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THOUGHT LEADERSHIP BRIEF

Global Liquidity and Corporate Financing in Emerging Asia

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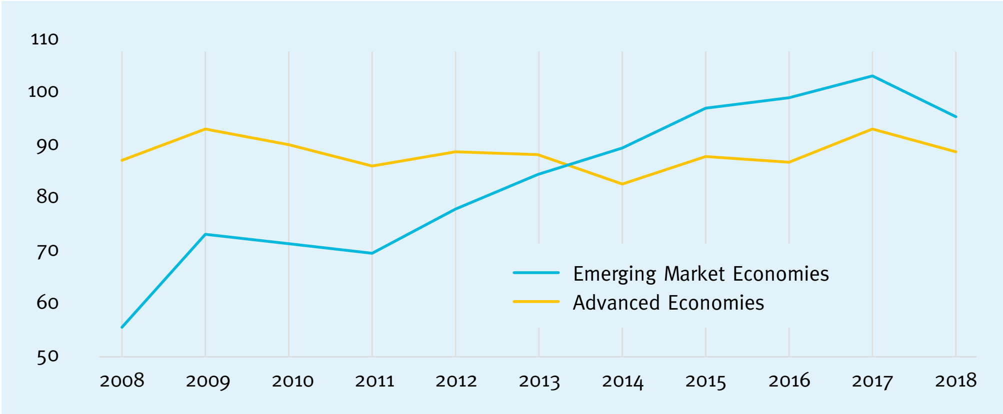
KEY POINTS

- When corporate debt is measured relative to assets, there is little evidence of an increase in leverage.Corporate leverage in Asia is generally stable. This contrasts sharply with what we observed ahead of the Asian financial crisis of the late 1990s.
- The legal environment and quality of institutions has an important influence on the capital structure of Asian firms. Leverage increases with the strength of creditor rights, political stability, and efficiency of resolution of insolvencies.
- Accommodative monetary policies in the U.S. since the global financial crisis has resulted in greater use of debt financing in countries with stronger institutions. Foreign investors prefer to invest in better governed firms since they are at an informational disadvantage relative to local investors.
- These policies have also resulted in higher capital expenditures by firms in countries with stronger institutions. Furthermore, global liquidity relaxes the financing constraints of firms.

Issue

Increasing debt burdens of corporations in emerging market economies (EMEs) have been of significant concern to both regulators and market participants alike. The data from the Bank for International Settlements show that non-financial corporate debt of EMEs as a percentage of GDP increased from 56% in 2008 to 96% in 2018, surpassing the ratio of advanced economies (see Figure 1). The accumulation of corporate debt has been even more marked in the subsample of emerging markets of the Asia-Pacific. This rapid debt build-up in the region harks back to the Asian financial crisis of the late 1990s.

Figure 1: Corporate Debt as % of GDP for Emerging Market Economies (EME) and Advanced Economies, 2008-2018



Source: Bank for International Settlements

Many commentators attribute this debt build-up to quantitative easing (QE) and the accommodative stance of monetary policies of advanced economies in the aftermath of the global financial crisis. To promote economic recovery, the Federal Reserve acted to move the federal funds rate close to zero. This can be seen in Figure 2, which plots the estimated shadow short rate (SSR) for the United States from 1991 to 2018. The rates turned negative sometime in late 2008, bottomed out in 2013 and are still low by historical standards.

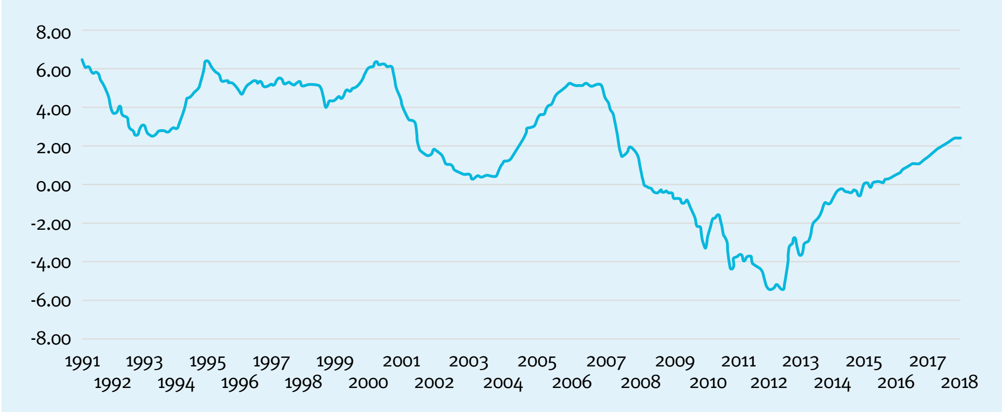
There are two prominent channels through which advanced economy monetary policies can affect financing of firms in emerging markets. One is the effect that monetary policy has on the portfolio rebalancing of investors, with easy monetary policy encouraging investors to reach for yield and seek higher returns by investing in overseas assets. The increased capital flows into emerging markets result in lower risk premia, lower costs of financing and greater debt issuances by emerging market firms. Another channel is the issuance of U.S. dollar-denominated bonds by non-U.S. firms, which can increase in times of easy monetary policy to take advantage of relatively low US dollar rates; local currencies tend to appreciate during these periods of US easing which diminishes the burden of US dollar debt.

The key questions are: Do firms in emerging markets respond to easier financing conditions and lower risk premia in advanced economies by issuing large amounts of corporate debt? How much of the debt build-up in emerging markets could be attributed to unconventional monetary policies in advanced economies? The answers to these questions are not obvious as various asset markets are affected. The policies of the U.S. Federal Reserve could affect both debt and equity markets, and result in portfolio rebalancing across assets in both markets across all regions.

We begin with an examination of capital structure decisions of listed firms in emerging Asia to document the extent to which recent increases in debt have outpaced those of equity and historical norms. The analysis is based on publicly-listed firms in Hong Kong, Malaysia, the Philippines, Singapore, and Thailand from 1991 to 2014. Corporate debt is best viewed as high or low relative to the balance sheet resources – including equity – that are available to support that debt. This recommends a focus on corporate leverage measures that take into account such support, estimated both with book and market values of equity.

Among the determinants of debt finance of companies in emerging Asia, the objective is to assess the importance of global liquidity conditions. Emerging market bond issuance has been positively influenced by quantitative easing in the U.S. What we do not know is the extent to which quantitative easing in the U.S. has affected the debt ratios of firms in emerging Asia. Have the financing patterns of Asian firms changed in response to the recent Federal Reserve policies? Which countries' firms are most affected, and why?

Figure 2: U.S. Monetary Policy Measure: Shadow Short Rates, 1991-2018



Source: Leo Krippner, Reserve Bank of New Zealand

Assessment

Leverage Trends

A useful way to examine the effect of global liquidity conditions on the securities issuance decisions of Asian firms is to check if net debt issuances of firms respond to their funding deficits and how these responses vary with advanced economy interest rates. In particular, we examine if the propensity to rely on debt financing increases with global liquidity as a function of the institutional and macroeconomic environment of a jurisdiction. In doing so, it is important to recognize that the ability of firms to increase the supply of corporate bonds to take advantage of easy financing conditions induced by QE would be a function of each country's institutional environment, that in turn reflects both laws in that jurisdiction and their enforcement.

In other words, the question is whether all countries receive inward capital flows equally as a result of more accommodative monetary policies in advanced economies, or do some countries benefit more than others. Do foreign investors disproportionately allocate capital to countries that have better institutions? If so, then countries with stronger creditor rights and better enforcement of property rights will receive more flows. And, we would expect firms in countries with stronger creditor rights, stronger protection of minority investors, and better political stability to finance a greater and disproportionate proportion of their deficit through debt financing in response to more accommodative U.S. monetary policy.

The research finding supports this view. We find that in countries with strong creditor rights, better protection of minority investors and greater political stability, firms finance more through debt than equity during periods of expansive monetary policy in the United States. Of the seven countries in our sample, Hong Kong and Singapore are the only two jurisdictions where firms increase financing through debt during periods of easy U.S. monetary policy. Both have strong institutions. On the contrary, firms in Indonesia, Malaysia, and Thailand finance more through equity during periods of low U.S. shadow short rates.

Global Liquidity and Corporate Investment

One could also examine the effect of liquidity and institutions on corporate investment. The main interest, however, is in examining the effect of global liquidity conditions on the investment (i.e., capital expenditures) of firms in emerging Asia. On their own, the U.S. shadow short rates (SSR) do not generally affect the capital expenditures of Asian firms. But, when interacted with a measure of the strength of legal rights, corporate investment in countries with strong creditor rights respond significantly to low SSR (representing abundant liquidity). In other words, global liquidity positively affects corporate investment but only in countries with strong institutions. The results show that global liquidity does not add to corporate investment when creditor rights are weak. The evidence suggests that global liquidity relaxes the financing constraints of firms.

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The bottom line is that global liquidity increases both debt financing and corporate investment but only when a country has strong institutions. This confirms the prevailing view that foreign investors invest relatively more in countries with strong institutions and in firms with better governance.

Recommendations

The risk of corporate debt is properly gauged taking into account the assets that support it. When corporate debt is measured relative to assets rather than GDP, neither the mean/median nor the upper tails of the distribution are currently in unusually high territory for the more than 7000 listed firms in the economies of emerging Asia. Thus, regulators and policy-makers are advised to use appropriate benchmarks to assess debt vulnerability.

The legal environment and quality of institutions are a very important influence on leverage decisions: standard firm factors are only weakly related to leverage in jurisdictions with stronger institutions. Firm characteristics such as asset tangibility and size help to overcome information asymmetries and are more important for corporate financing decisions of firms in jurisdictions with weaker institutions.

When institutions are strong, companies tend to increase both their leverage and capital expenditure in conditions of expansive global liquidity as proxied by the United States shadow rate. More generally, when global liquidity is high, investment is less sensitive to internal cash flows across the sample. This highlights the importance of establishing institutions that provide strong creditor rights and protect minority investors to enable companies to benefit from increases in global liquidity.

The confluence of global factors, risk-taking and institutions in determining the corporate financial policies of firms in emerging markets is a fertile area of future research. Local currency appreciation against the U.S. dollar has been associated with increases in capital inflows in emerging markets, as borrowers can appear stronger. Even if this channel has not resulted in excessive increases in leverage in our sample, it is worth monitoring going forward.

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