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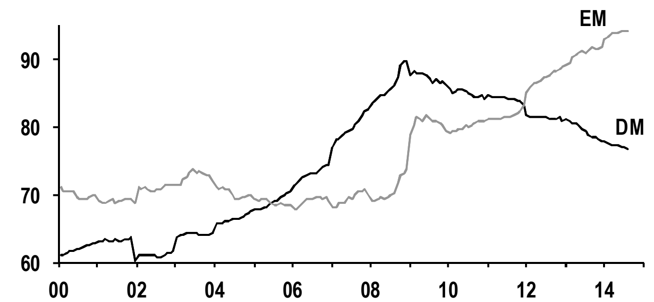
Economic Research Note

EM private leverage still rising

- **IIF survey shows modest net majority of EM banks still tightening lending standards**
- **Growth in EM private bank loans has moderated but still exceeds GDP growth**
- **Buildup of private leverage most worrisome in Asia**
- **Eventual Fed tightening poses risk**

Domestic bank loans

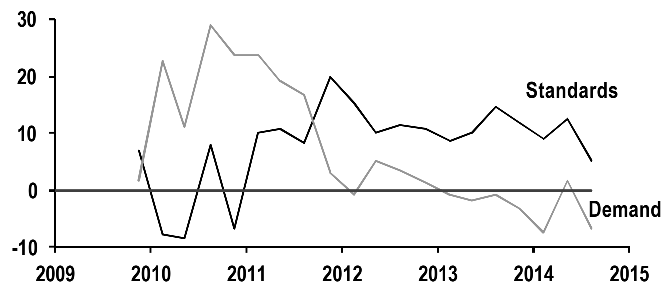
% of GDP



Source: J.P. Morgan

EM bank lending conditions

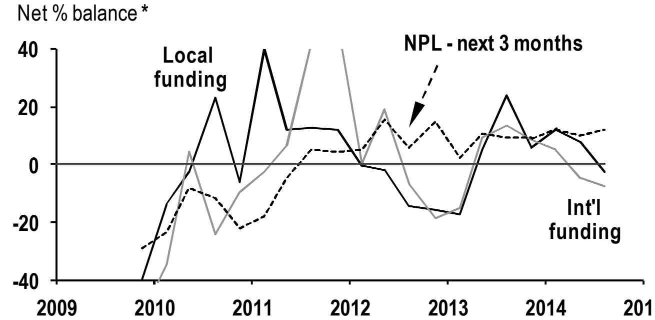
Net % balance*



* Above zero indicates tighter standards or more demand. Source: J.P. Morgan

EM bank lending conditions

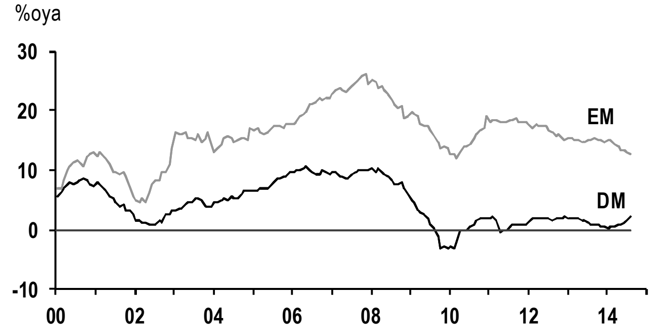
Net % balance *



* Above zero indicates tighter standards. Source: J.P. Morgan

Domestic bank loans

%oya



Source: J.P. Morgan

Our global forecast anticipates that EM growth will remain below potential for a fourth straight year in 2015. Although EM economies are getting a boost from stronger exports to the DM, this is being partly offset by a slowdown in domestic demand growth. The reasons for the demand weakness vary by country, though there also are common causes. EM businesses have curtailed spending to try to rebuild profit margins, slowing the growth of capex, hiring, and consumption. In addition, EM financial conditions have tightened. Likewise, EM banks continue to tighten lending standards, a point reinforced by this week's IIF survey on EM bank lending conditions in 3Q14.

The IIF survey is analogous to the Fed's survey of senior loan officers. We draw on the subset that covers institutions in Asia, Latin America, and EMEA EM. For a brief period after it was unveiled in late 2009, the IIF survey found that a net majority of EM banks were easing lending standards. However, the picture quickly deteriorated in 2011 when the EMU debt crisis intensified, curtailing funding to the EM, including its banks.

Since then, for 15 straight quarters a modest net majority of EM banks have reported that they are tightening lending standards in response to tighter domestic and international funding conditions and a steady escalation in non-performing loans. The survey also has registered a moderation in the growth of EM loan demand. That said, the 3Q14 survey reported a reduced number of banks tightening standards. The main shift was in EM Asia, which moved closer in line with Latin America and EMEA EM. EM banks continue to report higher non-performing loan ratios (NPLs), though recently domestic and overseas funding conditions have been more stable. All told, these developments imply that the credit spigot has been closed somewhat but has not been shut off.

Official data on EM bank credit bear out this assessment. Loan growth to the private sector has moderated by almost one-third since 2011, when banks first started tightening standards. The profile is similar excluding China. Still, EM bank loans are expanding at a double-digit pace and significantly faster than GDP. Consequently, the level of EM credit has risen to near 95% of GDP and is still climbing. In the DM, bank credit peaked near 90% in 2008 and has since retreated to under 80%.

It is impossible to know the "appropriate" level of credit to GDP. This ratio depends on the diversity of the financial system (how bank-centric) and the maturity of its banks, which itself is dependent on such factors as the domestic regulatory environment, culture, and so forth. It is easier to make judgments about the growth of credit. Rapid increases in credit tend to be a telltale sign of deteriorating loan quality. IMF researchers have found that increases in the credit to GDP ratio in excess of 5%-pts in one year were associated with a heightened risk of a financial crisis. In our EM aggregate, the credit ratio has increased about 25%-pts since 2008, or 4%-pts per annum for six years straight. Importantly, the metric only reflects bank loans. Non-bank lending also has been strong in some countries.

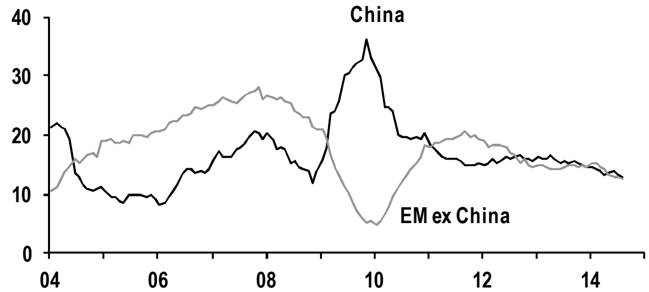
China has played a huge role in the expansion of EM credit. A good portion of the Chinese government's massive 2009 fiscal stimulus was financed via the banks. Chinese loan growth has since subsided, though it has maintained a double-digit pace. Elsewhere in the EM, loan growth collapsed in 2009. This was followed by a bounce back through the peak reached about three years ago. Since that time, loan growth in EM ex. China has decelerated and is tracking 13%oya, similar to China.

EM Asia credit exposure stands out, in terms both of the level and the expansion in the ratio of credit to GDP. China is central to the regional position but the country has company in Singapore, Hong Kong, Thailand, and Malaysia. (Note that social finance in China, which also includes non-bank credit, stands close to 200% of GDP.) In Latin America, the main concern is Brazil. In EMEA EM, it is Turkey.

It is not clear how the buildup in EM private leverage will end, or what its repercussions might be. One likely trigger is Fed tightening. History suggests a rise in US interest rates will pressure the emerging economies, draining portfolio flows and weakening currencies. Domestic interest rates are likely to rise, especially in the more stressed countries where monetary authorities are compelled to tighten policy. To the extent that EM debt is short-term or floating, these rate increases will boost debt service. The likely increase in defaults and bankruptcies will signal banks to curtail lending more aggressively. This process could become a vicious circle, feeding back on economic activity. Some of this debt has been pushed out in duration and some has been issued in local currency, both of which will limit stress. However, the slowing of credit origination and ultimate deleveraging that has yet to begin poses a threat at a time when EM growth already has downshifted significantly.

EM domestic bank loans

%oya



Source: J.P. Morgan

EM domestic bank loans

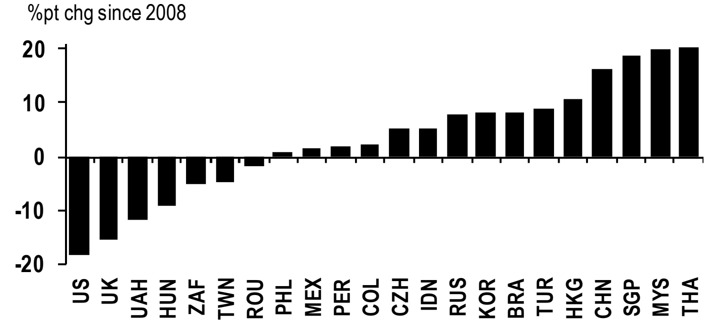
% of GDP

	2008	Aug-14	Change per annum
EM	**70.7**	**94.1**	**4.0**
EM Asia	**97.6**	**123.9**	**4.4**
China	99.6	139.1	6.7
India	49.8	55.6	1.2
Indonesia	23.7	32.2	1.4
Korea	152.2	134.2	-2.9
Malaysia	93.8	121.9	5.1
Singapore	93.8	128.4	5.7
Taiwan	136.9	146.5	0.6
Thailand	90.2	122.1	5.5
Hong Kong	192.8	323.9	20.7
Latin America	**30.0**	**47.6**	**3.0**
Brazil	43.3	71.2	4.9
Mexico	17.0	21.7	0.8
Colombia	29.7	40.2	1.8
Peru	21.8	31.6	1.7
Argentina	9.9	12.5	0.4
EMEA EM	**48.1**	**44.2**	**-0.7**
Russia	36.8	50.9	2.4
South Africa	76.8	69.4	-1.3
Turkey	30.7	68.4	6.2
Czech Republic	44.3	51.6	1.1
Hungary	62.1	46.8	-2.5
Poland	39.5	49.7	1.6

Source: IMF and J.P. Morgan

Household debt as a share of GDP

%pt chg since 2008



Source: J.P. Morgan, BIS, national central banks

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