IIF Weekly Insight
Let a thousand debates bloom

April 4th, 2019

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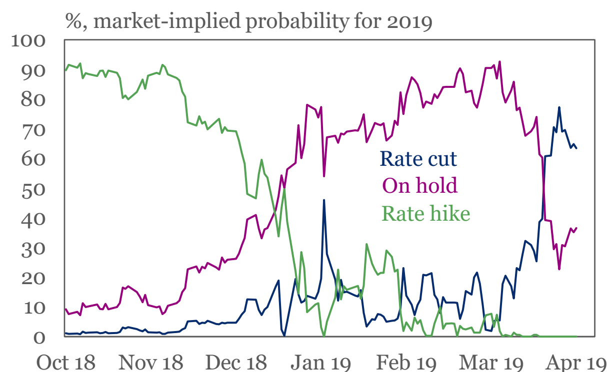
- Markets reassess chances for a Fed rate cut this year amid more optimism on trade talks, Chinese growth
- Policy backdrop feeds into asset valuation in emerging markets
- China may be taking a break from deleveraging, but non-financial corporate debt is still over 150% of GDP…
- …and at over 50% of GDP, household debt in China is well above the EM average—and growing strongly

Spring Meetings in focus: Cherry blossoms are in full bloom ahead of the IMF/World Bank Spring Meetings in Washington D.C., along with speculation on how next week's policy debates will play out. With the Fed's dovish pivot fully reflected in market pricing (Chart 1) and global growth forecasts cut by about 25bp year to date, early April has seen some change in tone. More optimism on U.S.-China trade talks, coupled with stronger growth signals from China, has tempered market expectations of a Fed rate cut. At the same time, the limits of unconventional monetary policy are coming into sharper focus. With policy rates in many parts of the world already near the zero lower bound or negative, there is limited policy space for monetary stimulus, highlighting the risks of secular stagnation and the importance of fiscal measures (though rising debt loads could pose a serious constraint, as noted in our new Global Debt Monitor). Partial U.S. yield curve inversion has underscored these fears (though the Fed's decision to end balance sheet runoff may be another factor behind the inversion). The debate around modern monetary theory should also be raucous at the Spring Meetings: Japan's FM Aso this week labeled MMT "dangerous," even as proponents of the U.S. "Green New Deal" argue that low rates help justify deficit spending.

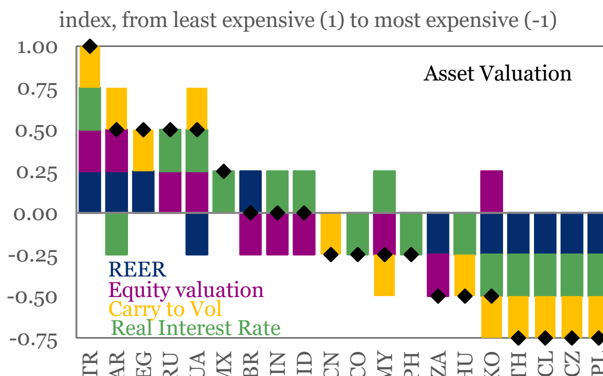
Policy as a driver of EM valuations: Comparing asset valuations across emerging markets (Chart 2) highlights the ways in which policy credibility can be an idiosyncratic driving factor. Using our broad scorecard to look across valuation metrics, lira devaluation and high real rates have left Turkish assets very attractively valued, but also reflect the country's uncertain policy path (see here for our economists' latest assessment). Similarly, eye-catching valuations in Argentina reflect price and currency instability as the electoral calendar heats up. For equities, geopolitical tensions can be another valuation driver—price/book and price/earnings ratios are low in Turkey and Argentina but also in Ukraine, Russia, and South Korea—which have relatively stronger or improving policy frameworks. On another side of the policy spectrum, central banks in countries where real exchange rates have been appreciating were under less pressure to raise rates in response to Fed tightening through end-2018,

Chart 1: After the Fed's dovish pivot, markets reassess the probability of a 2019 rate cut



Source: Bloomberg, IIF

Chart 2: EM valuations: some look "cheap for a reason"



Source: IIF, Bloomberg, Haver, Bruegel

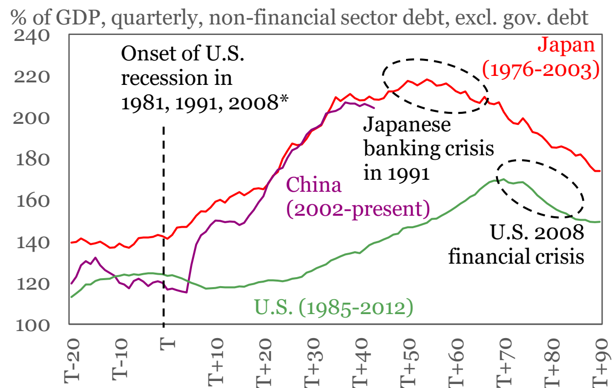
focusing instead on external competitiveness and stimulating domestic demand. This has been particularly true for export-dependent economies (Thailand, Chile, South Korea) or where the slow-growth Euro Area is the main trading partner (Poland, Czech Republic, Hungary). The result: pricey bonds and less alluring carry trades.

China—taking a break from deleveraging? China is one of the world's most indebted countries, with total debt across all sectors approaching 300% of GDP. However, following rapid debt accumulation in 2008-16, the pace of debt buildup in the private non-financial sector moderated in 2017-18 (Chart 3). With a strong political steer, the shadow banking sector was the main driver of this long-awaited deleveraging, cutting back lending by more than 10% since end-2017. This sharp drop in non-bank financing has meant some modest deleveraging in the non-financial corporate sector. At present, non-financial corporate debt is hovering near 150-155% of GDP, some 5-7 percentage points lower than its early 2016 peak (though this is still one of the highest corporate debt/GDP ratios in the world). With SOEs accounting for over 55% of total non-financial corporate debt, the continued decline in FX debt (from 9% of GDP in 2014 to 7% at present) leaves corporates less exposed to swings in the RMB. Moreover, firm-level data suggest that large cash holdings continue to provide an important cushion against downside risks in many cases. However, about 20% of Chinese firms have low interest coverage ratios—a problem facing companies in many parts of the world (Chart 4).

While the corporate sector may be cutting back, Chinese households continue to accumulate more debt. Indeed, the household debt to GDP ratio hit a record 52% in early 2019—well above the EM average (37%). While this secular rise partly reflects China's growing middle class, the striking increase in ratio of household debt to disposable income (now over 117%, up from just 25% in 2006) may pose a significant risk. Indeed, the pace of household debt accumulation has been much higher than underlying economic activity, leaving many households more exposed to business cycle swings. A sharp rise in interest rates or unemployment could burden household balance sheets still more, sending house prices and private consumption lower--further disrupting economic growth.

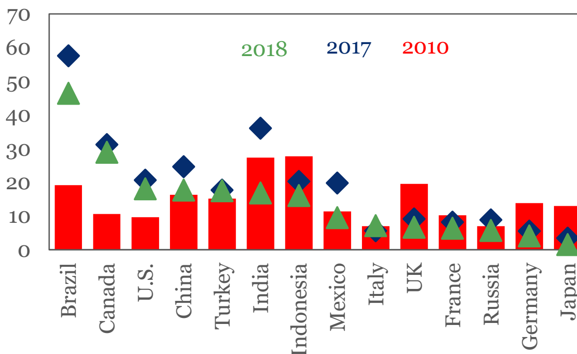
Looking ahead, China's debt trajectory will depend in large part on the policy backdrop, as credit policy continues to ease amid persistent external and internal headwinds. While the pledge from China's authorities to align credit growth with nominal GDP growth suggests a pause in deleveraging, the ongoing slowdown in producer price inflation could feed into weaker nominal growth, meaning that already-high debt levels could rise again this year (Chart 5).

Chart 3: China's debt boom–a different ending this time?



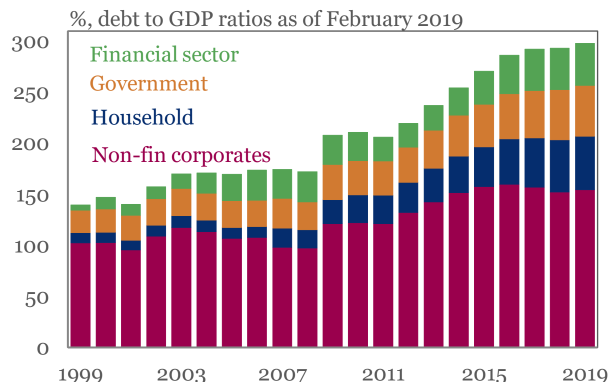
Source: BIS, IIF

Chart 4: Despite low global rates, a high share of firms in some countries find it hard to meet interest expense



Source: IIF, Bloomberg

Chart 5: Softer growth could constrain China's plans for deleveraging



Source: BIS, IIF

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