A closer look at EM bank lending

By Jan Dehn

EM is nearly 50% of global GDP, but EM countries have only issued 22% of the world's outstanding bonds, so there is widespread recognition that EM countries are healthier than developed countries when it comes to bond debt. But what about bank lending? How much do EM countries rely on bank financing? How have trends changed over time and across regions? This Weekly takes a closer look at bank lending in EM and concludes EM countries have generally not binged on bank credit. Bank credit has grown faster within the upper-middle income segment than in other parts of EM, but even within this group, very few countries appear to have borrowed in an irresponsible manner.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	-1.32%
MSCI EM Small Cap	10.3	–	-1.15%
MSCI Frontier	11.0	–	0.80%
MSCI Asia	11.1	–	-1.51%
Shanghai Composite	9.4	–	0.69%
Hong Kong Hang Seng	7.2	–	-2.38%
MSCI EMEA	8.7	–	0.41%
MSCI Latam	11.6	–	-0.26%
GBI-EM-GD	6.63%	–	0.37%
ELMI+	5.21%	–	0.28%
EM FX spot	–	–	0.35%
EMBI GD	6.87%	400 bps	0.84%
EMBI GD IG	5.09%	221 bps	0.89%
EMBI GD HY	8.94%	609 bps	0.80%
CEMBI BD	6.35%	356 bps	0.36%
CEMBI BD IG	5.15%	236 bps	0.42%
CEMBI BD Non-IG	8.02%	523 bps	0.27%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.8	–	-3.76%
1-3yr UST	2.71%	–	0.23%
3-5yr UST	2.70%	–	0.58%
7-10yr UST	2.85%	–	1.30%
10yr+ UST	3.14%	–	3.01%
10yr+ Germany	0.25%	–	1.28%
10yr+ Japan	0.04%	–	0.24%
US HY	7.32%	440 bps	-0.14%
European HY	4.89%	559 bps	-0.73%
Barclays Ag	2.13%	-72 bps	0.87%
VIX Index*	23.23	–	5.16%
DXY Index*	96.51	–	-0.53%
EURUSD	1.1431	–	0.68%
USDJPY	112.62	–	-0.92%
CRY Index*	184.15	–	2.41%
Brent	62.0	–	0.47%
Gold spot	1248	–	1.39%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

There is gradual recognition among investors that Emerging Markets (EM) are far less indebted than developed countries when it comes to bonds. About time, one might say. EM countries have issued USD 24.3trn of bonds, which is equivalent to 22% of the USD 109.6trn global bond market. EM countries account for about half of global GDP. Hence, EM countries are less indebted than developed countries in terms of GDP. This is clear from Figure 1, which show that EM bond debt to GDP is 77% compared to 177% of GDP for developed countries.

Fig 1: **The global bond universe (as of December 2017)**

Asset class	USD trn	% of global bond universe	% of GDP (global, EM, DM)
Global bond market	**109.6**	**100%**	**137%**
Governments	53.2	49%	67%
Corporate	56.4	51%	71%
Non-financial corporates	*14.9*	*14%*	*19%*
Financial corporates	*41.5*	*38%*	*52%*
Emerging Markets	**24.3**	**22%**	**77%**
Governments	11.5	10%	36%
Corporate	12.9	12%	41%
Non-financial corporates	*5.1*	*5%*	*16%*
Financial corporates	*7.8*	*7%*	*25%*
Developed markets	**85.3**	**78%**	**177%**
Governments	41.8	38%	87%
Corporate	43.5	40%	90%
Non-financial corporates	*9.9*	*9%*	*20%*
Financial corporates	*33.6*	*31%*	*70%*

Source: Ashmore, BIS.

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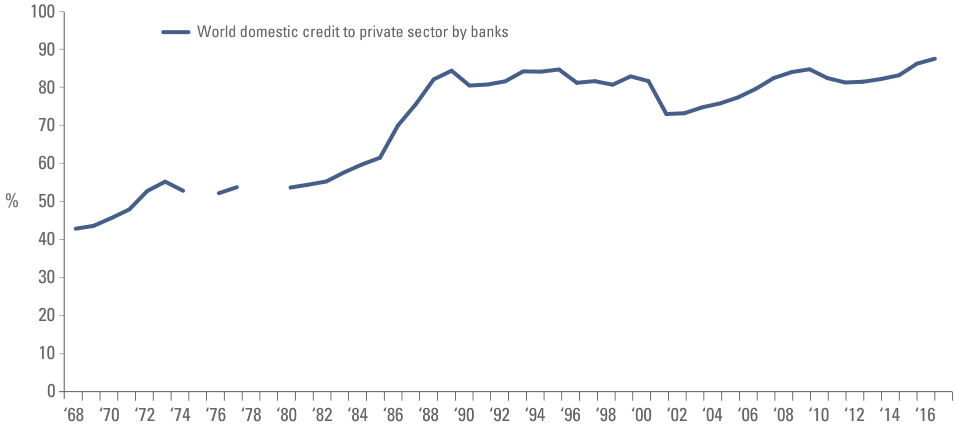
However, there is less appreciation of the level of EM indebtedness, when it comes to bank financing. To throw some light on this issue, it is useful to start with the global picture and then zoom in closer to EM. Figure 2 depicts the evolution of bank credit to the private sector (as a percentage of GDP) from 1968 to 2016 for the world as a whole.[1] Over this period, bank credit has grown steadily from 43% of GDP to 87% of GDP, indicating that the world has become significantly more banked, but at a relatively steady rate averaging 1.8% of GDP per year. The Big Bang in bank regulation and the use of credit cards appears to have pushed up bank penetration in the mid-1980s, while bank credit declined after the bursting of the Dotcom Bubble around the turn of the century and again following the 2008/2009 Developed Markets Crisis.

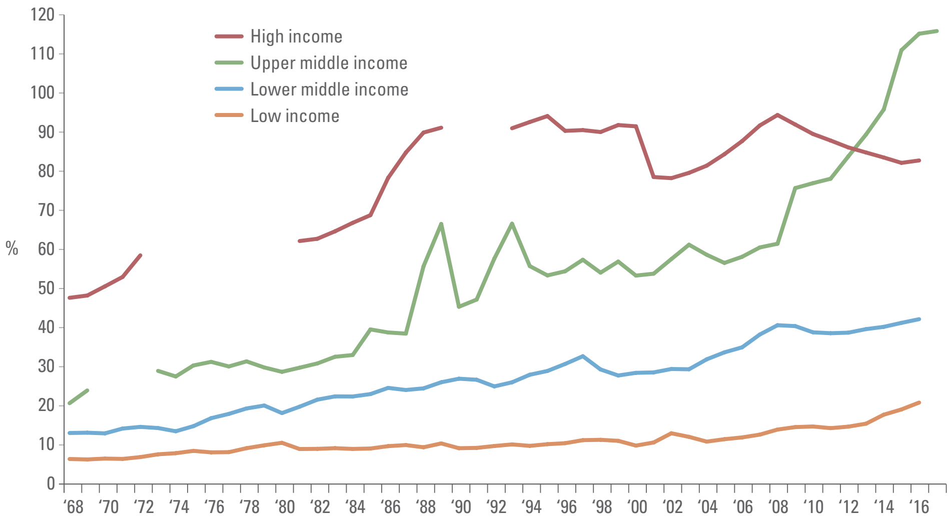
Fig 2: **World Domestic credit to the private sector from banks (% of global GDP)**



Source: Ashmore, World Bank.

Drilling deeper, consider how bank credit has evolved across the World Bank's four per capita GDP income categories (high income, upper-middle income, lower-middle income and low income). EM countries are predominantly found within low, lower-middle and upper-middle income categories, although some EM countries can also be found in the high income group, including Argentina, Panama, Bahrain, Chile, Czech Republic, Hong Kong, Korea, Oman, Panama, Poland, Taiwan, UAE, Uruguay and others.[2] Figure 3 shows that there are significant differences in the evolution of bank credit across the four income groups. Firstly, bank credit has increased in a very steady fashion from a very low base among low and lower middle-income countries. The trend higher in bank credit likely reflects the natural tendency for poor countries to become more banked as they develop. Second, bank credit been volatile around a flat trend since the mid-1990s in high-income countries. This pattern probably reflects the fact that developed markets are prone to financial bubbles and that bank penetration is generally close to complete. Finally, the big outlier among the income groups is the upper-middle income countries, where bank credit as a share of GDP has doubled from about 60% of GDP in 2008 to 116% of GDP in 2017.

Fig 3: **Bank credit as % of GDP by per capita income group (1968-2017)**[3]



Source: Ashmore, World Bank.

[1] All the data on bank credit is from the World Bank's Databank: http://databank.worldbank.org/data/home.aspx. Year-end 2016 is the last full year with full global data.
[2] According to the World Bank's system of income classification, there are 81 high-income countries, 56 upper-middle income countries, 47 lower-middle income countries and 34 low-income countries. EM countries with many poor people sometimes make it into the high-income group due to significant income inequality, i.e. a few very wealthy individuals skew average per capita GDP to the high side. The World Bank generates income group aggregates using GDP-weighted country-specific statistics.
[3] The data on upper-middle income is available up to and including year-end 2017.

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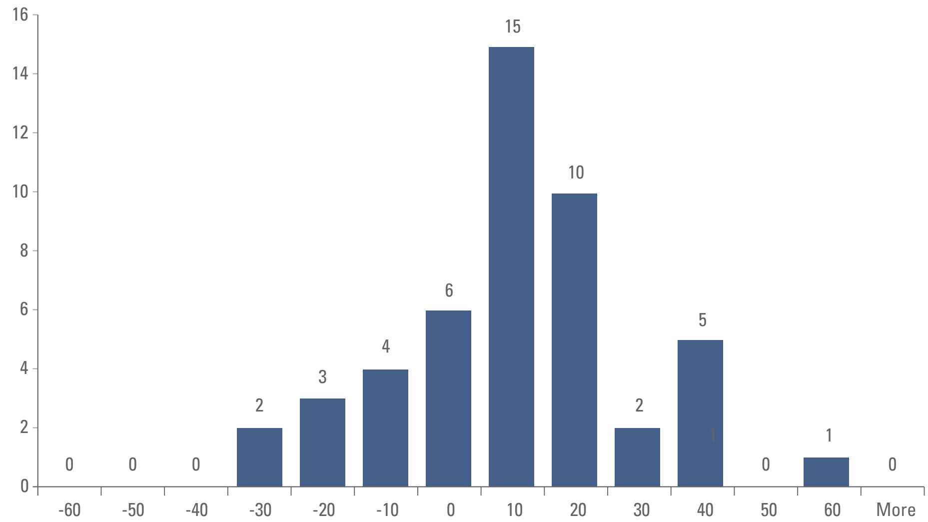
There are several possible explanations for the sharp rise in bank credit in upper-middle income countries. One explanation is that the upper-income group contains the fastest growing countries in the world, so bank penetration is naturally more rapid than in slower growing economies. The upper-middle income group also includes a number of Asian economies with much higher savings rates than in other countries. Higher saving rates means more money in the bank (as a percentage of GDP), which in turn means more bank credit, all else even. The World Bank's method for aggregating across countries using GDP weights also disproportionately skews group averages higher. For example, a country, such as China, which is large, has very high savings rates and has experienced rapid structural improvement in banking and fast economic growth, will naturally dominate the group average. It is also likely that banks in upper-middle income countries have been more successful in gaining market share at the expense of bond markets than banks in lower income segments in recent years. Finally, the rise in bank credit may simply reflect bad macroeconomic policies and unsustainable bank lending.

In order to get a sense of the relative importance of these different explanations, we examine how changes in bank credit over the last decade have been distributed within the upper-middle income segment (Figure 4). The average increase in bank credit is 6% of GDP and the median is 9%, so a small number of outliers in the right hand tail affects the distribution. Most countries in the group are clustered around the 0% and 20% of GDP segment, i.e. bank credit has grown up to 20% over the past ten years. This rate of bank credit expansion is entirely in line with the long-term average growth rate in bank credit from Figure 1, i.e. does not warrant concern.

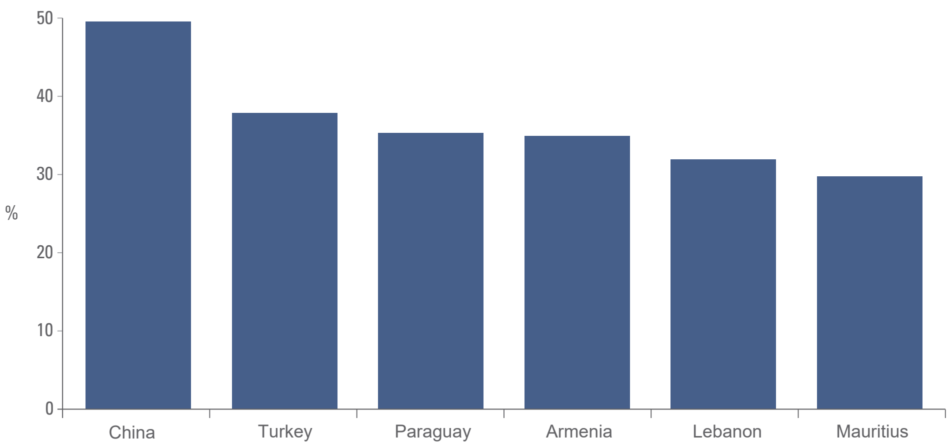
Fig 4: **Frequency distribution of changes in bank credit as a percentage of GDP**



Source: Ashmore, World Bank.

This means that the sharp rise in bank credit for upper-middle income countries over the past decade can be attributed to just six countries clustered within the right-hand tail of the distribution in Figure 4. These countries and their respective growth in bank credit over the past decade are shown in Figure 5.

Fig 5: **Countries with more than 20% of GDP bank credit expansion in the last decade**



Source: Ashmore, World Bank.

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Unsurprisingly, China features prominently within this group of six. China's savings rate in excess of 45% as well as the country's rapid financial and economic development have precipitated a dramatic increase in banking, which in turn has pushed up deposits in the banking system and thereby forced an increase in the extension of bank credit. Deposits in China were more than 198% of GDP as of the end of 2017, which is nearly 40% higher than in 2007. The good news is that deposits are the most stable source of bank funding and that Chinese bank credit mainly finances infrastructure investment, which is growth enhancing. Hence, we do not think China's credit growth reflects macroeconomic policy mismanagement. By contrast, Turkey, also among the six, saw bank credit growth expand rapidly mainly due to excessively loose monetary policies. This year's currency crisis was the result. The other four countries are Lebanon, Paraguay, Armenia and Mauritius. Paraguay is an improving credit story built on rapid development and credit improvement. Lebanon is more precarious, because funding is from overseas, although, unlike Turkey, the funding in Lebanon is diaspora-based, which tends to be more stable than bank funding. Finally, Armenia and Mauritius are not important allocations in most EM investors' portfolios.

What should investors conclude from this analysis? First, EM countries have generally not binged on bank credit. Second, the small segment of EM countries with unusually sharp rises in bank credit are strictly contained within the upper-middle income segment and within this small group only a few countries appear to have borrowed in an irresponsible manner. This reinforces the broader observation that EM credit fundamentals are generally sound and that only a small number of countries fall from grace in any given year. Such exposures are best handled with active management.

- Argentina: The central bank eliminated a minimum threshold for the policy rate of 60% as inflation expectations decline. The threshold is obsolete in any case, because the central bank targets monetary aggregates. Industrial production contracted at a yoy rate of 6.8% in October (though much better than -11.5% yoy in September). President Mauricio Macri's approval rating increased marginally to 42.2%.

- Brazil: The leader of PSDB, a major political party in Brazil, said last week that his party will support the Bolsonaro Administration's tax and pension reform proposals. Industrial production expanded at modest yoy rate of 1.1% in October and IPCA inflation declined to 4.05% yoy in November from 4.56% yoy in October.

- China: Inflation declined, trade weakened and services activity improved. CPI inflation declined to 2.2% yoy in November from 2.5% yoy in October. Imports and exports were also lower than anticipated in November with exports rising at a yoy pace of 5.4% (9.4% yoy expected) and imports rising at a rate of 3.0% yoy (14% yoy expected). The two drivers of the lower than expected numbers were tech and commodities. Meanwhile, the Caixin services PMI shifted sharply higher to 53.8 in November from 50.8 in October. The consensus expectation was 50.7. FX reserves also rose USD 9bn to USD 3.06trn in November. Finally, we note that year-to-date inflows to the Chinese government bonds have now reached a level, which is nearly the same as the entire stock of foreign portfolio holdings in the Brazilian bond market (Brazil is EM's second largest bond market).

- India: The Reserve Bank of India (RBI) left the policy rate unchanged at 6.5%, but maintained a hawkish bias even as RBI's inflation forecasts for this fiscal year dropped to 3.6% from 4.3%. Services PMI surged to 53.7 in November from 52.2 in October. The Q3 2018 current account deficit was USD 19.1bn compared to the consensus expectation of USD 19.9bn. Elections have kicked off in five states, which will provide an indication of how the balance of power may change in the 2019 parliamentary election next year. Exit polls point to a hung parliament in next year's parliamentary election. Final results will be available tomorrow.

- Mexico: President Andres Manuel Lopez Obrador said last week that oil contracts signed under the energy reform of 2013 will be honoured, but he also urged companies to step up production. PMIs delivered mixed messages with one index (Inegi) rising and the other index (Markit) declining. Core inflation declined to 3.63% yoy in November from 3.73% yoy in October.

- South Africa: South Africa rebounded out of recession with a stronger than expected growth rate of 1.1% yoy in Q3 2018. The market has expected 0.5% yoy growth. The current account deficit increased marginally to 3.5% of GDP in Q3 2018 from 3.4% of GDP in Q2 2018.

Snippets:

- Angola: IMF approved a USD 3.7bn credit to Angola under the Extended Fund Facility of which USD 991m will be made available immediately.
- Chile: Bank of Chile left the policy rate unchanged at 2.75%. October retail sales were strong (7.4% yoy versus 1.4% yoy in September).
- Colombia: CPI inflation was 0.1% in November, which was below expectations (0.2% mom).
- Costa Rica: Moody's downgraded the sovereign to B1 from Ba2 with negative outlook over long-standing fiscal concerns.
- Czech Republic: Industrial production was up 6.7% yoy in October, rebounding from -0.9% yoy in September, while inflation was -0.1% mom in November, down from +0.4% mom in October.

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- **Ecuador:** Vice-president Maria Vicuna stepped down over allegations of corruption.
- **Egypt:** CPI inflation declined to 15.7% yoy in November from 17.7% yoy in October.
- **Hungary:** The Statistical Office revised the Q3 2018 real GDP growth rate higher from 4.8% yoy to 4.9% yoy.
- **Kazakhstan:** The National Bank of Kazakhstan kept the policy rate unchanged at 9.25%.
- **Malaysia:** Exports powered ahead at a yoy rate of 19.6% in October compared to 8.3% yoy in September.
- **Nigeria:** The rate of real GDP growth increased to 1.8% yoy in Q3 2018 from 1.5% yoy in Q2 2018.
- **Philippines:** The yoy rate of CPI inflation slowed significantly from 6.7% in October to 6.0% in November.
- **Poland:** The National Bank of Poland left the policy rate unchanged at 1.5%.
- **Qatar:** FX reserves rose to USD 46.5bn in September, according to central bank sources. Reserves fell below USD 15bn in late 2017 during a diplomatic dispute with Saudi Arabia.
- **Russia:** Food prices pushed yoy consumer prices to 3.8% yoy in November from 3.5% yoy in October.
- **South Korea:** Inflation was stable at 2.0% yoy in November.
- **Taiwan:** Headline inflation was 0.31% mom in November versus 0.90% mom expected. Export slumped to -3.4% yoy in November versus +1.3% yoy expected due to poor iPhone orders.
- **Turkey:** The yoy rate of real GDP growth was 1.6% in q3 2018, which was lower than expected (2.2% yoy) and much slower than growth in Q2 2018 (5.3% yoy). Growth on a qoq sa basis was -1.1% in Q3 2018.
- **Ukraine:** The IMF Board will likely approve a new USD 3.9bn standby agreement for Ukraine on 18 December after President Poroshenko signed the 2019 Budget into law on Friday.
- **Venezuela:** The Andean Development Fund (CAF) turned down a request from Venezuela for fresh funding.

Global backdrop

Regarding the US-instigated trade war, China announced last week that violations of intellectual property would be more severely punished, while committing to deliver on obligations agreed within the terms of the 90 days truce with the US government. Reeling over the negative market and economic impact of its own trade war, the US government last week indicated that it might grant China more than 90 days to comply with the agreed changes in the trade regime. As far as China is concerned, they are going to undertake the commitments under the trade truce anyway as part of China's broader multi-year programme of economic liberalisation. As such, the trade war merely gives political cover for reforms with the possibility of extracting US concessions in exchange. Time will also favour China, partly because China has far more tolerance for pain than America, partly because growth differentials will soon favour China as US growth slows further under waning fiscal stimulus and rising interest rates, while China's economy is about to benefit from a pickup in fiscal spending.

The spread between 5-year and 3-year bond yields went negative last week as the evidence of a slowdown in US growth continues to mount. Recent economic data, including Friday's payroll data, point to a gradual slowdown in economic growth in the US, with the main risk skewed towards a faster slowdown. In addition to yield curve inversion, there are plenty of other indicators, which point to mounting economic headwinds, including weaker performance in the high yield credit sector and rising claims for unemployment benefit (the 4-week average increased again last week). Tariffs, the over-valued Dollar, Fed hikes and wages are also eating into company earnings.

In Europe, Annagret Kramp-Karrenbauer (AKK) was chosen to succeed Angela Merkel as leader of the CDU party. A close ally of Merkel, AKK's rise to the leadership signals policy continuity within the CDU. The next important electoral contest is the May 2019 European Parliamentary election. German industrial orders increased 0.3% in October from 0.1% mom in September.

Confirming that developed economies struggle with even the most basic of economic reforms, the French government abandoned a planned hike in fuel taxes after widespread protests, which continued over the weekend. By U-turning, the government has sent a powerful signal that resistance to reforms pays, making future reforms even more challenging.

In the UK, the probability of hard Brexit declined after the European Court of Justice this morning confirmed that the UK government can unilaterally revoke the decision to leave EU. All eyes will be on an expected parliamentary vote early this week on Prime Minister Theresa May's Brexit deal, though a delay cannot be ruled out. If May's deal is rejected a number of possibilities emerge, including a leadership contest, fresh elections, a hard Brexit in March of next year or even a new referendum. Facing these choices, the government's best option may be to play for time.

Finally, oil found some support on Friday as OPEC agreed to cut production by 1.2m barrels.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.32%	-6.19%	-13.19%	-8.34%	9.65%	2.33%
MSCI EM Small Cap	-1.15%	-6.72%	-18.05%	-12.39%	4.03%	1.27%
MSCI Frontier	0.80%	-0.65%	-13.21%	-11.10%	5.67%	1.88%
MSCI Asia	-1.51%	-7.53%	-13.18%	-9.12%	9.02%	4.55%
Shanghai Composite	0.69%	-7.61%	-19.28%	-18.41%	-7.69%	5.46%
Hong Kong Hang Seng	-2.38%	-5.87%	-7.82%	-3.20%	6.12%	2.03%
MSCI EMEA	0.41%	-2.11%	-13.89%	-5.49%	8.09%	-2.07%
MSCI Latam	-0.26%	0.94%	-5.80%	-0.61%	13.69%	-1.28%
GBI EM GD	0.37%	1.17%	-7.07%	-4.89%	4.85%	-1.26%
ELMI+	0.28%	0.80%	-3.72%	-2.43%	3.25%	-0.99%
EM FX Spot	0.35%	-0.49%	-8.82%	-7.42%	-1.54%	-7.17%
EMBI GD	0.84%	-1.75%	-4.74%	-4.27%	4.69%	4.92%
EMBI GD IG	0.89%	-1.39%	-3.15%	-3.03%	3.92%	4.32%
EMBI GD HY	0.80%	-2.12%	-6.45%	-5.67%	5.50%	5.45%
CEMBI BD	0.36%	-0.40%	-2.00%	-1.85%	4.77%	4.37%
CEMBI BD IG	0.42%	-0.33%	-1.32%	-1.30%	3.41%	3.85%
CEMBI BD Non-IG	0.27%	-0.49%	-2.80%	-2.48%	7.01%	5.01%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-4.55%	-9.27%	0.32%	1.80%	10.46%	10.07%
1-3yr UST	0.23%	0.74%	0.98%	0.98%	0.72%	0.68%
3-5yr UST	0.58%	1.37%	0.46%	0.40%	0.84%	1.17%
7-10yr UST	1.30%	2.31%	-0.50%	-0.59%	0.89%	2.39%
10yr+ UST	3.01%	1.76%	-4.13%	-3.50%	1.51%	5.19%
10yr+ Germany	1.28%	3.21%	6.08%	3.99%	3.92%	7.35%
10yr+ Japan	0.24%	1.39%	0.69%	1.05%	3.57%	4.09%
US HY	-0.14%	-2.59%	-0.08%	0.19%	7.26%	4.36%
European HY	-0.73%	-3.95%	-3.90%	-3.76%	3.15%	4.00%
Barclays Ag	0.87%	0.06%	-2.31%	-1.76%	2.30%	0.81%
VIX Index*	28.56%	91.67%	110.42%	142.48%	20.11%	67.00%
DXY Index*	-0.78%	1.45%	4.76%	2.78%	-1.46%	20.69%
CRY Index*	1.33%	-5.64%	-5.01%	-0.47%	4.02%	-34.41%
EURUSD	0.98%	-1.49%	-4.78%	-2.87%	4.47%	-16.93%
USDJPY	-0.82%	-0.95%	-0.06%	-0.84%	-7.35%	9.50%
Brent	5.57%	-25.07%	-7.31%	-2.24%	56.00%	-43.34%
Gold spot	2.06%	4.63%	-4.25%	0.46%	16.44%	-1.15%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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