Mizuho Economic Outlook & Analysis

September 4, 2019

Emerging market currency depreciation and debt problems

Latent risk in the expansion of foreign currency debt in China's private sector

< Summary >

◆ Against the backdrop of intensifying tension between the US and China, downward pressures on emerging market (EM) currencies are increasing. Currency depreciation increases the burden of repayment of debt denominated in foreign currencies and tends to create a vicious cycle of further currency depreciation due to concerns over default.

◆ Argentina is unique in that it has a high degree of dependency on foreign currency-denominated (FX) debt centering on the government and has extremely inadequate foreign currency reserves. The risk that an Argentina-type sovereign crisis spreads to major EMs is limited.

◆ Given the size of the debt and its international impact, we should be more cautious about the expansion of FX debt in China's private sector. Further depreciation of the yuan could trigger a crisis stemming from China's FX debt.

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1. Wariness of increasing currency depreciation pressures and debt problems in emerging markets

(1) In Argentina the currency crisis has evolved into a debt crisis

Against the backdrop of concerns about the slowdown of the global economy due to intensifying trade tensions between the US and China, as well as speculation that Chinese authorities are allowing the yuan to depreciate, the risk-off trend in the global financial market has become stronger and many emerging market (EM) currencies are exposed to downward pressures associated with capital outflow. Currency depreciation increases the burden of repayment of FX debt. As a result, it is easy to create a vicious cycle of further currency depreciation due to concerns over default.

Argentina is currently experiencing a serious crisis. Argentina has been forced to apply for financial support from the IMF due to the peso's rapid fall in 2018 (annual rate of decline against the US dollar: -50.6%). In addition, as the presidential election primary (held on August 11) saw a left-leaning candidate claim overwhelming victory and there is now a widespread view that incumbent president Mauricio Macri will have difficulty getting re-elected in the October national election, the peso's downward trend has intensified (as of August 30, the peso's value has declined 37% since the beginning of the year).

As the possibility of the resurrection of a left-leaning government has increased, skepticism over the continuity of financial support from the IMF is growing, and concerns over a default in Argentine are rapidly rising. This is because there is a strong possibility that if elected the left-wing presidential candidate will try to steer Argentina away from the fiscal austerity imposed under IMF lending conditions and embark on a program of expanded fiscal management. Following defeat in the primary, the Macri government has already been forced to implement economic stimulus measures such as tax cuts. In 2001, IMF financing was not available to Argentina due to the government's failure to meet budget deficit reduction targets, which tipped Argentina into default. With the next loan drawing date (September 15, $5.4 billion) approaching, on August 28 Argentine's government announced the postponement of repayment of a portion of government bonds and signaled a policy of negotiating its loan repayment plan with the IMF. The credit ratings for Argentinian government bonds have been downgraded, with the premium on 5-year credit default swaps, an indicator of the creditworthiness of government bonds, skyrocketing from about 1,000bpsbefore presidential primary election to more than 4,000bps (as of August 30, 4,211bps).

Is it likely that the Argentine-type crisis will spread to major EMs in the future? In the discussion that follows, the characteristics of FX debts in major EM countries will be summarized and the spillover risks will be examined.

(2) Argentina and Turkey are extremely vulnerable to currency depreciation

Argentina is unique in that it is highly dependent on FX debt among the major EMs and significantly lacks foreign currency reserves, making it extremely vulnerable to currency depreciation (**Chart 1**).

According to data from the Institute of International Finance (IIF)[1], Argentina's FX debt to GDP ratio is 98.6% (as of the end of March 2019, same applies below), the largest among the major EMs (18 countries) (Argentina also has the highest FX debt/total debt ratio at 77.6%), which makes it highly susceptible to an increased debt burden due to currency depreciation. Looking at the coverage ratio, which shows the ratio of foreign currency reserves to short-term external debt (World Bank data) with an original maturity of one year or less, Argentina is close to the minimum requirement of 1 time. Argentina's foreign currency reserves were on an uptrend since 2018 due to IMF support financing. However, the country has been forced to undertake market interventions to resume dollar selling due to the recent currency crash. As a result, its reserves have started to decline again, further increasing its vulnerability. In August alone, foreign exchange reserves declined by $13.8 billion, leading Argentine's government to announce capital controls on foreign-currency purchases by individuals and corporations (September 1).

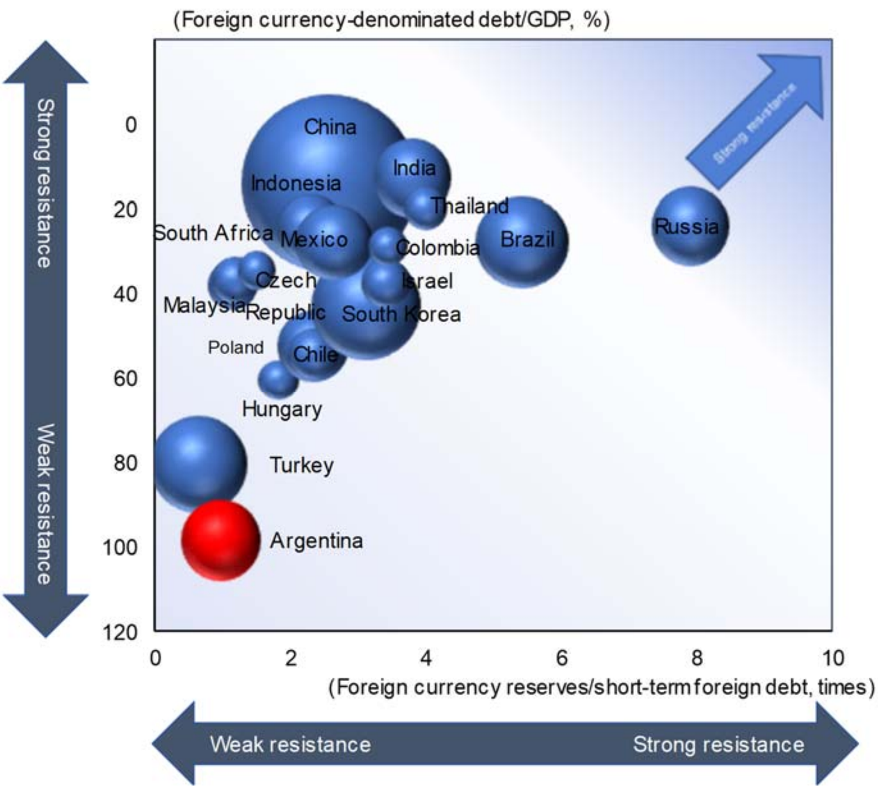
Turkey, like Argentina, is considered vulnerable to currency depreciation. Turkey's FX debt to GDP ratio is 80.7%, the second highest after Argentina, and the ratio of short-term foreign debt covered by foreign currency reserves is 0.6 times, less than 1 time, which puts it below Argentina. In August 2018, the Turkish lira experienced a sharp drop (Turkey shock) in response to wariness about the policy management of the increasingly authoritarian Erdogan government and plummeting foreign exchange reserves. After moving into 2019, such actions as strengthening regulations to block lira selling (March) and the government's dismissal of the central bank governor (July) have been factors behind a weaker lira, and thus mistrust in Turkey's policy management remains strong.

In contrast to Argentina and Turkey, Russia and Brazil are in a position that makes them highly resistant to currency depreciation. Russia's FX debt to GDP ratio is 24.1%, which is relatively low among the target countries, and its ratio of short-term foreign debt covered by foreign currency reserves is highest at 7.9 times. Brazil also has a low FX debt to GDP ratio of 27.9%, and its foreign currency reserves are the second highest after Russia (resulting in a coverage ratio of 5.4 times).

[1] Global Debt Monitor Database.

China is the opposite of Argentina in terms of its low dependence on FX debt, and it is not vulnerable to currency depreciation among major EMs. Its FX debt to GDP ratio is the lowest after India at 13.9% (but it has the lowest FX debt to total debt ratio of 4.6% among major countries), and its ratio of short-term foreign debt covered by foreign currency reserves is about 2.6 times, which is above the required level. China's foreign exchange reserves (as of the end of March 2019) are about $3.1 trillion, well above the appropriate level of foreign exchange reserves (in the case with capital controls) calculated by the IMF (**Chart 2**), which means China has sufficient foreign currency reserves to cope with the risk of capital outflow, including repayment of external debt.

Chart 1: Major EM country resistance to currency depreciation



Note: 1. The size of the bubble represents the amount of foreign currency-denominated debt (in dollars). The data are as of the end of March 2019.
2. Foreign currency-denominated debt is the sum of dollar, euro and other foreign currency debt.
3. EMs are 18 countries (China, Korea, Thailand, India, Indonesia, Malaysia, Argentina, Mexico, Brazil, Chile, Colombia, Russia, Czech Republic, Poland, Hungary, Turkey, Israel, and South Africa).
Source: Made by MHRI based upon Institute of International Finance (IIF), World Bank, country data etc.

(3) Even in the composition of FX debt holding entities, government-centered Argentina is unique

Even from the perspective of entities holding FX debt, Argentina is unique in that the government is a major holder. After returning to international financial markets in April 2016, Argentina expanded its FX debt by, for example, issuing its first-ever 100-year bond as a non-investment grade issue in 2017, leading to FX debt comprising 72.3% of total government holdings (**Chart 3**). On the other hand, in other major EMs, non-financial corporates and the financial sector are the main holders of FX debt. In Turkey, which is second most dependent on foreign currency debt after Argentina, the government's holding ratio is only 19.1%, and non-financial corporates are the largest holders (50.9%). However, the FX ratio of Turkey's government debt has increased from 28% in December 2009 to 48%, suggesting that attention should be paid to the susceptibility of government debt to currency depreciation.

In the case of China, private companies account for 97.1% of FX debt. As of the end of March 2019, non-financial corporates (51.8%) held more than the financial sector (45.3%). However, looking at the growth in holdings since the bottom after the yuan shock in August 2015, non-financial corporate holdings have stalled at 1.2 times while the financial sector holdings have expanded at a faster rate of 2.1 times, suggesting that funding through cross-border bank borrowing and bond issuance is increasing rapidly. As for non-financial corporates, there is particular concern over the expansion of FX debt among real estate companies. This is because many of those companies are raising considerable amount of funds through the issuance of dollar-denominated bonds and that China is currently facing a downturn in the domestic real estate market.[2] In July this year, the Chinese government asked real estate companies to tighten the requirements for issuing FX bonds and formulate a FX debt management plan.

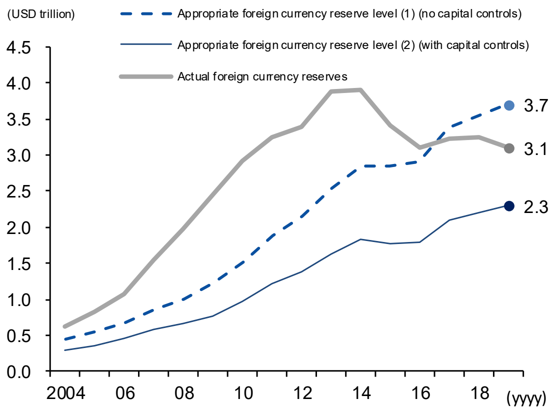
The spillover effects of the FX debt problem due to the depreciation of currency differs between the government-centric Argentine type and private enterprise-centric type countries. When the government is the primary debt holder, an increase in debt repayments due to currency depreciation affects the creditworthiness of the sovereign (the entire country) and leads to bring upward pressure on a wide range of funding costs owing to government bond downgrades and other problems. If the government becomes hard-pressed for cash-flow, it will be necessary to request assistance from international financial institutions such as the IMF.

On the other hand, in the case of debts owed by private companies, the impact on creditworthiness caused by currency depreciation varies greatly from company to company. For example, natural hedging, or the increase in company FX revenue due to currency depreciation, works at export companies, while at non-exporting companies the impact of currency depreciation can be mitigated depending on the degree of use of currency risk hedges such as derivatives. Yet, if a chain reaction of bankruptcy occurs mainly in companies with insufficient risk hedging, leading to instability in the financial system, and

[2] Don Weinland and Sherry Fei Ju, "China developers' dollar debt spooks investors," *Financial Times*, April 30, 2019.

government fiscal and financial support is required, the overall creditworthiness of the country may be affected.

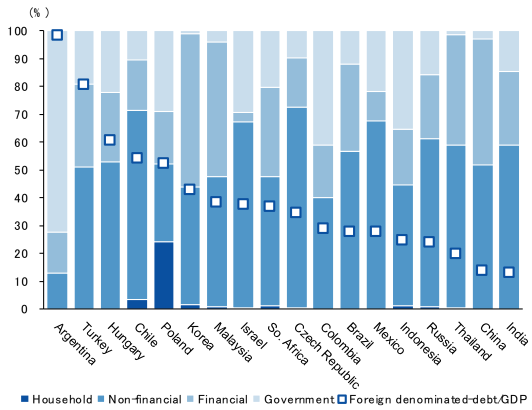
Chart 2: China's foreign currency reserves and appropriate levels



Note: Until 2018, the values published by the IMF are used. End-March 2019 values are estimated by MHRI. The appropriate level without capital controls is a reference value. The current appropriate level without capital controls is higher than actual foreign currency reserves, but since China's capital account is not liberalized, it is considered the appropriate level with capital controls is closer to the reality. In addition, the IMF sees it desirable that actual foreign currency reserves become 100%-150% of the appropriate level of the reserves (China's ratio is 135% as of the end of March 2019).

Source: Made by MHRI based upon on International Monetary Fund (IMF)

Chart 3: Composition of foreign currency denominated-debt by holding entity



Note: As of end-March 2019. Foreign currency-denominated debt is the total of debt in dollars, euros and other foreign currencies.

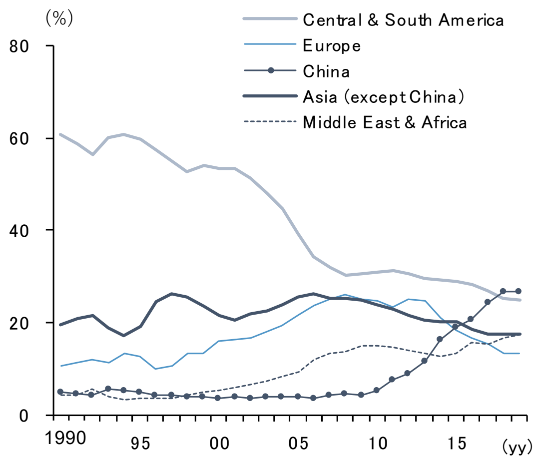
Source: Made by MHRI based upon Institute of International Finance (IIF)

2. Risk hidden in the expansion of FX debt in China's private sector

As mentioned above, Argentina's vulnerability to currency depreciation is prominent. It is also unique in that the Argentinian government is the largest holder of FX debt, which means that the risk of an Argentine-type sovereign crisis spreading to the other major EMs being analyzed in this report is considered to be limited.

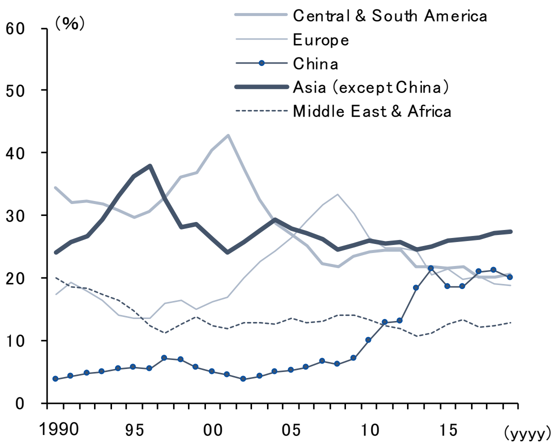
More alarming is the expansion of FX debt in China's private sector. This is because China's debt problems are quite different from those in EMs in the past in terms of scale and international impact. Specifically, three points should be noted: (1) the scale of FX debt in China's private sector is strikingly large, (2) China's presence in international financial markets is increasing and (3) when it becomes difficult for China to raise new funding, it is necessary to consider the impact on low-income countries for which China has become the creditor country.

Chart 4: Share of international bond issues



Note: Share of total outstanding international debt securities in EMs countries. The region/country classification is based on the location of the issuer's parent company headquarters (by nationality). General governments are not included. 2019 is up to the end of March and the end of December in other years.
Source: Made by MHRI based upon Bank for International Settlements (BIS)

Chart 5: Share of international bank foreign claims



Note: Share of the balance of international bank foreign claims on EMs countries. Location based. 2019 is up to the end of March and the end of December in other years.
Source: Made by MHRI based upon Bank for International Settlements (BIS)

First, as seen in the previous section, although China is not in the position of having weak resistance to currency depreciation, the size of its FX debt is exceptional at $1.85 trillion ($1.5 trillion, equivalent to more than 80% of the debt, is denominated in US dollars), leaving no reason for optimism. In fact, during the past yuan shock, the associated sharp rise in payments on FX debt by Chinese non-financial corporates was viewed as a key driver of large net capital outflow from China.[3] In addition, private companies that are holders of FX debt have not sufficiently hedged the risk of foreign currency exchange, which could lead to a higher debt burden. After the yuan shock in August 2015, foreign exchange derivative product transactions have become active in the interbank market, but the rate of use of foreign currency hedges by non-financial corporates has remained at a lower level compared to the international average.

Second, China's presence in international financial markets is growing. According to the Bank for International Settlements (BIS), China's share (parent companies of issuers are headquartered in China) in the issuance of international bonds (debt securities) has grown from 5.4% in 2010 to 26.8% as of the end of March 2019, a scale that puts China above other major EM regions (Latin America, Europe, Middle East & Africa and Asia [excluding China]) (**Chart 4** on the previous page). China's share of international bank foreign claims

[3] Institute of International Finance (IIF), *IIF Weekly Insight*, August 8th, 2019

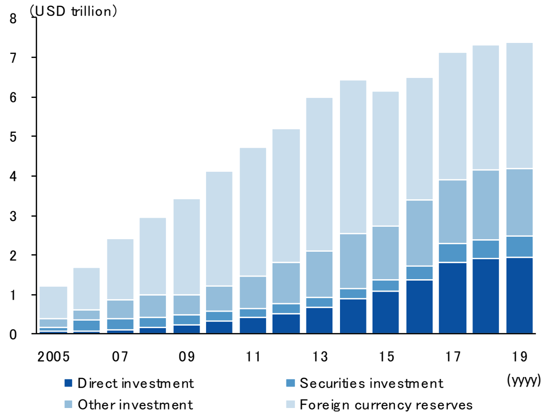
has also increased rapidly from 4.9% to 20.1% over the same period (**Chart 5** on the previous page).

Third, China, which has actively continued to raise funds, is increasing its presence not only as a debtor country but also as a creditor country. For this reason, if it becomes difficult for China to raise funds, it may lead to a reduction in credit to low-income countries for whom China is a creditor. Looking at China's external assets balance, in addition to direct investments, the scale of "other investments," especially "loans," has increased in recent years (**Charts 6 and 7**). In addition, according to the IMF[4], the debtor composition of external debt in low-income developing countries (LIDC) has seen a lower share held by international organizations such as the IMF and the World Bank and the Paris Club (a group of creditors that addresses public claims). On the other hand, the share of creditors other than the Paris Club, particularly China, is rising. In fact, since 2010, China has provided commitments of more than $100 billion a year, on average, in financing to EMs, over $30 billion of which has been to LIDC. The IMF has noted that the shift to a more diverse composition of creditors can facilitate faster debt expansion of LIDC and can also make debt resolution more complex.

If China, which accounts for 40% of the GDP of EMs (2018, dollar base), suffers a serious credit contraction, the impact on the global economy will be incomparably greater than any other EMs. At present, China is opening up its financial markets, such as its domestic bond market, making it structurally prone to an increase in FX debt. Therefore, it is unlikely that China will actively encourage yuan depreciation, which can lead to an increase in the burden of repaying FX debt. China's financial authorities are also taking measures to curb capital outflows to prevent excessive yuan selling. However, in the face of intensifying tensions between the US and China, if the Chinese authorities have to accept further depreciation of the yuan as a de facto countermeasure, this could trigger a crisis stemming from FX debts in the private sector.

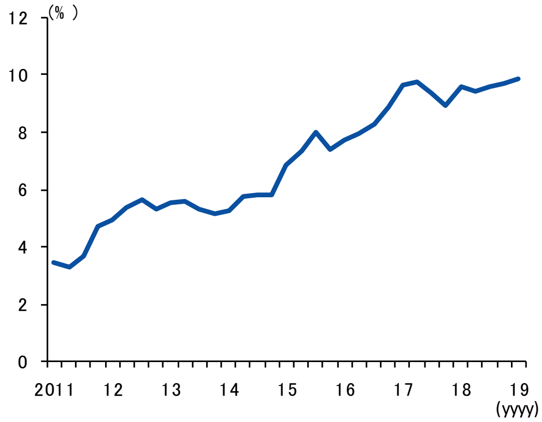
[4] International Monetary Fund (IMF), *Global Financial Stability Report*, April 2018, Figure 1.17-3, 4

Chart 6: China's external assets balance



Note: The figures for 2019 are values up to the end of March.
Source: Made by MHRI based upon State Administration of Foreign Exchange of China

Chart 7: Ratio of loan assets to external assets in China



Note: The figures for 2019 are values up to the end of March.
Source: Made by MHRI based upon State Administration of Foreign Exchange of China