

Bank flows and the state of EM

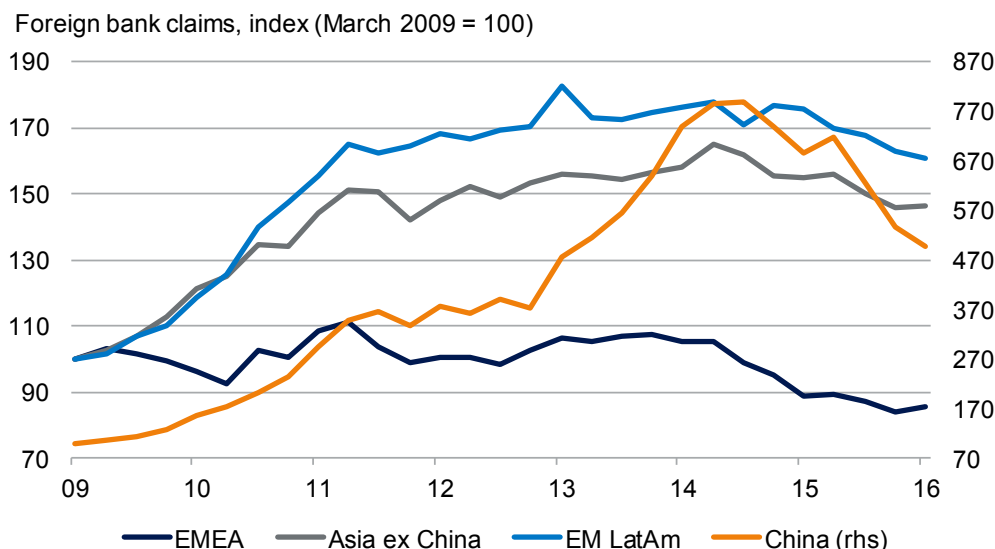
New data offers a more granular look at lending to EMEs

The Bank for International Settlements (BIS) recently released its quarterly update, including a plethora of statistics on lending across borders. For the first time, the BIS also made available a breakdown of country to country flows, rather than dealing only with aggregate claims. In what follows, we take this opportunity to examine which emerging markets (EM) may be building up credit risks, and which countries are helping to finance them.

Dividing EM into broad regions, it is clear that capital flows have increased far more rapidly to Asia and Latin America than to the Europe, Middle East and Africa (EMEA) region. This would indicate a build up of risks is more likely in the first two regions than in the latter. China, as ever, is in a league of its own, with cross-border flows at one point over seven times their March 2009 levels (chart 9). Over the last 18 months, however, all regions have seen these flows decline, with a combination of Federal Reserve (Fed) and China worries likely drivers. Whilst encouraging in that this indicates that deleveraging and a reduction of risk may be underway, it will also serve as a drag on regional activity. Arguably there is scope for a rebound in EMEA lending at least, given that current activity is below 2009 levels.

Chart 9: EMEA seems to have missed out on the foreign credit rush

Risks likely to be concentrated in Asia and Latin America

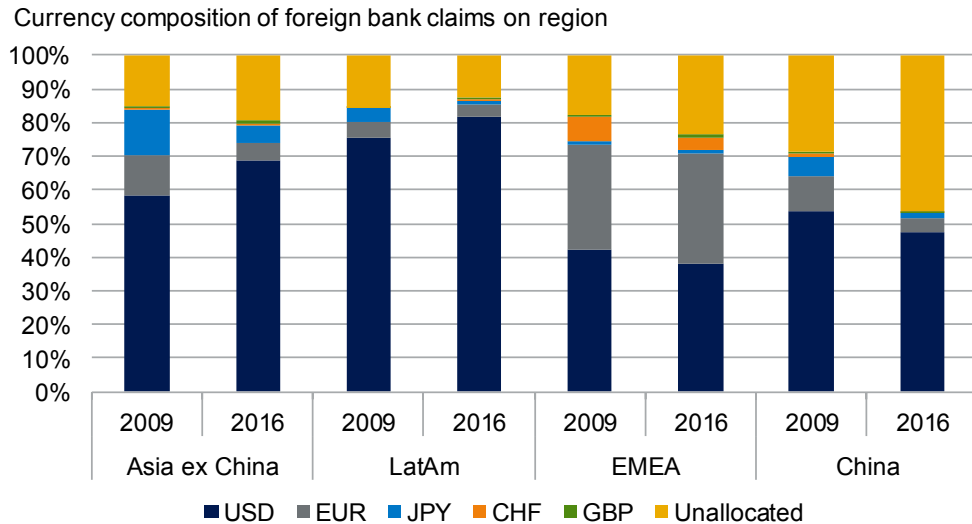


Source: Bank for International Settlements, Schroders Economics Group. 26 September 2016. EMEA consists of the Czech Republic, Hungary, Poland, South Africa, Turkey, Russia. Asia ex China consists of India, Indonesia, Malaysia, Philippines, Thailand. EM LatAm consists of Brazil, Chile, Colombia, Peru.

The BIS also provide data on the currency composition of these flows, showing that the euro vies with the dollar for dominance in EMEA, but elsewhere the dollar dominates (chart 10). There is little evidence in Asia that easy policy by the Bank of Japan has encouraged much uptake of yen – the share of yen in total financing has actually fallen from 13.6% in March 2009 to 5.4% in March 2016. US quantitative easing (QE) instead looks to have been the dominant monetary policy force in Asia and Latin America. Borrowers in EMEA have turned marginally towards euro financing, though both in EMEA and China the bigger increase has been in “unallocated” (non-reported) denominations.

Chart 10: The dollar still reigns supreme outside Europe

High use of the dollar emphasises the importance of the Fed



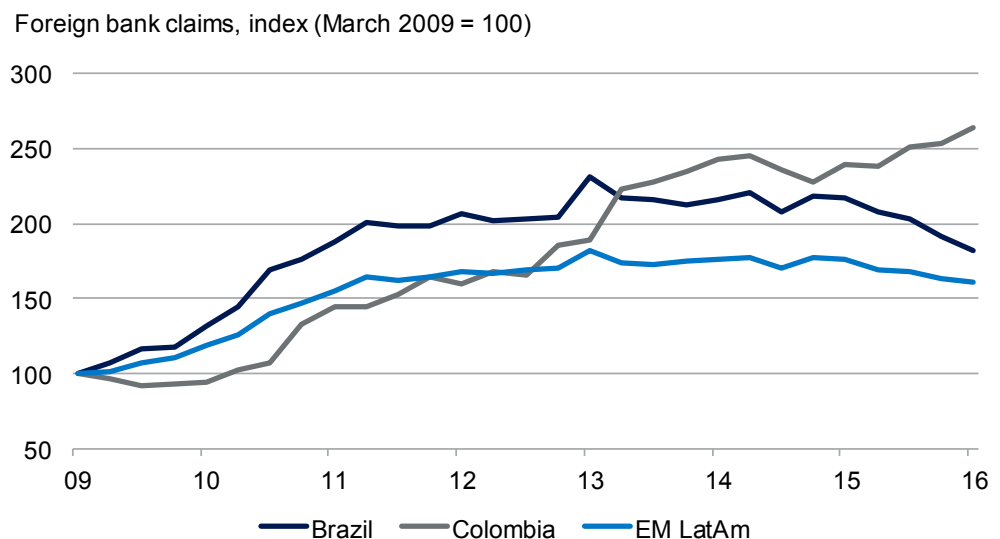
Source: Bank for International Settlements, Schrodgers Economics Group. 26 September 2016. EMEA consists of the Czech Republic, Hungary, Poland, South Africa, Turkey, Russia. Asia ex China consists of India, Indonesia, Malaysia, Philippines, Thailand. EM LatAm consists of Brazil, Chile, Colombia, Peru. Data as of Q1 2016. Claims are in gross terms.

Region by region: where do the problems lie?

Of course, regional aggregates can mask quite striking disparities. In Latin America, for example (chart 11), from 2009 to 2013, Brazil led the regional average higher, and as the largest constituent has continued to dominate since. During that time, Colombia has seen its borrowing massively outpace the rest of the region following a period of relatively sluggish growth. The first leg of this surge coincides with a slowdown in metals prices, and a second leg upwards occurs as oil prices slumped.

Chart 11: Should we be worried about Colombia?

Colombia bucks the declining trend despite a negative backdrop



Source: Bank for International Settlements, Schrodgers Economics Group. 26 September 2016.

As a major commodity exporter, it seems fairly apparent that Colombia was forced to borrow to make up for collapsing export earnings, and this is reflected by the current account deficit, which has expanded from 2.2% of GDP in 2009 to around 5% today – though we have seen improvements recently. Though the recent OPEC agreement on cutting production offers some hope of a modest

recovery in oil prices, a return to pre-shale pricing seems very unlikely, and so the ongoing growth in cross border claims (in contrast to the prevailing trend for the rest of EM) is a cause for concern.

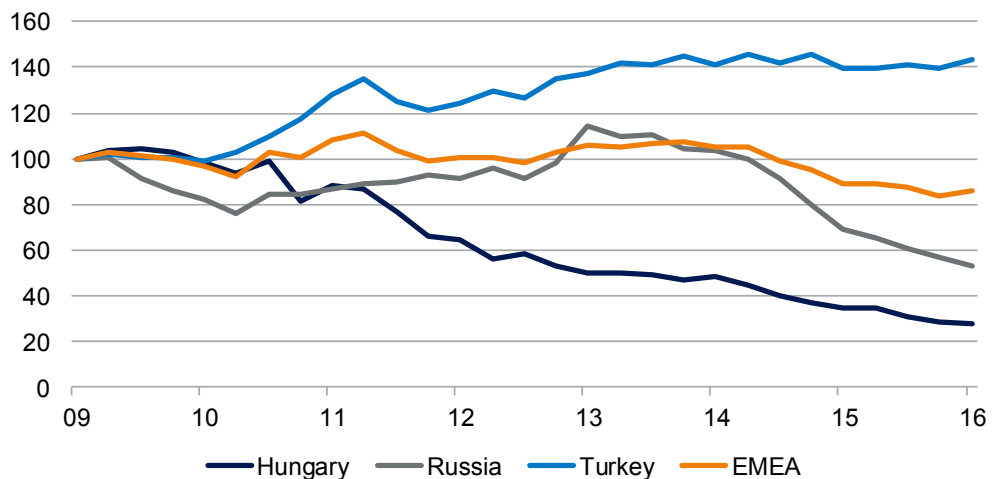
The question then is, which foolhardy country is bankrolling this spree? The country's largest international lender is the US, whose banks accounted for 39% of all cross border claims in Q1 2016, and while this share has climbed slightly over the last two years, the more significant increase has been led by eurozone banks (16% of cross border claims, up from 7% in 2009), particularly the French. This diversification can provide some mitigation of risks, but 80% of the claims are still denominated in USD, so tighter dollar liquidity remains a big risk.

As discussed, EMEA as a region has seen a far less frenetic pace of credit expansion by foreign banks, but one country has still managed to ramp up overseas exposures. Though this source of credit growth appears to have stabilised, Turkey has seen the largest increase in foreign bank claims of any country in EMEA. Turkish banks appear to have been the main beneficiaries, accounting for 54% of claims, up from 29% in 2009. Growing reliance by a domestic banking sector on foreign funds typically suggests a growing currency mismatch between assets and liabilities, a key ingredient in many EM crises. Financial stability in Turkey will be increasingly reliant on the kindness of strangers, in this case the UK (22% of claims) and assorted Eurozone countries who between them account for 50% of all cross border claims on Turkey. Even though 72% of claims originate from European lenders, 46% of claims are still dollar denominated. So Turkey is less reliant on dollar liquidity than EMEs in Asia and Latin America, but it would be a mistake to think its European creditor base insulates it entirely from Fed action.

Growth for Turkey but large declines in Russia and Hungary

Chart 12: Contrasting experiences in EMEA

Foreign bank claims, index (March 2009 = 100)



Source: Bank for International Settlements, Schrodgers Economics Group. 26 September 2016.

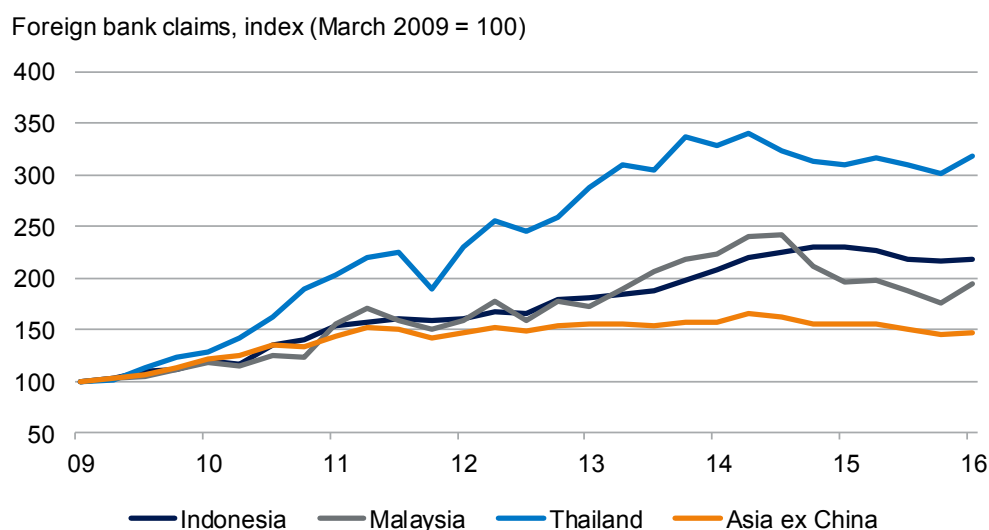
By contrast, Hungary has seen a collapse in flows from overseas. This is chiefly connected to the legal issues in the country around foreign currency (chiefly the Swiss franc) mortgages, which the government ultimately forced foreign banks to pay for after the Hungarian forint suffered a large depreciation against the Swiss franc. We can see this in a more granular analysis of the data; Swiss franc claims have fallen to less than 5% of their 2009 level, and claims by Austrian and German banks (key mortgage generators and the biggest foreign lenders for Hungary) have also fallen sharply. Russia meanwhile has seen a recent decline linked to sanctions related to the Ukrainian crisis.

In Asia, the focus is almost always on China when it comes to debt. While, as we saw in chart 9, China is literally on another scale compared to the rest of EM,

Thailand stands out in Asia, after China

there are other economies in Asia which have seen sizeable increases in foreign claims (chart 13). Thailand, in particular, stands out for the rate of increase. Indonesia and Malaysia are also notable for their above average growth in reliance on foreign banks. Perhaps unsurprisingly, Japan is a more active lender in the region than other major economies, accounting for 37% of foreign bank claims on Thailand and 20% of claims on Indonesia. Interestingly, Hong Kong banks rank second for Thailand and Indonesia, and actually have the biggest share of claims on Malaysia, at 15%. Our suspicion is that Hong Kong will often be a proxy for Chinese involvement in bank lending, with Chinese bank claims not reported. Given China’s global ambitions, it would be odd if there were not a significant Chinese lending presence, and this perhaps accounts for the large share of “unallocated” bank claims. Around 40–50% of bank claims on these three economies are not assigned to a particular country. Fed policy then perhaps matters less here, especially when we combine the low presence of US banks with the relatively low share of USD denominated lending (chart 10). The bigger risks here stem from the Japanese and Chinese monetary authorities, and we think liquidity problems in China would not take long to spread to these three regional economies as a result.

Chart 13: China is not the only Asian economy of concern



Source: Bank for International Settlements, Schroders Economics Group. 26 September 2016.

Data on flows to China still opaque

As for China, it turns out that 42% of foreign bank claims on the country come from banks located in Hong Kong, with Taiwanese banks in a distant second at 9%. Capital controls in China likely mean that Hong Kong banks are used as channels for overseas capital, so we should also consider the overseas claims on Hong Kong. The largest lender here is Japan (18%), followed by the UK (11%). The US comes in after Taiwan and Macao, with 7% of bank claims. The Eurozone as a whole accounts for some 13%, and there is also a reasonable Australian presence. Lending to China is most probably a fairly global industry. As for the recipients, 60% of claims on China are made on the banking sector, implying a sizeable chunk going to non-banks, but the data does not reveal whether the remainder is channelled towards non-bank financial institutions (shadow finance) or non-financial corporates. Either way, the rapid build up is troubling for what it says about China’s growing reliance on foreign capital, which is much harder to control than domestic flows. However, we would note that the rapid decline since mid-2015 (when the authorities devalued the currency and sparked a wave of FX repayments by firms nervous about further increases in the cost of their FX debt) has reduced vulnerabilities somewhat, even if there is much further to go.