Emerging Market Debt Ratios – Opportunities And Risk

Not all emerging market debt is created equal.

Simon Quijano-Evans – emerging markets strategist at LGIM – explores the different debt profiles of individual emerging markets (EM) more closely, and where the risks and opportunities lie for investors, placing the overall picture of EM fixed income instruments in context versus their developed market peers.

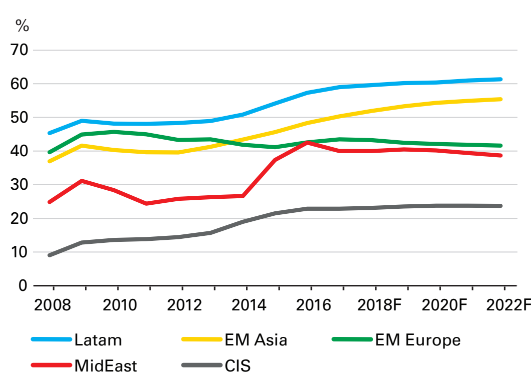
While EM enjoys lower debt ratios than developed market peers all in all, it is also clear that the EM debt picture is quite disparate.

THE PUBLIC SECTOR – LESSONS LEARNED

In general, emerging market governments learned important lessons from the crises of the 1990s, resulting in a more cautious approach towards fiscal excesses and external debt exposure, as seen for example in Turkey, the Philippines, Indonesia, Mexico and Brazil. That allowed emerging markets as a whole to better weather the 2008/9 global financial crisis, while developed market peers faced a strong jump in debt/GDP ratios.

Nonetheless, the post-2013 rise in emerging market public debt ratios (Figure 1) highlights: 1) the vulnerability of emerging market commodity exporters to commodity price shocks (mainly Middle East and ex-Soviet Union or CIS countries), 2) the damage that negative politics can have on economies, important examples being Brazil, Egypt and South Africa, and 3) the expansive fiscal policy reaction that was needed in China to cushion the domestic (and global) economy against a hard landing.

Figure 1: Public debt/GDP by region



Although there appears to be a relatively benign public debt picture in numerous emerging market countries, the emerging market macro and public debt picture is very diverse and emphasises the importance of active debt management strategies to deal with the risks and opportunities of investing in emerging markets.

THE PRIVATE SECTOR – CHINA LEADS THE WAY

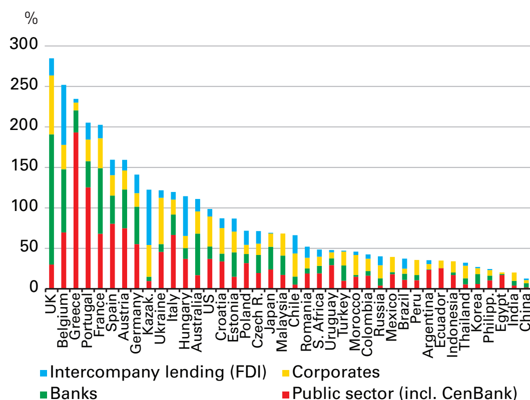
Just as the public sector debt backdrop in emerging markets has become more constructive in the past decade, the lower degree of "crowding out" by the public sector appears to have paved the way for sizeable increases in private sector debt ratios, although most of that has come out of China.

While emerging market countries look relatively less leveraged on a global scale, the substantial increase in credit provided by banks in China means the country clearly leads the way as far as total debt/GDP is concerned, closely followed by South Korea and Malaysia that also faced a post-2008 increase in domestic bank lending.

EXTERNAL DEBT – CURRENCY RISK

However, at the same time, China, Malaysia and Thailand face relatively low external debt/GDP ratios (i.e. debt owed to the rest of the world), while countries like Brazil and Mexico reduced their exposure and built up FX reserves after having learned from crises of prior decades. This is especially relevant in emerging markets, where exchange rate volatility always provides an added risk component for investments (particularly in countries such as Turkey or South Africa, which have a low FX reserve cushion). And, larger levels of external debt (usually denominated in foreign currency), as well as higher amounts of local currency bonds held by non-residents, increase the fiscal costs for any particular emerging market country in the event of a sharp currency depreciation.

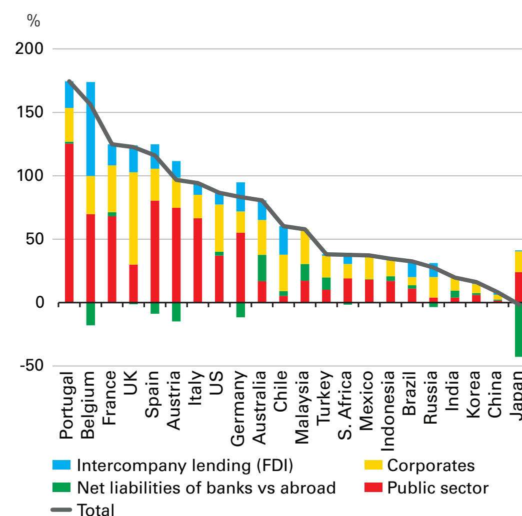
Figure 2: Gross external debt by sector as % of GDP



Any comparison between external debt data in emerging market and developed market countries needs to be taken with a pinch of salt. 'Gross' external debt data (i.e. total outstanding debt) is widely used in emerging markets for cross-country comparison, on the assumption that individual banking systems in emerging markets are generally net external borrowers. At the other end of the scale, the assumption is that the banks of developed market countries are usually net lenders.

To reflect that point, we adjust Figure 2 (which shows 'gross' external debt for all sectors), using net external liabilities for the banking sector in Figure 3 (i.e. subtracting claims abroad from gross external liabilities). Figure 3 shows how developed market banks are generally net lenders. However, total external debt ratios still show higher exposure of Eurozone countries than emerging markets (not least because of the issuance of euro-denominated debt that is held by non-residents in other Eurozone countries), while the Japanese banking sector stands as the largest net lender to the world both in % GDP and in absolute terms.

Figure 3: External debt/GDP adjusted for bank assets abroad



SO WHAT DOES THIS MEAN FOR EM INVESTMENTS?

A look at the details of emerging market debt shows a diverse backdrop that has some countries more exposed to domestic and/or corporate debt (e.g. China and Brazil) and others more exposed to external debt (e.g. Croatia, Ukraine, Malaysia and to a certain extent Hungary).

From the point of view of a foreign investor, that means dealing with a mix of FX risk on the one hand, and any potential financing risks on the other, although clearly the picture in many emerging market countries has not only improved from a historical point of view but also relative to some developed market countries.

The diverse sovereign and corporate debt spectrum of such a wide group of emerging market countries highlights the need for investors to scrutinise their individual debt profiles more closely to ensure not only that risks are contained, but also that opportunities are identified.

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