IN SEARCH OF DISTRESS RISK IN EMERGING MARKETS

Discussion by Stephen G. Cecchetti

www.moneyandbanking.com
When is EME corporate default more likely?

• Firm characteristics
• Home country conditions
• U.S. financial conditions

Data: Mostly 2002 to 2015, 25 countries, publicly traded, market access, large, peak year there are more than 6000 firms, 590 default events.

Estimates: Logit model on monthly panel, determinants lagged one month.
When is EME corporate default more likely?

• Firm characteristics
  • Low profitability
  • Low level of cash
  • High leverage
  • High market-to-book ratio (?)
  • Prior default (?)
When is EME corporate default more likely?

• Firm characteristics

• Home country conditions
  • Higher unemployment
  • Lower inflation
  • Lower real interest rate
  • Lower sovereign spread
When is EME corporate default more likely?

• Firm characteristics
• Home country conditions
• U.S. financial conditions
  • U.S. monetary policy tightening
  • VIX increases (S&P500 volatility)
  • TED spread rises (3 mon USD LIBOR – 3 mon UST)
Why do we care?

• EME firms’ debt rose under favorable conditions
• Risks: maturity and rollover (& currency)
• Transmission mechanisms of distress:
  • Bank asset impairment
  • Large firms resort to banks, crowding out SMEs
  • Reduced intermediation
    (EME “nonfinancial” corporates can be intermediaries)
  • Trigger a general slowdown
A few points

• Level and growth in EME debt
• Reliance on US dollar
• US policy spillovers in general
• Impact of US policy on EME corp default
EME Non-financial corporate debt

Dramatic growth in debt (13.6% a.r.)

From 12 to 37% of GDP

Foreign currency share is declining.

Note: China from 45% to 68% of the total.

Source: Institute for International Finance, Global Debt Monitor
Significant fraction in foreign currency.

**Current composition:**
- Government: 45%
- Financials: 25%
- Nonfin Corp: 30%
A few points

• EME Debt: large, rising, primarily from banks

  Do the same factors create distress for bank borrowers?

• US dollar
• US policy spillovers
• Impact of US policy on EME Corp Default
Importance of the US dollar

- Imports: 30% of non-American trade is in USD
- Non-US banks have >$15 trillion liabilities
- Foreigners hold 45% of US Treasuries (>6 tr)
- ~90% of FX transactions have USD as one leg
A few points

• EME Debt: large, rising, primarily from banks
• US dollar: important outside the US
  US interest rates matter for everything!
• US policy spillovers
• Impact of US policy on EME Corp Default
Change in leverage following extended monetary policy easing

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US Easing has a BIGGER impact than domestic easing
A few points

• EME Debt: large, rising, primarily from banks
• US dollar: dominant outside the US
• US policy spillovers: big impact on non-US financials

Bigger impact on financial leverage than domestic policy

• Impact of US policy on EME Corp Default
US financial and distress risk in EMEs

What is the impact of US policy tightening?

Fed funds rate +1.00pp
5yr UST rate +0.75pp
US financial and distress risk in EMEs

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Average default rate in ACH data:
0.088% per month ⇒ 1.05% per year
Impact of tightening = 0.13pp
US financial and distress risk in EMEs

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5yr UST rate +0.75pp

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Median annual defaults is 33 ⇒ increases by 4!

(When US tightens policy, exchange rates and sovereign spreads move, too.)
US financial and distress risk in EMEs

Lower leverage $\Leftrightarrow$ tighter monetary policy

Distressed firms: Liabilities = 58% of total assets

Equivalence:

1pp tightening $\approx$ 15% reduction in debt
A few points

• EME Debt: large, rising, primarily from banks
• US dollar: dominant outside the US
• US policy spillovers: big impact on non-US financials
• Impact of US policy on EME corp default is large
Should EME policymakers do anything?

• Advance economy policymakers will do nothing!
• Standard policy recommendations:
  • Improve monitoring
  • Financial system resilience to ΔFX & shifts in capital flows
  • Remove tax incentives to issue debt (where they exist)
  • Reduce liquidity risks in open-ended mutual funds
  • Move toward more flexible exchange rates
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