Brandeis | INTERNATIONAL BUSINESS SCHOOL

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?

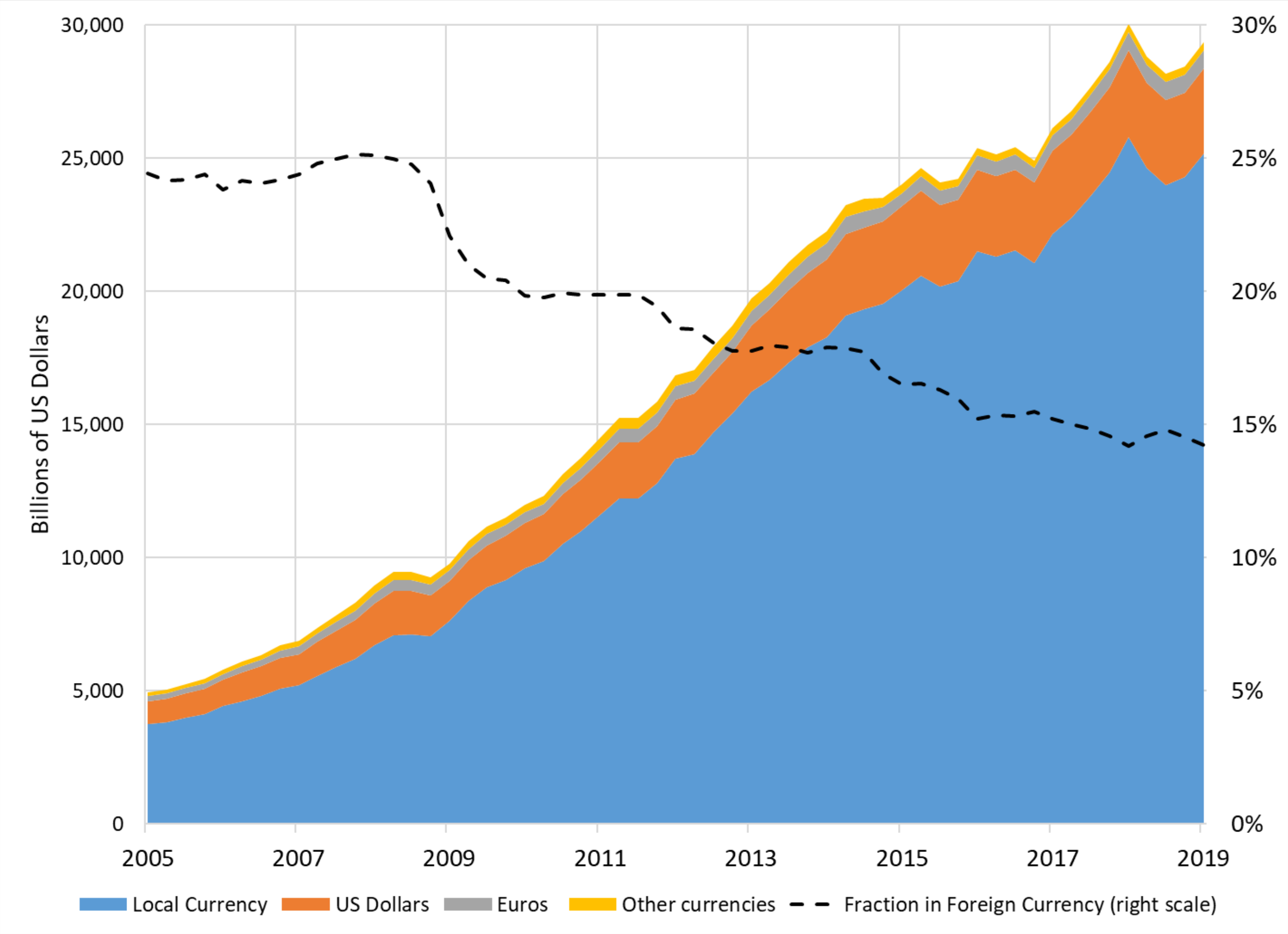
- EME firms' debt rose under favorable conditions
- Risks: maturity and rollover (& currency)
- Transmission mechanisms of distress:
  - Bank asset impairment
  - Large firms resort to banks, crowding out SMEs
  - Reduced intermediation
    (EME "nonfinancial" corporates can be intermediaries)
  - Trigger 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

Brandeis | INTERNATIONAL BUSINESS SCHOOL

EME Non-financial corporate debt



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

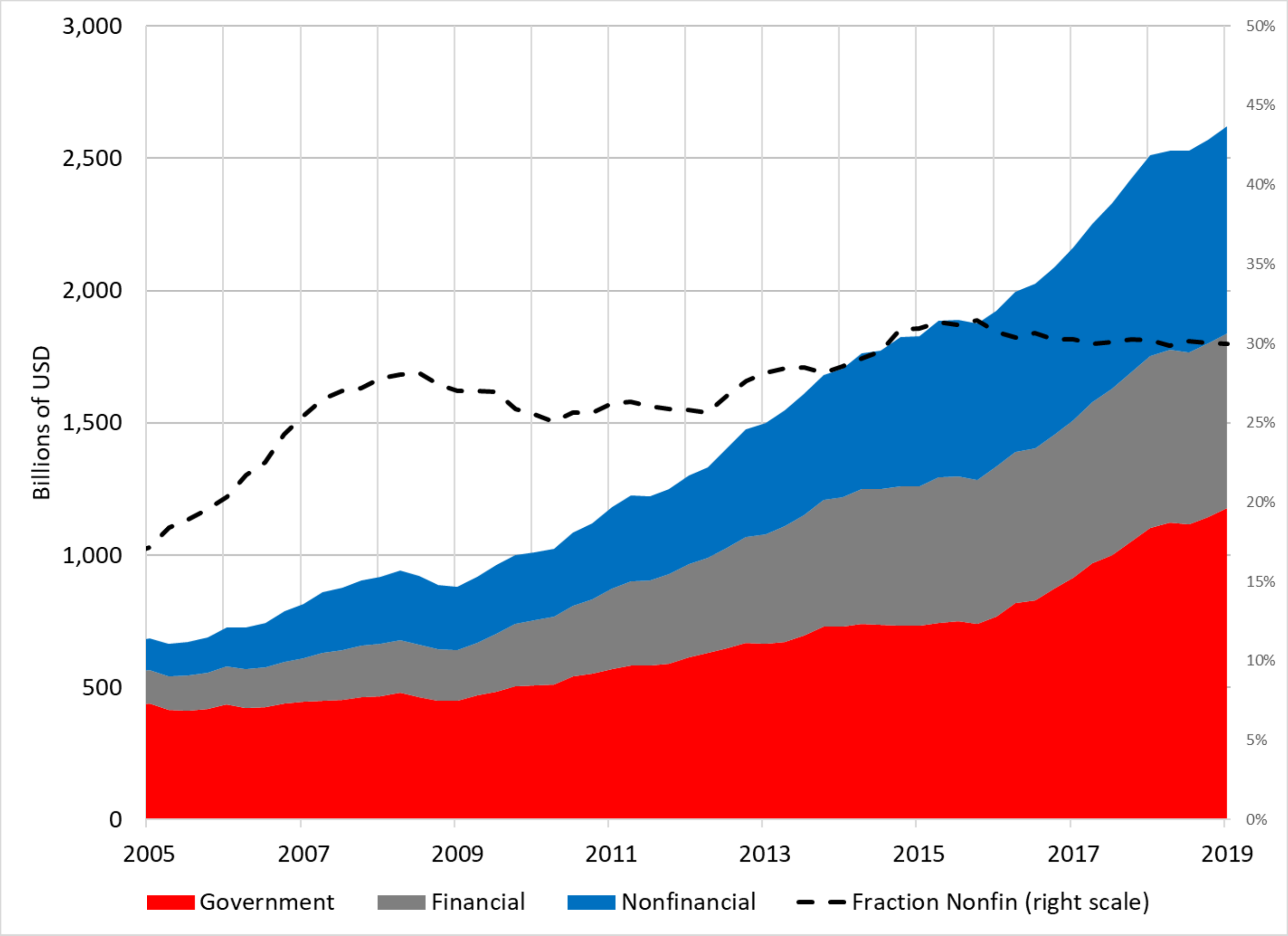
From 12 to 37% of GDP

Foreign currency share is declining.

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

Source: Institute for International Finance, Global Debt Monitor

EME Bonds Outstanding



Source: BIS.

Significant fraction in foreign currency.

<u>Current composition:</u>

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

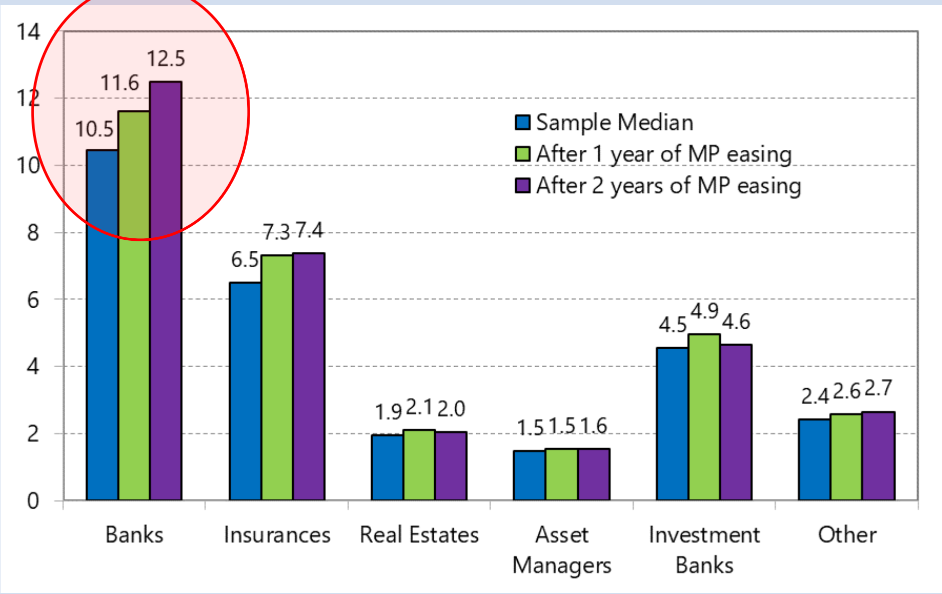
- EME Debt: large, rising, primarily from banks
- US dollar: important outside the US

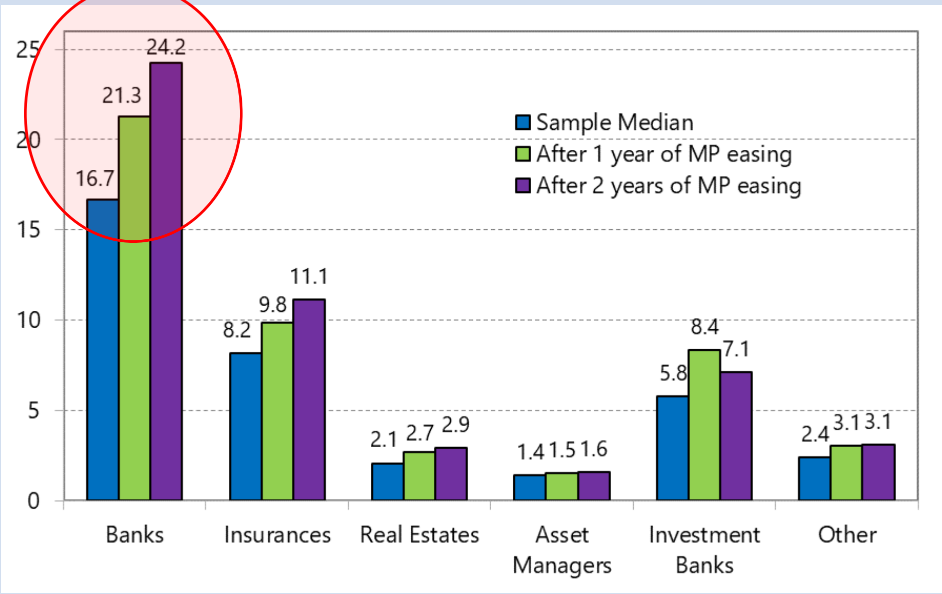
US interest rates matter for everything!

- US policy spillovers
- Impact of US policy on EME Corp Default

Change in leverage following extended monetary policy easing

Domestic Easing	U.S. Policy Easing





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

What is the impact of US policy tightening?

Fed funds rate +1.00pp
5yr UST rate +0.75pp

Average default rate in ACH data:

0.088% per month $\Rightarrow$ 1.05% per year

Impact of tightening = 0.13pp

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

Average default rate in ACH data:

0.088% per month $\Rightarrow$ 1.05% per year

Impact of tightening = 0.13pp

Median annual defaults is 33 $\Rightarrow$ 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

Brandeis | INTERNATIONAL BUSINESS SCHOOL

IN SEARCH OF DISTRESS RISK IN EMERGING MARKETS

Discussion by Stephen G. Cecchetti

www.moneyandbanking.com