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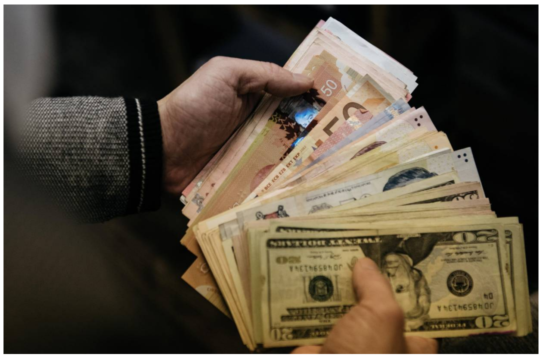
THE OUTLOOK

Flood of Dollar Debt Could Come Back to Haunt Emerging Economies

Worry grows over impact on repayments if global growth eases or interest rates increase



Dollar-denominated debt has soared in emerging-market economies in recent years, which could prove problematic for some companies if interest rates pick up. PHOTO: ANTHONY KWAN/BLOOMBERG NEWS

By Carolyn Cui, Ian Talley and Ben Eisen

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Emerging-market companies are binging on U.S. dollar debt and that could become a source of trouble in some parts of the world if growth slows, interest rates rise or the dollar resumes its ascent.

Governments and companies in the developing world sold $179 billion in dollar-denominated debt in the first quarter, the most dollar debt ever raised in the first quarter and more than double the amount raised during the same period last year, according to data provider Dealogic.

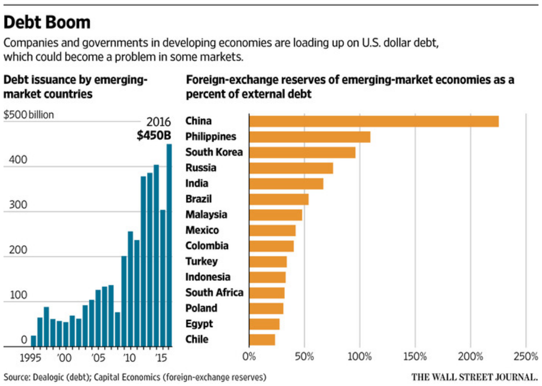
In all, U.S. dollar debt stood at $3.6 trillion in emerging markets through the third quarter of 2016, an all-time high, according to the Bank for International Settlements. Including local currency debt, and emerging-market companies have increased their borrowing by a staggering $17 trillion since 2008, according to the Institute of International Finance.

The International Monetary Fund warned of risks in reports ahead of its semiannual meetings in Washington, saying a bout of investor risk aversion could expose $135 billion worth of corporate credit to repayment problems.

“Emerging-market corporates have made progress in terms of making their economies more resilient, but vulnerabilities remain,” said Tobias Adrian, the IMF’s top financial economist. He pointed to 2013’s so-called Taper Tantrum, when the Federal Reserve signaled it would end a bond-buying program. Global interest rates soared and emerging-market currencies tumbled, hitting their economies. “We have seen how global interest rates can have negative spillover effects on emerging markets, and those risks are still present.”

Companies with dollar borrowings can be especially exposed. If the dollar rises, it makes the debt more expensive to pay off.

Companies that don’t earn dollar revenues, including some telecoms, property developers and retailers, can stumble. Repayment risk is especially high in countries



with large external deficits and low levels of foreign-exchange reserves. If the dollar appreciates faster than expected, some corporate borrowers, especially those who derive their revenues largely in local currencies, could find themselves in a currency mismatch and be forced to ask the central bank for help—which not all central banks are positioned to do.

"A rise in the dollar would be a double whammy for countries that have significant current-account deficits and significant amounts of dollar-denominated corporate debt," said Eswar Prasad, a professor of trade policy at Cornell University.

For now, borrowers are getting in while rates are still low and investor appetite for more exotic, higher-yielding credit is strong. The government of Paraguay, which is rated below investment grade, sold $500 million of 10-year debt last month at a yield below 5%.

After the Latin American and Asian credit crises of the 1990s and 2000s, some countries stocked up on foreign currencies for emergency cash in times of shortages. Many also now better balance borrowing between domestic currencies and foreign debt. That's why vulnerabilities around the globe are mixed.

Countries such as India and the Philippines, which have relatively low stocks of external debt and healthy foreign-exchange reserves, are in better shape, analysts say. Economies such as Malaysia and South Africa, which have small currency reserves and high levels of dollar-denominated debt, are at particular risk. Venezuela and Turkey look especially vulnerable.

"Some could still feel stress, especially where there are pre-existing political or economic strains," said Maurice Obstfeld, the IMF's chief economist.

A slew of missed payments by major telecom operators in South Africa and Turkey, as well as Venezuela's largest oil producer, have already sounded the alarm for emerging-market corporate borrowers, reflecting the increasingly challenging environment of rising borrowing costs, sluggish earnings growth, low commodity prices and growing trade protectionism.

"The protracted period of low U.S. dollar interest rates led to borrowers in emerging markets taking more than their fair share of foreign currency debt," said Lesetja Kganyago, governor of South Africa's central bank.

The parent company of Turk Telekom AS, Turkey's largest phone company, missed two payments of $290 million each to its lenders in September and March, following a slump in the lira and sluggish earnings. The company has been borrowing aggressively in recent years, securing a record $4.75 billion syndicated loan from a group of international and local banks. According to the company, total debt amounted to 15 billion lira as of end-2016, and 70% of it was denominated in dollars.

"When we see companies with large foreign-exchange debt, we will just walk away right now," said Elena Tedesco, an emerging-market equity manager at Hermes Investment Management. She added the outlook for the Turkish lira is also unclear given the country's political and economic uncertainties.

South Africa, which has been running a current-account deficit, saw the fallout when Cell C, the country's third-largest mobile operator, missed interest payments in January on its €400 million bonds, citing rising inflation, a weaker rand and industry uncertainty, according to S&P Global. Venezuela's state-run oil company PdVSA was late on its coupon payments worth $404 million in November, in an apparent struggle against low oil prices and falling foreign-exchange reserves.

In 2016, the number of defaulted dollar bond issues reached 32 in emerging markets, the highest since the financial crisis, according to S&P Global. More companies are poised for further downgrades, rather than upgrades, the rating agency said.

“There are potential vulnerabilities looking further ahead, particularly if the Fed were to raise rates much more aggressively than what the market has priced at the moment,” said Michael Grady, senior economist at Aviva Investors, which has $422 billion of assets under management.

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