

## Box 1

### Private credit overhang in emerging economies and risks to euro area financial stability

#### Many emerging market economies (EMEs) have seen a rapid expansion of credit to the private sector since the onset of the global financial crisis.

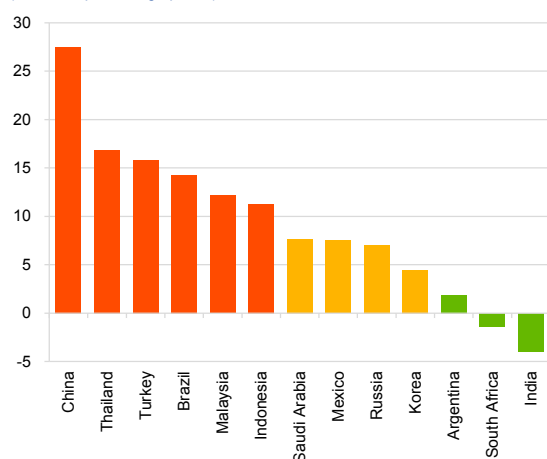
Strong credit growth was often driven by abundant capital inflows on the back of both positive growth differentials and the global search for yield by investors amid accommodative macroeconomic policies in advanced economies. As a result, several EMEs appear to be facing a large credit overhang, with a potential for disorderly unwinding amid deteriorating economic growth prospects. The prospective implications of any such correction could reverberate beyond the affected EMEs given their growing economic and financial linkages with the rest of the world in recent years.

#### Chart A

Rapid credit growth is a concern in a number of emerging economies, notably China

##### Credit-to-GDP gaps for selected EMEs

(Q3 2015; percentage points)



Sources: BIS and ECB calculations.

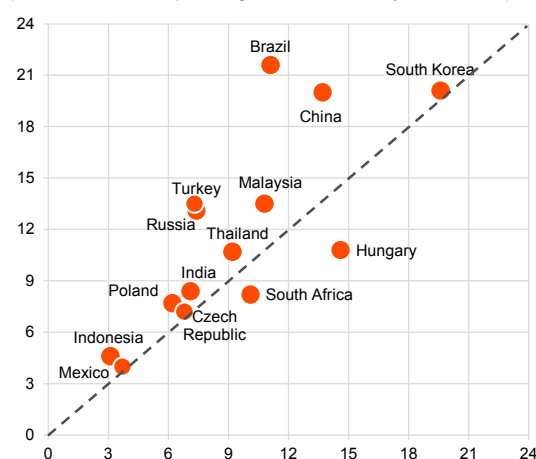
Notes: The credit-to-GDP gap is calculated as the difference between the private credit-to-GDP ratio as at September 2015 and its long-term trend. The thresholds for the red and yellow bars are 10 and 2 percentage points, respectively, following the BIS approach; for more details, see *BIS Quarterly Review*, March 2016.

#### Chart B

Most emerging economies have seen rising debt service ratios since the financial crisis

##### Debt service ratios for selected EMEs

(Q4 2007 vs. Q3 2015; percentages; x-axis: Q4 2007; y-axis: Q3 2015)



Source: BIS.

Note: The debt service ratio reflects the share of income used to service debt in the non-financial private sector.

**Financial stability concerns stem from the historical regularity that rapid growth in private credit that leads to an excessively large stock of debt is often a leading indicator of subsequent financial turmoil.**<sup>2</sup> As the expansion of credit to the private sector has outpaced GDP growth in a number of EMEs over the near decade since the onset of the global financial crisis, credit-to-GDP ratios are substantially above their long-term trend in several countries (see **Chart A**), while credit gap levels have risen over the past few years in some of those countries. While contributing to fundamental financial deepening, the sheer pace of credit growth may suggest potential vulnerabilities in several EMEs, notably China. Clearly, risks are accentuated in countries with a substantial foreign currency-denominated component of the resulting debt overhang.

<sup>2</sup> See, for example, Schularick, M. and Taylor, A., "Credit booms gone bust: Monetary policy, leverage cycles, and financial crises, 1870-2008", *American Economic Review*, Vol. 102(2), 2012.

**The ongoing economic slowdown may indicate heightened credit risk for banks via**

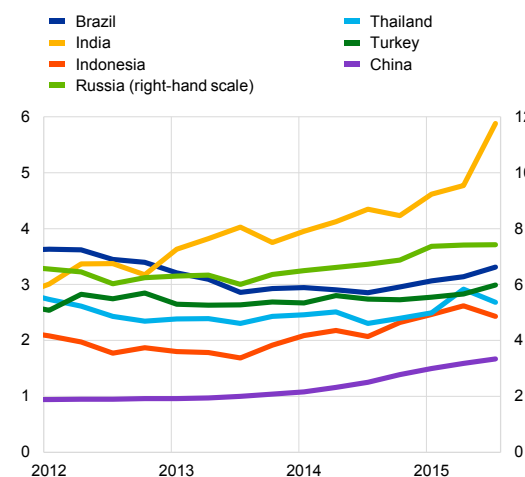
**deteriorating asset quality.** In fact, past credit excesses and the related high debt burden may challenge borrowers’ debt servicing capabilities. Despite relatively low interest rates, mounting debt levels have pushed up debt service ratios for the private sector in most EMEs, notably Brazil and China (see **Chart B**). This, together with low interest coverage ratios of firms in a number of EMEs, may increase the likelihood that local borrowers run into debt servicing difficulties in the event of a further slowdown in economic growth. That said, bank loan quality has started to deteriorate since early 2014 in a number of EMEs, even though non-performing loan (NPL) ratios – being a lagging indicator – are still at relatively low levels (see **Chart C**). In China, despite the rapid accumulation of credit, looking at bank accounts suggests an NPL ratio of about 1.5%. At the same time, estimates based on Chinese firm-level balance sheet data suggest that the NPL ratio could be in the higher single digits, while a stress scenario could yield even higher figures.

**Chart C**

Non-performing loan ratios have started to rise in many EMEs, albeit from low levels

**Non-performing loan ratios in selected emerging economies**

(Q1 2012 – Q4 2015; percentages)



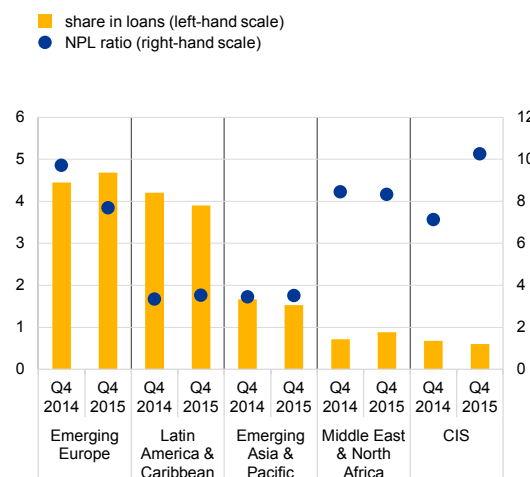
Source: IMF Financial Soundness Indicators.

**Chart D**

Euro area banks’ EME exposures are limited, but asset quality problems vary across regions

**Euro area banks’ exposures and non-performing loan ratios in selected emerging market regions**

(Q4 2014; Q4 2015; percentage of total loans; weighted averages)



Source: ECB.  
Note: Based on a sample of significant banking groups that report the geographical breakdown of their exposures.

**Potential spillovers from EMEs to the euro area via direct banking exposures are limited.**

Euro area banks’ overall EME exposures have dropped in recent years given banks’ increased home bias and balance sheet deleveraging. The cross-border claims of euro area banks on emerging economies account for about 12% of their total loan portfolio. The bulk of these exposures are to emerging Europe and Latin America, while exposures to emerging Asia, the Middle East and North Africa (MENA) as well as the Commonwealth of Independent States (CIS) are relatively contained (see **Chart D**). Euro area banks are mostly confronted with asset quality problems in emerging Europe, MENA and the CIS, with the latter two regions also hard-hit by the ongoing turmoil in global commodity markets. That said, given the economic slowdown in many Asian and Latin American economies, banks are likely to incur higher loan losses also on those exposures going forward.

**All in all, the direct impact of a potential further worsening of credit quality in emerging markets should not represent a systemic risk for the euro area.** Nonetheless, the presence of localised pockets of risk cannot be ruled out and individual euro area banks with more material exposures to emerging economies may face heightened earnings risks and asset quality problems. That said, a more broad-based emerging market shock could have more pronounced implications for the euro area, in particular if heightened concerns about the economic outlook were to trigger volatility in financial markets and adversely affect global confidence.

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