
Mizuho Economic Outlook & Analysis

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Rising private debt in the emerging market countries

may weigh on the recovery of private demand and restrain the implementation of economic stimulus measures

< Summary >

- ◆ Private sector debt is growing in the emerging market countries, and the problem of debt overhang is particularly notable in Asian countries. Debt in the emerging market countries is thought to weigh on the recovery of private demand by heightening the difficulty of obtaining new loans and increasing repayment burdens.
- ◆ In countries suffering from high debt levels, the implementation of economic stimulus measures is limited in view of the possibility of triggering financial turmoil by inviting even higher debt and outflow of funds. In the immediate future, emerging market growth is expected to remain gradual, supported mainly by exports.
- ◆ Among the risks are that emerging market countries with debt overhangs may be subject to the outflow of funds triggered by an US interest rate hike, leading to financial destabilization such as the increase of external debt burdens accompanying the depreciation of local currencies, and the rise of interest rates accompanying the tightening of liquidity.

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1. Expansion of private debt in the emerging market countries

Private debt is rising in the emerging market (EM) countries. The emerging market economies have been a driving force behind global economic growth, as various economic measures implemented since the 2008 financial crisis (the financial crisis in triggered by the bankruptcy of Lehman Brothers in 2008) took effect and boosted private demand, such as investment and consumption. However, these emerging market countries are now suffering from accumulating debt that has swelled along with economic growth that peaked out in 2015. Private debt (share to nominal GDP) in the overall emerging market countries rose from 88% at the end of December 2008 to 136% at the end of June 2016, coming closer to the level of developed market (DM) countries, which has been kept flat around 160% (**Chart 1**). Rising outstanding debt in the emerging market countries will not only weigh on their economic recovery but may also cause financial instability, a possibility pointed out by the BIS (Bank for International Settlements).¹

In this report, we shall analyze emerging market country debt by borrowing sector to confirm how debt affects the economies of the respective countries as well as the need for prudent economic measures to avoid financial turmoil.

2. Debt overhangs in the corporate and household sectors hinder the recovery of investment and consumption

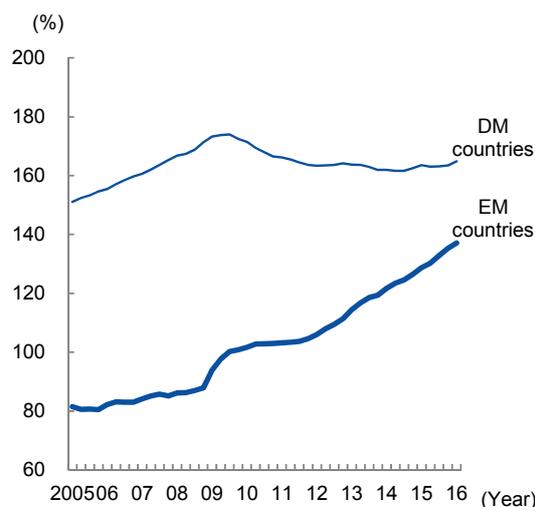
(1) Countries with significantly large corporate debt overhangs are China, South Korea and Thailand

The degree of expanding debt in the emerging market countries varies depending on the borrowing sector and country.

In the corporate sector, the volume of outstanding debt is particularly large in China (share to nominal GDP, vertical axis of **Chart 2**), reaching 171% at the end of June 2016. This is followed by South Korea, with its debt ratio standing at 107%.

It should be noted that the share of outstanding debt to nominal GDP tends to rise

Chart 1: Private debt/nominal GDP



Note: The sum of household debt and corporate debt excluding financial institutions.

Source: Made by MHRI based on the Institute of International Finance.

¹ BIS (2016)

along with the development of the financial sector, and to remove this effect we also focused on the debt ratio's deviation from the trend of outstanding debt to nominal GDP. But even from this measure (horizontal axis of **Chart 2**), it is clear that China's debt stands out from other countries, and likewise in Thailand, we can also see the country's corporate debt growing at a pace faster than the trend.

Looking at the above mentioned two measures, we can see that China, South Korea and Thailand are the three countries with particularly high corporate debt. And the background to such higher corporate debt in China is the government's implementation of a large-scale economic stimulus package amounting to 4 trillion yuan (13% of nominal GDP at that time) to mitigate the impact of the 2008 financial crisis triggered by the collapse of Lehman Brothers. This stimulus package led to the rapid expansion of investment by companies centering on construction-related sectors, such as iron and steel companies. While Chinese companies watched their earnings deteriorate as a result of too much investment leading to excessive production capacity, the lending banks saw their nonperforming loans increase,² making the situation look like Japan after the collapse of the Bubble Economy in the early 1990s. Even today, Chinese corporate debt continues to rise, and the IMF (International Monetary Fund) is asking the Chinese government to initiate a comprehensive approach to solve the issue of China's corporate debt because it can no longer be dealt with through individual initiatives.³

(2) Household debt overhang is felt strongly in South Korea, Malaysia and Thailand

With regard to the household sector, the share of outstanding debt to nominal GDP in South Korea was distinctly high at 90% at the end of June 2016 compared with other emerging market countries, followed by Malaysia and Thailand at 71%. Of these three countries, Malaysia and Thailand saw their ratio of outstanding debt to nominal GDP deviate significantly upward from the trend (**Chart 3**). In sum, we can point to South Korea, Malaysia and Thailand as the three countries with notably excessive household debt.

In the case of South Korea, although household debt has always been quite large in the past, household debt (led mainly by mortgages) has grown particularly strongly since 2014. This is mainly due to the increase in home acquisition triggered by a further cut in the interest rate and the relaxation of home acquisition restrictions as part of the government's economic stimulus measures.⁴ Later on, although South Korean

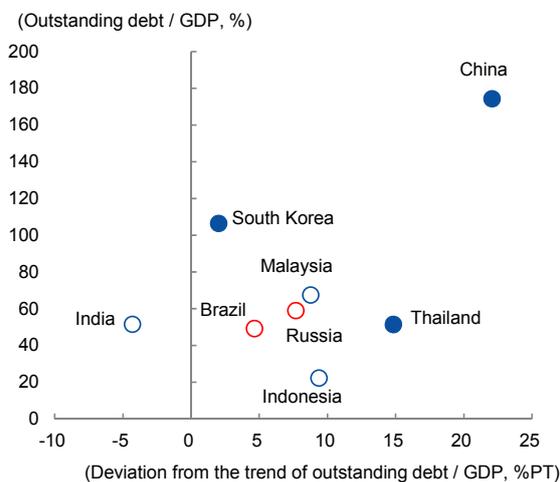
² For details of China's excessive debt problem, refer to chapter 3 of Mizuho Research Institute (2016a).

³ IMF (2016)

⁴ Kashiwagi (2016)

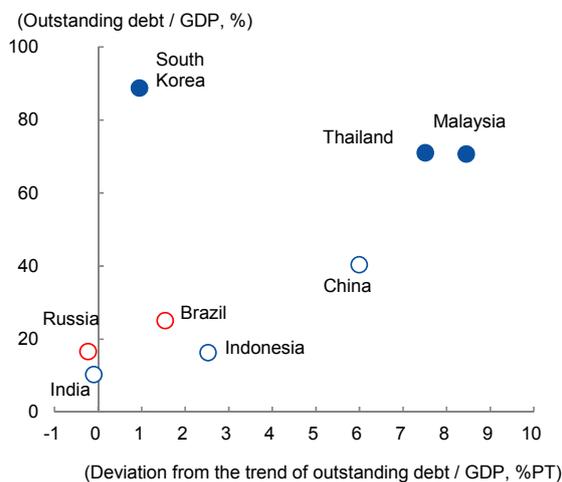
authorities made the mortgage examination process more stringent, household debt has continued growing at a strong pace in 2016.⁵

**Chart 2: Corporate debt
(end of June 2016)**



Source: Made by MHRI based on the Institute of International Finance.

**Chart 3: Household debt
(end of June 2016)**



Source: Made by MHRI based on the Institute of International Finance.

In Malaysia, mortgages account for half of household debt. Since the economic stimulus package launched by the government after the 2008 financial crisis included measures to promote home acquisition, housing prices started climbing in 2009 and doubled by 2015, with household debt increasing alongside the housing boom. Household debt was still growing in 2015, albeit at a slower pace, and it finally seems to have peaked out in 2016.

Looking at Thailand, the major part of household debt comprises automobile purchases and mortgages, as well as loans for sole proprietorships. The introduction of incentive measures for automobile and home buying targeted at low-income earners by the Yingluck administration from 2011 to 2012 fueled an increase in households taking out automobile loans and mortgages. Furthermore, since the rice pledging scheme adopted by the same administration enabled farmers to sell rice at a higher price than the market price, it is said that farmers now earning more income increased their borrowing from banks as sole proprietors. Debt continued rising even after the resignation of the Yingluck administration in 2015, suggesting the possibility that farmers hit by the drought in the same year were compelled to increase their borrowing.

⁵ Refer to page 10 of Mizuho Research Institute (2016b).

(3) The debt overhang is a drag upon Asian economies, but the debt issue in Brazil and Russia is limited

As we have seen, the countries with notably excessive corporate debt are China, South Korea and Thailand, and those with excessive household debt include South Korea, Thailand and Malaysia, suggesting that the debt issue is particularly serious in Asian countries. And the problem of such large debt is expected to hamper the recovery of private demand, such as investment and consumer spending, mainly in these countries, due to the greater difficulty in raising new loans and an increasing repayment burdens.

On the other hand, the level of household and corporate debt in Brazil and Russia remains subdued compared with the emerging market countries in Asia. The reason for this may lie in the situation where debt in the emerging market countries of Asia grew more conspicuously given that their economic growth was also stronger compared with Brazil and Russia after the 2008 financial crisis. Also, with the acute drop in commodity prices after 2014, the economies of Brazil and Russia, whose dependence on the natural resource sector is stronger than in the Asian emerging market economies, have been contracting since 2015, cooling off the demand for funds. This is in stark contrast to the emerging market economies of Asia where the debt level continued to rise even after 2015.

In the case of Brazil, bank loans grew far more faster than its nominal GDP growth rate, led mainly by government-owned financial institutions after the collapse of Lehman Brothers. The issuance of foreign currency denominated bonds also increased, particularly by companies involved in oil and gas and other natural resources. But as the period of serious economic recession lingered, as seen in Brazil's economic growth rate in 2015 falling to -3.8% under high inflation and maintenance of the government's high interest rate policy, the size of the country's debt started declining.

For Russia, bank loans to both companies and households grew strongly after the Lehman Brothers' collapse, rising at a pace faster than the rate of nominal GDP growth. Lending to oil and gas companies by Western financial institutions also continued expanding. However, just like in Brazil, the serious economic downturn was prolonged, with the economic growth rate in 2015 dipping to -3.7%. Meanwhile, given the maintenance of a high interest rate policy amid high inflationary conditions, the number of bank loans contracted, and lending to oil and gas companies by Western financial institutions also declined after economic sanctions were imposed by the US and European countries in August 2014.

3. Excessive debt also limits the scope of economic measures to boost domestic demand

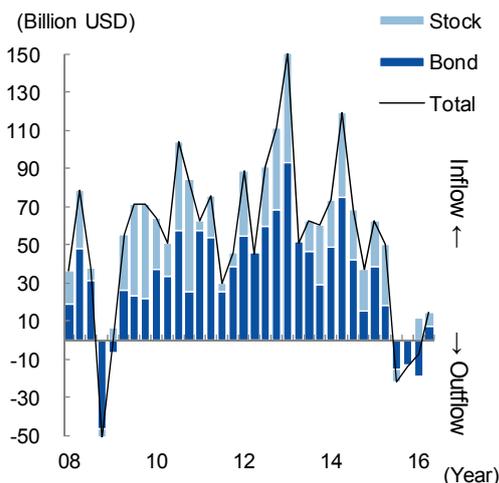
The problem of excessive debt not only weighs on the recovery of private demand comprised of investment and private consumption, but may also narrow the scope of economic measures to boost private demand. This is because stimulating private demand through monetary easing and fiscal expansion can prompt a further expansion of private debt and increase the risk of financial instability.

In addition, as the emerging market countries increased their dependence on overseas fundraising in the process of debt expansion, the implementation of economic measures may run the risk of reversing the flow of funds through a contraction of the spread between domestic and overseas interest rates and the impact on imports. Looking at the inflow of funds to the emerging market countries, stable capital inflow continued after the 2008 financial crisis consisting more of bonds than stocks. This capital inflow was driven by a fund overflow in emerging market countries which had implemented unprecedented monetary easing policies, with such funds being directed to the emerging market economies with relatively high investment returns. Although overseas funds temporarily fled from the emerging market countries due to the uncertain outlook on the emerging market economies centered on China from the Jul-Sep quarter in 2015 through the Jan-Mar quarter in 2016, funds resumed their flow back into the emerging market economies from the Apr-Jun quarter of 2016 due to the ebb of speculation on the interest rate hike in the US (**Chart 4**). But as the Federal Reserve is anticipated to raise the US interest rate toward 2017 and after, albeit at a gradual pace, the emerging market economies are expected to face the pressure of capital outflow once again. Under such circumstances, it is only natural that these countries become more cautious about introducing economic stimulus measures which may spur the outflow of funds.

If we observe the multiplying factor derived from foreign currency reserve / short-term external debt (vertical axis of **Chart 5**), which is the first indicator to measure vulnerability to capital outflow, the figure is currently higher than the threshold of 1 in the major emerging market economies. In China, however, although the figure now stands at a sufficient level of higher than 3, China has become more vigilant about the possibility of capital outflow as the country's foreign currency reserve is decreasing sharply. Also, it is worth noting that the figures for Malaysia and Indonesia are moving close to 1. Furthermore, looking at the share of foreign investors among government bond holders (horizontal axis of **Chart 5**), which is the second indicator to measure vulnerability to the outflow of funds, the shares of Malaysia and Indonesia are notably high, suggesting that the two countries are relatively vulnerable to capital outflow. As

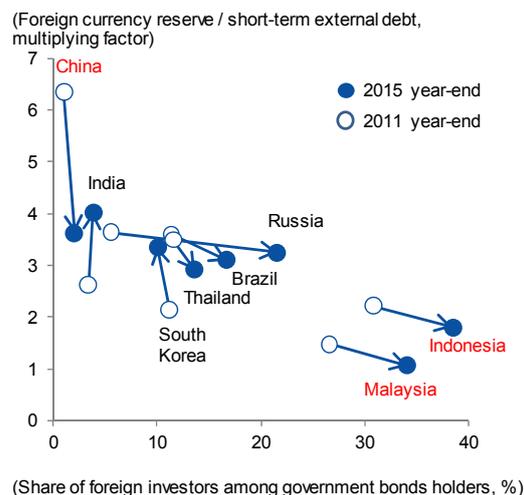
overseas money accumulated in the government bond market starts to flow outside, it will likely trigger a hike in the government bond yield, a benchmark for various other interest rates, and increase the debt burden.

Chart 4: Capital inflow to the emerging market countries



Note: The above chart includes the ten countries of China, India, Indonesia, Brazil, Mexico, Chile, Russia, Turkey, Poland and South Africa.
Source: Made by MHRI based on the Institute of International Finance.

Chart 5: Foreign reserve/short-term external debt, share of foreign investors among government bond holders



Note: China's figure is the share of foreign investors among holders of government bonds, corporate bonds and debentures.
Source: Made by MHRI based on the Institute of International Finance, central banks of each country, the IMF and Wind.

4. Conclusion

A look at the issue of rising debt in the emerging market countries reveals that the debt overhang is felt strongly among the in emerging market countries of Asia, and that it may weigh on the recovery of private demand through the adjustment of balance sheets in the corporate and household sectors. Given this situation, if these countries implement economic stimulus measures to bolster private demand, it may invite the continued rise of debt and place even heavier pressure on the balance sheet adjustment, triggering a capital outflow and heightening instability in the financial market. Hence, the emerging market countries are restricted in their ability to implement aggressive economic stimulus packages.

From the above discussion, while we cannot expect to see an economic expansion effect of private demand and fiscal stimulus measures in the emerging market countries, their economies are projected to recover gradually supported by exports, since economic growth in the DM countries, mainly the US, is anticipated to improve slightly.

Nonetheless, we must keep a close watch on the risks threatening the emerging market economies, especially those countries burdened with excessive debt. For example, in the process of the gradual US economic recovery, heightened speculation on the interest rate hike in the US, or actual interest rate increase, may trigger the outflow of capital from these emerging market economies. Should the capital outflow from the emerging market countries accelerate, it will also strengthen the downward pressure on their economies through an increase in the external debt burden resulting from the fall in value of local currencies and the rise in interest rates following tighter liquidity.

With a mid- to long-term perspective to enabling the stable development of the emerging market economies invulnerable to unstable financial situations with the relentless swelling and contraction of debt, it is imperative to strengthen macroprudential measures in a broad sense, including controlling the movement of overseas capital, in addition to monitoring the overall domestic financial system and imposing tougher lending restrictions, such as stricter down payment requirements, among others.

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