

Briefing The world economy

Pulled back in

The world is entering a third stage of a rolling debt crisis, this time centred on emerging markets

BY THE time the third film in a franchise comes around, it is not just audiences that may be getting restive; the characters themselves have been known to complain. It is his inability to put the sins of screenplays past behind him that gives Al Pacino's Michael Corleone the most memorable line in "The Godfather: Part III": "Just when I thought I was out, they pull me back in!"

As with anti-heroes in sequels, so with the world's debt crisis; seeming conclusions serve only to set the narrative off in new directions. Householders in America have struggled for years to work off the excess borrowing taken on during a global housing boom in the 2000s. The economy has suffered from a shortfall of spending as a consequence. The world economy was dealt a second blow, after 2010, when the delayed effects of that earlier boom were played out in a debt crisis at the fringes of the euro area, one that at several points threatened to break up the currency union.

America has put that crisis behind it. Consumer spending is rising at a healthy 3% or so. Nominal wages are beginning to edge up in response to a tighter labour market, leaving the Federal Reserve poised to increase interest rates for the first time since 2006 (see page 33). And household debt looks as if it is bottoming out. Much the same is happening in Britain, which suffered a boom and hangover quite like America's (see chart 1 on next page).

Europe was slower in dealing with its debt and always tends to lag behind America and Britain in its economic cycle. Nevertheless it is having its best year of growth since 2011. It is for these reasons, among others, that the IMF is predicting that world GDP will pick up to 3.6% next year; not the sort of growth seen in the early 2000s, or when emerging markets were booming after the financial crisis, but not too shabby, considering the slowdown in the developing world that started a few years ago.

Yet just as the rich world seems to be getting shot of its dodgy legacy of indebtedness, it risks being dragged back into the mire by a third leg of the debt crisis. The debt that built up in emerging markets after the American bust is still there. It has continued to grow even as the economies have slowed, and now overhangs them ominously. In the past, the rich world had the muscle to shake off such problems elsewhere. But emerging markets now make up most of the world economy (around

58% if exchange rates are measured at purchasing-power parity). They are quite capable of weighing down rich-world recoveries—especially if, as in Europe, they are already fragile ones. Taking full account of the effects of emerging-market debt makes the world economy look far less secure.

The burdens of past opportunities

The build-up of emerging-market credit began just as the rich world's financial system started to creak in 2007. According to figures collated by J.P. Morgan, a bank, private-sector debt in emerging markets rose from 73% of GDP at the end of 2007 to 107% of GDP by the end of last year. These figures include loans made by banks and bonds issued by companies. Including the credit extended by non-bank financial institutions (so-called "shadow banks") for the handful of emerging markets where such estimates are available gives a steeper rise and a higher total burden: 127% of GDP.

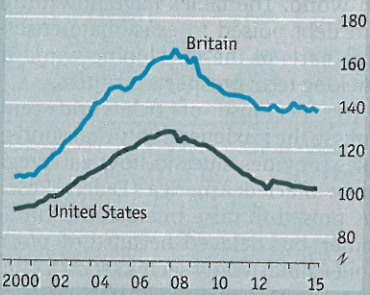
The credit boom in emerging markets was in large part a response to the credit bust in the rich world. Fearing a depression in its richest export markets, the authorities in China brought about a massive increase in credit in 2009. Meanwhile a flood of capital escaping the paltry yields on offer in developed economies pushed interest rates lower in developing ones. This search for yield by rich-world investors took them to ever more exotic places. A dollar-denominated government bond issued in 2012 by Zambia, a copper-rich country with an average GDP per person of \$1,700 a year, offered just 5.4% interest; even so, it was 24 times oversubscribed as rich-world investors clamoured to buy. The following year a state-backed tuna-fishing venture in Mozambique, a country even poorer than Zambia, was able to raise \$850m at an interest rate of 8.5%.

In contrast to the credit booms in America and Europe, where households were the main borrowers, three-quarters of the private debt burden in emerging markets is shouldered by businesses: corporate debt has ballooned from less than 50% of GDP in 2008 to almost 75% by 2014. Much of the lending was done in Asia, notably in China. But Turkey, Brazil and Chile also saw substantial increases in the ratio of company debt to GDP (see chart 2 on next page). Construction firms (notably in China and Latin America) increased their leverage a great deal. The oil and gas industry was a big player, too, according to the IMF's latest

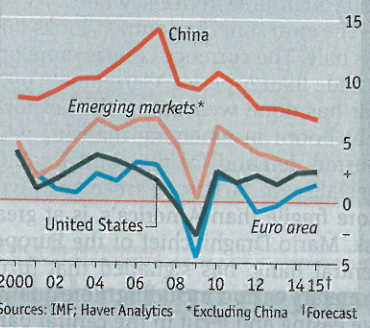


The story so far

Household debt as % of disposable income



GDP, % change on a year earlier



Sources: IMF, Haver Analytics *Excluding China †Forecast

▶ **Global Financial Stability Report.**

Growing debt in emerging markets is not of itself something to worry about. It may be that savings are getting into local capital markets more effectively or that there are more, better investment opportunities. Sadly, those happy possibilities do not seem to account for what is now going on. While corporate leverage in emerging markets has been going up, corporate profitability there has fallen, says the IMF. There is plenty of evidence to suggest that rapid debt build-ups are the hallmarks of periods of indiscriminate lending that eventually end in tears.

David Mackie, of J.P. Morgan, has analysed 52 episodes in which the ratio of private debt to GDP increased by at least 20 percentage points over five years. He found that annual GDP growth falls by almost three percentage points in the three years after the debt ratio peaks. The impact is less severe in countries where the peak is not marked by a crisis of some sort. His finding is backed up by academic research. A paper by Alan Taylor and Oscar Jorda, of the University of California, Davis, and Moritz Schularick, of the Free University of Berlin, shows that in the rich world recessions preceded by unusually rapid bank-credit growth are followed by weaker recoveries. Looking at the way credit moves up and down as a proportion of GDP, they found that larger increases in credit on the upswing were correlated with deeper recessions and slower recoveries.

Indeed, credit booms are among the most reliable signals that trouble is brewing. Research by Pierre-Olivier Gourinchas

of the University of California, Berkeley, and Maurice Obstfeld, now the IMF's chief economist, finds that credit booms have been one of the two best predictors of crises in emerging markets (the other is a rapidly appreciating real exchange rate). Increasing the credit-to-GDP ratio by nine percentage points is associated with higher probabilities of various misfortunes. In the subsequent three years the probability of a sovereign-debt default goes up by 11.5%, that of a currency crisis increases by 9.4% and that of a banking crisis by 6.4%.

Taken together, such studies of the aftermath of credit booms strongly suggest that growth in emerging markets will be much slower than it was in the early 2000s and the early 2010s. With recessions already under way in Brazil and Russia, this should temper any expectations that growth in emerging markets as a whole is going to buoy up the rest of the world.

There are reasons not to overdo the gloom. Evidence suggests that corporate-lending splurges, which account for most of what is being seen in emerging markets, are less damaging than big build-ups in consumer debt of the sort seen in America in the 2000s. A paper by Boris Cournède and Oliver Denk of the OECD, a think-tank, finds that corporate-debt booms are only half as damaging to subsequent growth in GDP per person as soaring consumer debt. Research from Atif Mian and Emil Verner of Princeton University and Amir Sufi of the University of Chicago Booth School of Business also suggests, albeit tentatively, that the link between rising debt and falling GDP growth is weaker where lending is to companies and not households. Declines in house prices might make busts in mortgage lending more damaging than corporate-debt crashes, because they depress the wealth of all consumers, and not just the indebted.

Broader changes in the world economy militate against a repeat of famous emerging-market blow-ups at the end of the 20th century, such as Mexico's "tequila crisis" in 1994 or the Asian financial crisis of the late 1990s. In the past rich-world banks lent to poorer countries in dollars. That meant that when things went pear-shaped wilting local currencies made debt burdens even larger. This time, though, much of the flood of capital has gone into local-currency bonds, which means that when currencies weaken, some of the losses are automatically shared with rich-world investors. It is still a hit—but spread out this way it does not have the same impact. What is more, memories of crises past have prompted Asian governments, in particular, to build up their foreign-exchange reserves. They are now a bulwark against a sudden exit of foreign capital. Still, some companies will face a mismatch between their earnings (in local currency) and their debts, and an arsenal of reserves may not

help them. After all, the foreign-exchange reserves are held by governments, not companies. "In a crisis the money is in one place but the holes are in a different place," says Mr Taylor.

Even allowing for mitigating factors, the scope for the debt saga's latest instalment to do more damage is clear. Brazil and Russia are already mired in deep recessions. The IMF reckons Brazil's GDP will shrink this year by around 3% and Russia's by 4%. South Africa, Turkey and Malaysia have seen their currencies plummet over the past two years. After 2007 capital flooded from rich markets into emerging ones (see chart 3 on next page). But now it is flowing the other way. Rising interest rates in America might turn that reversal into a rout.

Market triage

This makes it difficult to be optimistic about emerging markets in general. But "it is also hard to think of who might blow up," says George Papamarkakis of North Asset Management, a hedge fund. This is in part because, as Manoj Pradhan of Morgan Stanley notes, there are two types of emerging markets, and those with the largest debt are not in general of the type more disposed to acute crises.

The classic sort of emerging market has a current-account deficit and is prone to inflation. Its central bank has to pay obsessive attention to the exchange rate: too low and it stokes inflation; too high and it hurts exports. The other kind, too new to feature in textbooks on emerging-market crises, has a hearty current-account surplus, huge foreign-exchange reserves and decent public finances—but lots of private debt and an excess of goods-producing capacity, leaving it prone to deflation.

The most highly indebted emerging ▶▶

Big and bigger

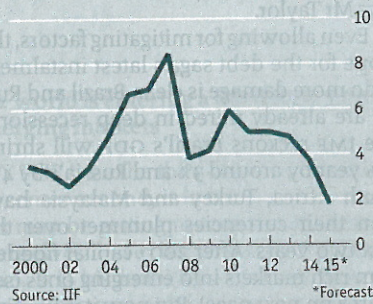
Emerging-market private debt As % of GDP



Sources: J.P. Morgan, BIS, IMF

Flood warning

Emerging-market net private capital inflows
As % of GDP



markets, such as China, South Korea, Singapore and perhaps Thailand, mostly fall into Mr Pradhan's second category. They are unlikely to suffer an abrupt crash brought on by capital flight; most of them have formidable defences against a balance-of-payments crisis. But that stability also means the problems brought on by excess debt are likely to linger for years. With inflation absent interest rates can be kept low; that makes the carrying cost of debt manageable, at least for a while. And banks heavily influenced by governments may be unwilling to tackle non-performing corporate loans, because they will result in factory shutdowns. Instead the debt overhang is perpetuated as bad loans are rolled over, creating zombie companies and industries. Overcapacity pushes down factory-gate prices, which hurts profits and investment. Capital is trapped in underperforming businesses and sectors, which steadily saps GDP growth.

A second group of countries, including Brazil and Turkey, is at more immediate risk. These are emerging economies of the more classic type. They saw a build-up in private debt after 2007, much of it in the corporate sector. Their big current-account deficits make them reliant on foreign lending to sustain GDP growth. As the prospect of interest-rate increases by the Federal Reserve draws capital back to America, such countries become more vulnerable to further currency weakness. That stokes inflation. The higher interest rates required to curb inflation and to slow capital outflows make servicing debt more costly. In such circumstances, the pressure to address the debt problem is greater and the impact on the economy is potentially more dramatic; these are the countries that are most at risk of true crises. Not all of the countries in this sort of danger have current-account deficits. Malaysia runs a surplus, but probably still belongs in this category because of its high private-sector debt (181% of GDP), its weakening currency and its strong trade ties to China's slowing economy.

There is a third sort of emerging market, though: economies that are either less blighted by private-sector debt or have oth-

er reasons to be optimistic about growth. India belongs here. Like others in Asia, India saw corporate credit soar after 2007. But its investment boom hit the buffers earlier than in other places; overall private-sector debt was a comparatively modest 60% of GDP in 2014 (though this is also in large part because the market for consumer debt is under-developed). The central bank has put pressure on state-owned banks to recognise bad debts, and bankruptcy legislation to help clear up the mess that goes along with them is pending.

The IMF expects Indian GDP to rise by 7.3% in 2016, which will make it the world's fastest-growing big economy. It is less affected by the slowdown in China than other Asian economies, and the halving in oil prices which has hit Asian producers like Malaysia hard has been a boon to India, which imports 80% of the oil it consumes. The current account has moved closer to balance, in part because of low oil prices but also because of the prompt action taken after concerns about capital starting to leave emerging markets sparked a mini-crisis (the so-called "taper tantrum") in 2013. Inflation, which was in double-digits in 2013, was down to 4.4% in September; the oil price has helped, but so have measures to curb food-price inflation. Interest rates have been steadily reduced this year from 8% to 6.75%, and there is scope for the central bank to make further cuts.

Glimmerings of hope

The trouble in Brazil and Russia, and the volatility of China's stockmarket, have made India an increasingly attractive haven. But look harder and it is possible to find other biggish developing economies that are not afflicted by a corporate-debt overhang. Mexico, though an oil exporter, saw only a modest increase in credit growth after 2007. Its private-debt burden rose to just 35% of GDP by the end of last year. It is more closely tied to America, an economy that is escaping its private-debt problems, than to China, which has yet to deal with them.

Pakistan, like India, benefits from low oil prices and has seen a dramatic fall in inflation and a pick-up in GDP growth. Argentina has barely any private debt and could shed its reputation for chronic economic mismanagement if Mauricio Macri, a reformer, wins presidential elections this month. Russia, though still mired in recession, might return to growth sooner than many expect in response to a quite brutal devaluation of the rouble. "It is hard for Russia to go down much further," reckons Mr Pradhan. Its central-bank governor, Elvira Nabiullina, is well regarded. And like India, Russia has relatively high interest rates, giving it "an arsenal of monetary policy" to bring to bear.

In the immediate aftermath of 2007 the growth rate of the world economy was a

contest between emerging markets, which pressed forward, and the obstructions put in the way of progress by the woes of the rich world. The tables have now turned, with debt poised to exacerbate crises in some parts of the developing world and dent long-term prospects in others.

The response of rich-world central banks to the anxieties this turnaround provokes provides clues to how each region will be affected. America's Federal Reserve was poised to raise interest rates in September, but delayed because of worries about China. It now seems set on a rate increase in December. The feeling is that America's recovery is sufficiently robust to shrug off trouble from elsewhere.

The euro zone, by contrast, looks much less hale. The currency zone is more open to trade than America. Germany in particular has done well out of the corporate-debt boom in emerging markets, which spurred demand for the capital goods it specialises in. So Europe's recovery, always more fragile than America's, is at greater risk. Mario Draghi, chief of the European Central Bank, has signalled that further monetary easing, including more quantitative easing and a cut in the central bank's deposit rate, looks to be on the cards.

More quantitative easing in Europe while America tightens monetary policy is a recipe for a stronger dollar. If the greenback rises far enough, that will hurt export earnings in America, which will eventually feed through to weaker investment and softer GDP growth. The Fed may thus find that even a gradual increase in interest rates will have to be cut short.

Some stories come to a satisfactory end. Some, like the Godfather saga, outstay their welcome. The chronicles of debt seem to fit firmly in the second category. Michael Corleone's driving ambition was to settle all family business; but nothing stays settled for ever. ■

