

Danger of the super-dollar

Emerging market debt bubble is worse than 2007-08

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The dollar has reached its highest level since the early 2000s on a trade-weighted basis. This reflects higher US interest rates, expansive monetary policies elsewhere, and rising international tensions. The 'super-dollar' cheapens exports to America's still world-beating economy, helping the world recovery.

But there is a considerable downside – the rising value of \$7.6tn of dollar-denominated debt issued by international borrowers, mainly concentrated on emerging countries.

Strong economic growth and cheap credit in countries such as China, Brazil and Indonesia have driven governments, banks and large companies into massive dollar borrowing over the past decade.

As the credit tide turns, the volume of bad loans is likely to grow to dangerous proportions. For example, China's non-performing loans are estimated at \$630bn, roughly equivalent to Sweden's GDP.

One more positive view could be that the dollar has reached its peak, and further Federal Reserve interest rate rises following the 0.25 percentage point hike on 16 December may be already 'priced in'. But if the dollar rises further, many private debtors in emerging economies could be forced over the limit of sustainability, triggering runs on government finance and possibly another bout of global financial chaos.

In the past, emerging market issuers gained a number of advantages by following their dollar borrowing strategy.

After the Federal Reserve's quantitative easing started in 2009, they benefited from low US interest rates and a low dollar. The industrialised countries' financial system encouraged a 'race to debt' through the 'hunt for yield', pushing a slice of the funds freed up by quantitative easing towards emerging market economies.

US and European banks and institutional investors sold government bonds to their central banks, obtaining liquidity they then transferred to investment funds specialising in emerging markets (hedge funds and leveraged funds).

Those funds in turn bought money market instruments issued by emerging market banks or invested in corporate equities and debt. Not all loans funded positive investment, infrastructure or development projects. A large proportion remained in Asian and Latin American bank accounts, fuelling speculation on financial markets.

The credit multiplier in countries with relatively loose banking regulation means that \$1 stemming from the US was transformed into \$4 of new loans in Brazil, \$8 in Malaysia and \$10 in Chile.

As a result, a large proportion of dollar debt in these countries (more than 90% in some cases) is owed by the private rather than the public sector. Total corporate debt exceeds 100% of GDP in leading emerging economies such as China and Russia. This represents a higher debt overhang than in industrialised countries in 2007-08, just before the subprime crisis.

China's economic slowdown and the decline in commodity prices since early 2013 have seen the dollar's 10-year dollar devaluation cycle go into reverse. Banks and large companies in emerging economies face increasing costs to repay their dollar debts, just when their economies are in trouble.

Specialised investment funds are reining in their emerging market positions to reduce risks. This is increasing pressure on the real economy, as well as on currencies in countries such as Brazil.

All this runs the risk of a vicious circle in many emerging market economies, just one of the uncertainties besetting investors at the beginning of a volatile new year.

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