Lending to emerging markets comes to halt

Jonathan Wheatley, *Financial Times*, February 5, 2016

The surge in lending to emerging markets that helped fuel their own — and much of the world's — growth over the past 15 years has come to a halt, and may now give way to a "vicious circle" of deleveraging, financial market turmoil and a global economic downturn, the Bank for International Settlements has warned.

"In the risk-on phase [of the global economic cycle], lending sets off a virtuous circle in financial conditions in which things can look better than they really are," said Hyun Song Shin, head of research at the BIS, known as the central bank of central banks. "But flows can quickly go into reverse and then it becomes a vicious circle, especially if there is leverage," he told the FT.

That reversal has already taken place, according to BIS data released on Friday.

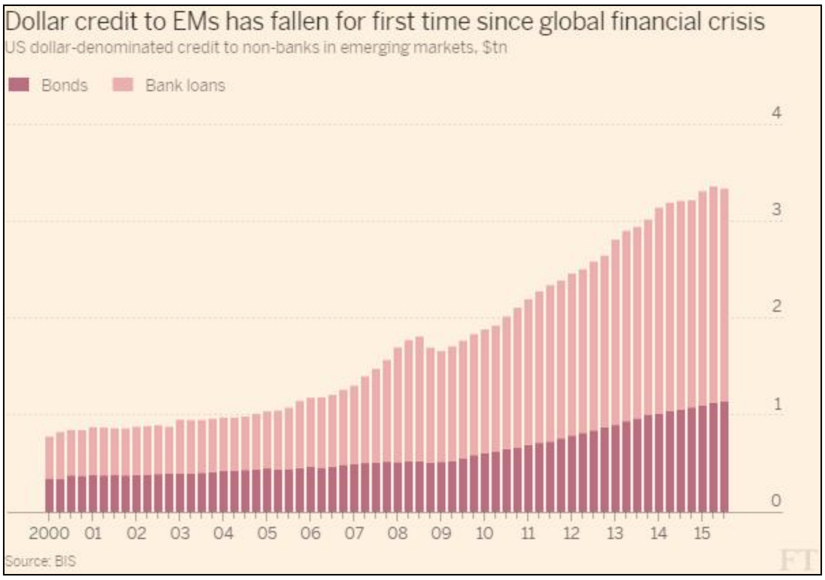
The total stock of dollar-denominated credit in bonds and bank loans to emerging markets — including that to governments, companies and households but excluding that to banks — was $3.33tn at the end of September 2015, down from $3.36tn at the end of June.

It marks the first decline in such lending since the first quarter of 2009, during the global financial crisis, according to the BIS.

The BIS data add to a growing pile of evidence pointing to tightening credit conditions in emerging markets and a sharp reversal of international capital flows. On Thursday, Christine Lagarde, managing director of the International Monetary Fund, warned of the threat to global growth of an impending crisis in emerging markets.

The Institute of International Finance, an industry body, said last month that emerging markets had seen net capital outflows of an estimated $735bn during 2015, the first year of net outflows since 1988.

In November, the IIF warned of an approaching credit crunch in EMs as bank lending conditions deteriorated sharply. This month, it said a contraction over the past year in the liquidity made available to the world's financial system by central banks, primarily those in developed markets, now presented more of a threat to global growth than the slowdown in China and falling oil prices.



Jaime Caruana, general manager of the BIS, said that recent turmoil on equity markets, disappointing economic growth, large movements in exchange rates and falling commodity prices were not unconnected, exogenous shocks but indicative of maturing financial cycles, particularly in emerging economies, and of shifts in global financial conditions.

He noted that, while some advanced economies had reduced leverage after the crisis, debt had continued to build up in many emerging economies. “Recent events are manifestations of maturing financial cycles in some emerging economies,” he said. The problem was aggravated, Mr Shin added, by the deteriorating quality of the assets financed by the lending boom.

He noted that the indebtedness of companies in emerging markets as a percentage of GDP had overtaken that of those in developed markets in 2013, just as the profitability of EM companies had fallen below that of DM ones for the first time. Since then, leverage in emerging economies had increased further as profitability had decreased, with exchange rates playing an important role.

“Stronger EM currencies fed into more debt and more risk taking. Now that the dollar is strengthening, we have turned into a deleveraging cycle in EMs. So there is a sudden surge in measurable risk; all the weaknesses are suddenly being uncovered.”

He added: “The issue is not just for emerging markets. It is spilling back into developed markets. The broader financial markets are recoiling from risk, and that spreads across all markets. The problem now is that the real economy is being affected.”

Mr Caruana urged policymakers to recognise the significance of the stock of global debt and to address it through long-term rather than short-term measures.

“Unless policy is guided by a long-term perspective, short-term fixes may end up being just a palliative that only puts off the bad day,” he said.