses producing goods the world would soon have too much of: cement factories in China, steel mills in China, Russia or Brazil or iron ore mines in Australia.

Now the Fed has called an end to ultra-loose money, pushing companies such as Shanshui into a credit crunch and forcing them to postpone or cancel investments. The result is a world economy dicing with deflation and recession.

By some estimates, $7tn of QE dollars have flowed into emerging markets since the Fed began buying bonds in 2008. Now, a year after the Fed brought QE to an end, companies in emerging markets from Brazil to China are finding it increasingly hard to repay their debts.

The excess capacity these companies created became apparent just as China's slowing economy triggered a collapse in global commodity prices, hurting companies across the emerging world and sending Brazil's economy into deep recession. Some experts say QE policies by the Fed and other central banks have left a legacy of oversupply from which it will take years to recover.

They also warn that the leveraging of QE money has resulted in piles of debt around the emerging world that are very hard to measure or even detect. As Carmen Reinhart, a Harvard University economist, said recently, it is often only after things go wrong that the size and destructive power of hidden debts become apparent.

Creating oversupply

How did this happen? For an answer, we must look at the mechanisms that turned the ambitious project of QE into a driver of global oversupply.

Speed read

- **Warning sign** Private debt in emerging markets is higher than in develped markets before the 2008 financial crisis
- **Big impact** Some estimate that $7tn of QE has flowed to emerging markets since the Fed began buying bonds
- **Tricky assessment**Leveraging QE money has resulted in piles of debt that are hard to measure in EMs

It begins with the creation of money under QE, the post-crisis stimulus programme led by the Fed and joined by the Bank of England, the European Central Bank, the Bank of Japan and others. The Fed has run four QE programmes, printing money under the last one at a rate of $85bn a month. Western central banks have created about $8tn since 2008.

There are two main routes by which QE money reached emerging markets. One involved the Fed buying US Treasury bonds from savers such as pension funds, which hold them as long-term, super-safe investments with unexciting but reliable yields. By doing so, the Fed drove bond prices up and yields down, sending savers in search of higher yields — such as in mutual funds buying corporate and emerging market debt.

"This is the route most people think of," says Andrew Hunt of consultancy Andrew Hunt Economics. "I suspect it is the smaller channel."

Another route involved the Fed buying Treasuries from commercial banks, which — again, to replace the yield they lost by swapping Treasuries for cash — loaned the proceeds to hedge funds and other investors. Hedge funds and so-called leveraged funds often used these loans to buy money-market instruments in the Singapore dollar, Philippine peso or Brazilian real, for example, earning a higher yield.

On this route, which Mr Hunt believes is more widely used, some QE money would be multiplied before leaving the donor country: a leveraged fund might take $10 in cash, borrow another $30 and invest $40 in an emerging currency. Some of it would not be leveraged, but all the money on this route is taking part in the "carry trade":

borrowing in currencies where interest rates are low and investing the proceeds where they are high. This works while exchange rates are favourable — but can go wrong when they change.

Our concern is not of a full-blown emerging market crisis but of the heavily indebted companies and the banks exposed to them

Between 2009 and 2014, when the Fed generated some $4tn in QE, credit provided overseas in US dollars through bank loans and bonds hit $9tn, according to the Bank for International Settlements. Mr Hunt estimates that the $4tn or so created by the Fed became $7tn by the time it reached emerging markets. And once it arrived, the money was leveraged yet again.

Enter the shadow banks

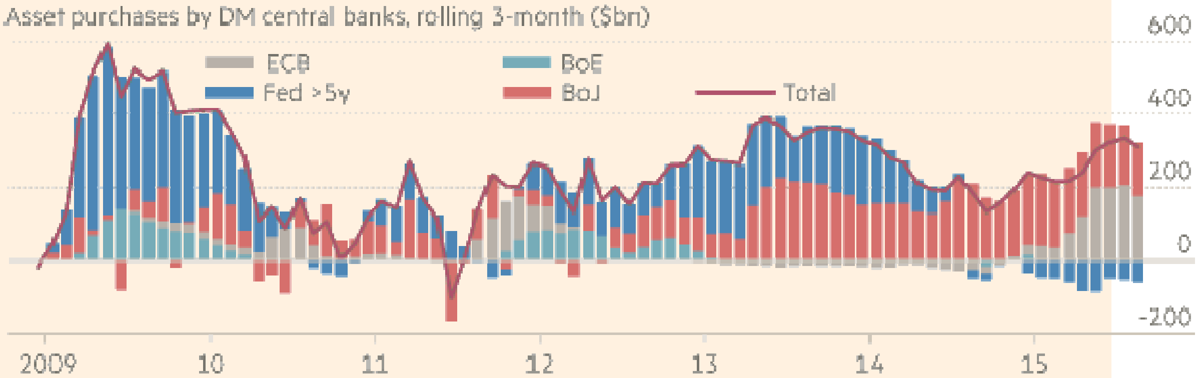
When floods of cash wash ashore in Brazil, Malaysia or Singapore, local central bankers start to worry. If they leave the inflows unchecked, their currency will appreciate strongly. This makes their economies less competitive than those of their trade rivals. So central bankers intervene, buying the incoming dollars, sterling or euros.

In taking these foreign assets on to their balance sheets, they must also create liabilities. So they print money, which makes its way into the local banking system. Flush with new cash, local banks can lend more. In fact, with their cash deposits parked at the central bank, they can lend multiples of those amounts — about four times in Brazil, eight times in Malaysia and 10 times in Chile, for example.

Banks are not the only lenders. The role of "shadow banking" has grown strongly since the crisis, as new regulations have reined in banks. Some shadow banking is provided by hedge funds and other financial institutions that are lightly regulated. Some is provided by companies lending to other companies, such as within a supply chain, and may be impossible to detect.

QE delivered a wave of money after the crisis...

The US Federal Reserve led QE from 2008. Other central banks joined in, hoping to stimulate growth. The Fed stopped last year; the BoJ and ECB continue, although a printed dollar has more impact globally than a printed yen or euro



Sources: Citi Research; Haver Analytics

A recent study by the BIS found evidence that big EM companies were issuing foreign currency bonds expressly to take part in the carry trade. Big issuers of bonds tended to be cash-rich, and they were most likely to issue when the difference between interest rates in their own country and the country where they issued was at its greatest.

Foreign direct investment is another likely route. Total FDI to Brazil in 2014, for example, was $97bn, according to its central bank, of which $39bn was intracompany loans. In China, FDI last year was $289bn, of which $105bn was "other capital flows", including intra-company loans and payments. Some of this would be used to fund productive activities, but it is likely that some of it ended up in the carry trade or shadow banking.

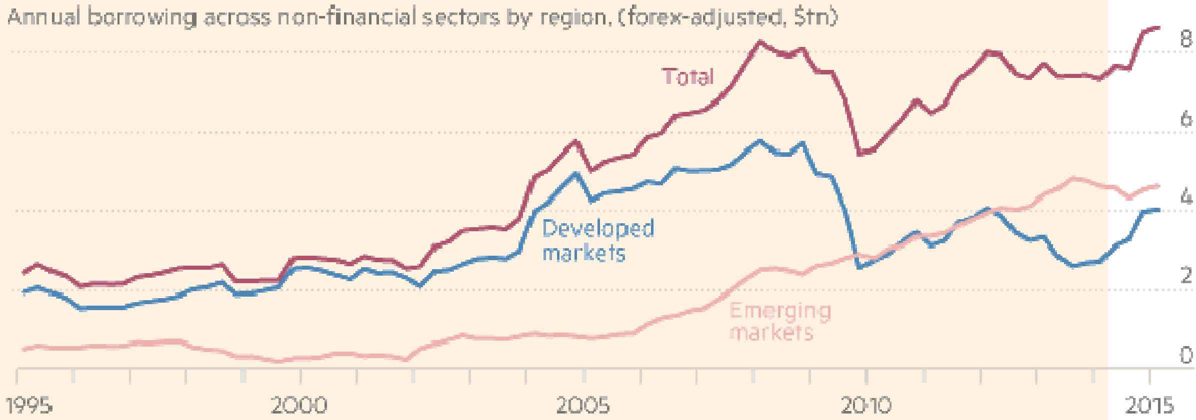
It is impossible to say how much. "We have no way of knowing just what the resulting leverage ratio for a dollar that left the US in 2010 was by the time it became the basis for a loan made in Singapore, Hong Kong, Brazil or elsewhere, but we suspect that the answer would be well into double figures," Mr Hunt says.

What is clear is that debt has risen to alarming levels. As a percentage of gross domestic product, private sector debt (households and companies) is now greater in emerging markets than it was in developed markets on the eve of the financial crisis.

... turbocharging borrowing by EM companies...

Added to stimulus from Beijing, QE has helped drive a huge build-up not only in cross-border lending but also in local bank lending. Cross-border lending is at risk of currency mismatches, while local lending is at risk of liquidity mismatches

Annual borrowing across non-financial sectors by region, (forex-adjusted, $tn)



Sources: Citi Research, BIS

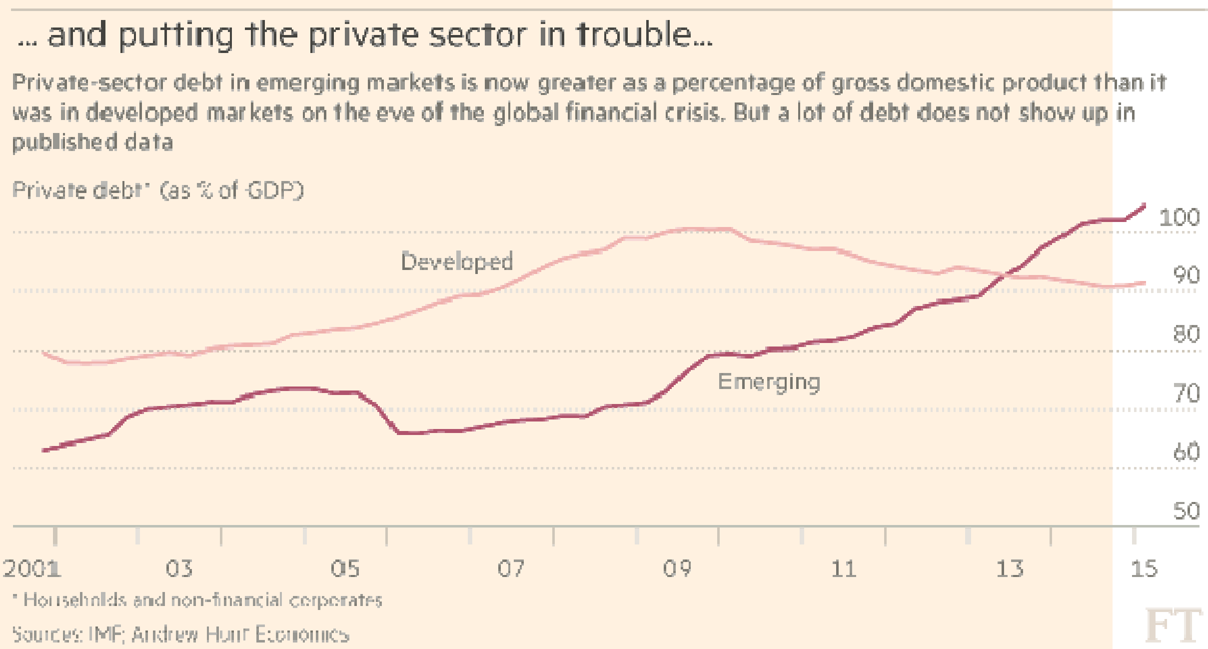
Taking on more debt for productive investment may well be a good idea, but it is not what has happened. Philip Turner and colleagues at the BIS looked at leverage and profitability at 280 big EM corporate bond issuers. They found that while leverage at those companies was up, profitability was sharply down.

And while foreign currency bond issuance at EM corporates has risen enormously since the crisis, it represents only a small part of the build-up in EM corporate debt. The vast majority — about 90 per cent by most estimates — is in plain old lending by local banks. This may be cause for some reassurance — after all, local bank lending is unaffected by the currency mismatches that can upend the carry trade. Or is it?

As Mr Turner at the BIS points out, some of the money borrowed by big EM companies was deposited at local banks, encouraging them to lend. And as big companies have turned to foreign capital markets to raise debt, local banks have had to find new companies to lend to. Were big companies to find it harder to refinance their foreign currency bonds as they fall due — because their earnings are down, or exchange rates have moved against them, or both — a withdrawal of liquidity would spread through local banking systems.

Lending conditions worsen

Trouble can also spread through mismatches in liquidity. Savers and other lenders in developed markets often believe the assets they are buying — a fund or a bond — can easily be sold if times change. But the final borrowers, who have used the funds to build a factory or provide a mortgage, cannot take their money back so quickly. As investors in developed markets withdraw their money, indebted EM companies are forced to pare activities and costs to the bone. The capital outflows weaken the local currency, pushing up foreign borrowing costs and tightening local lending conditions.

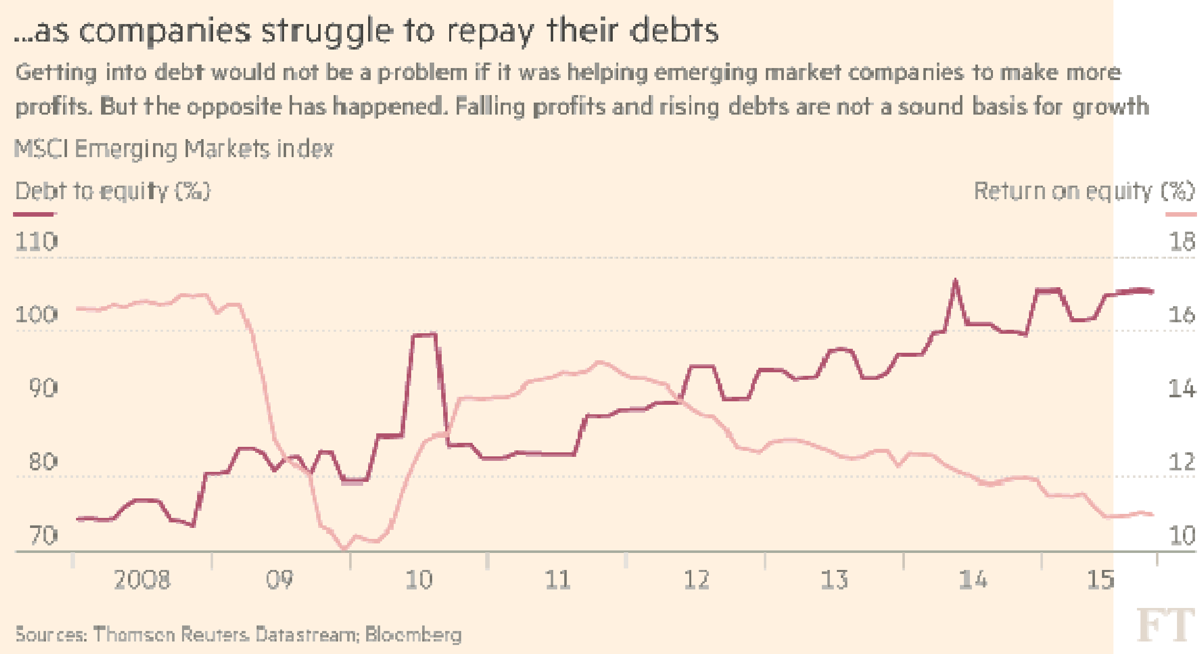


This is already happening. Last week, the Institute of International Finance said bank lending conditions in emerging markets — a broad measure that includes credit demand, availability and non-performing loans — had deteriorated sharply, with some measures at their worst levels since the IIF began monitoring conditions in 2009.

Hung Tran, the IIF's managing director, says EM companies are finding it harder to repay their debts and raise new money for investment, putting further downward pressure on growth. And he does not buy the argument that currency mismatches — especially in the overseas debts of EM governments — no longer present the danger they did in the crises of the 1990s.

"People say, this time there is no currency mismatch," he says. "They are not wrong. But the problem now is much deeper and much more general than a currency mismatch. This is a pure and simple problem of over-indebtedness and of slowing economic growth."

EM companies are suffering from the same problems as Shanshui: too much borrowing invested in too much capacity, coming to market as demand is falling. This misallocation of capital is blowing the ill winds of deflation to the developed world. The process is not over yet: as the Fed pulls back, the ECB and BoJ are in full QE mode.



Mr Hunt believes emerging markets, especially China, have already driven global growth below 3 per cent a year. He says the developed world is heading for a recession similar to the one that followed the turn of the century; if no action is taken, he expects the impact to be worse than the Asian financial crisis of the late 1990s.

"QE has made this possible," says Luis Oganes, head of EM research at JPMorgan. "Our concern is not of a full-blown EM crisis but of the heavily indebted companies and the banks exposed to them, as they fall into a vicious circle of low profitability, higher non-performing loans and tighter credit conditions. We should not expect an investment-led recovery anytime soon."

Chinese companies may have more immediate help. Beijing has reined in credit over the past two years to curtail overcapacity, mainly through restrictions on shadow banking. But this year, official lending has again been on the rise.

For Shanshui and thousands of others, though, the party is over.