HIGHLIGHTS from SPECIAL FOCUS 2:

CORPORATE DEBT: FINANCIAL STABILITY AND INVESTMENT IMPLICATIONS

Key Points

- *Corporate debt in emerging market and developing economies (EMDEs) has risen 30 percentage points of GDP above pre-crisis levels, on average, to 86 percent of GDP in 2017.*
- *Higher corporate debt relative to debt service capacity has been associated with weak investment and may strain debt service capacity when global borrowing cost rise.*
- *Countercyclical and macroprudential policies can address financial stability concerns. Structural policies, including the strengthening of bankruptcy regimes, are appropriate tools to address the investment implications of elevated corporate debt.*

Elevated corporate debt in emerging and developing economies. By 2017, corporate debt in EMDEs reached 86 percent of GDP, 30 percentage points of GDP above pre-crisis (2007) levels (Figure SF2). Excluding China, corporate debt expanded over the same period by 10 percentage points of GDP to 44 percent of GDP in 2017. Outside of China, foreign currency debt has constituted nearly half of the growth in corporate debt over 2010-2017. A growing share of corporate debt is held by firms with higher financial risk (e.g., lower interest coverage ratios).

Financial stability risk. Disorderly tightening of global financing conditions as monetary policy normalizes in advanced economies could raise debt service costs in EMDEs. A sharp appreciation of the U.S. dollar may also weaken balance sheets to the extent foreign currency liabilities are not matched with assets. Rollover risks may rise if financial conditions tighten abruptly, given the growing amount of international bonds that are expected to mature in EMDEs over the next three years.

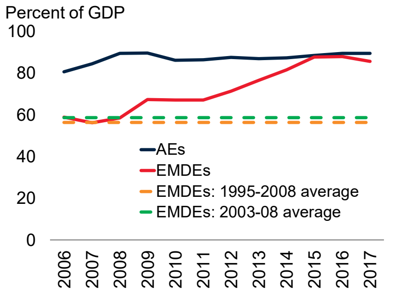
Investment implications. Since 2011, growing corporate debt in EMDEs has coincided with a period of weak private investment growth. At the firm-level, higher debt relative to debt service capacity has been associated with weaker private investment growth. Investment is more sensitive to corporate debt service capacity among large firms than small companies and among firms that are highly indebted as opposed to entities that are less leveraged.

Policy implications. Cyclical and prudential policies, including the monitoring of foreign exchange risks in large systematically important firms, can help reduce financial stability risks associated with elevated corporate debt. Structural policies, such as promoting equity market development and strengthening bankruptcy protection rights, can help lift investment and mitigate the medium-term consequences of excessive corporate debt.

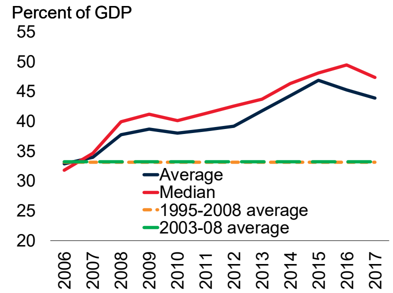
Figure SF2. Corporate debt: Financial stability and investment implications

Corporate debt in EMDEs has risen over the past decade, raising concerns for financial stability and growth prospects. Debt service costs of EMDE firms are expected to rise as advanced economies normalize monetary policy. High corporate debt relative to debt service capacity has been associated with weak investment. Structural policies, to improve bankruptcy protection rights and develop equity markets, can help mitigate the implications of high corporate debt for investment.

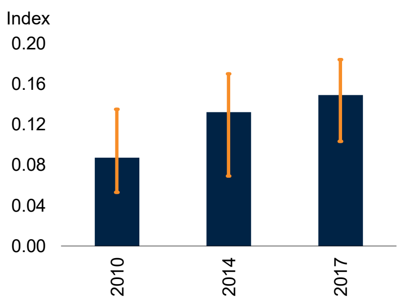
A. Corporate debt in EMDEs



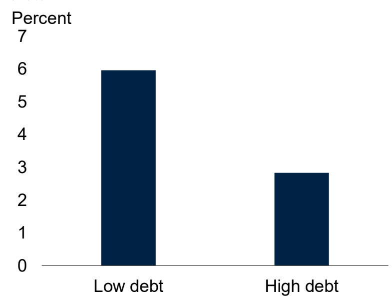
B. Corporate debt (excluding China)



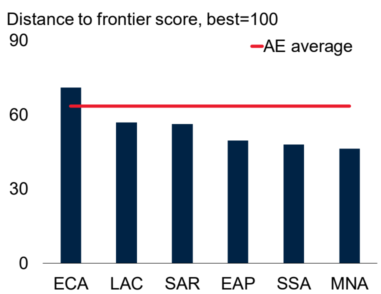
C. Corporate vulnerability index



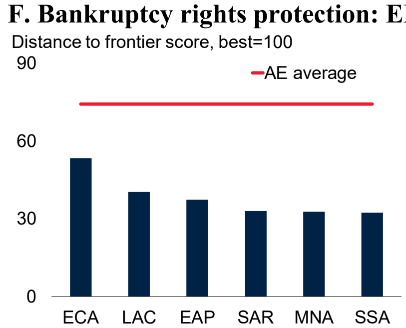
D. Private investment growth: low and high corporate debt



E. Shareholder right protection: EMDEs



F. Bankruptcy rights protection: EMDEs



Sources: Bank for International Settlements, Haver Analytics, Institute for International Finance, International Monetary Fund, Oxford Economics, World Bank. Notes: ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, and SSA = Sub-Saharan Africa, AE=advanced economies.

A. GDP-weighted averages for 16 EMDEs (excludes China in figure B) and 27 advanced economies (AE).

C. The Corporate Vulnerability Index (CVI) tracks financial conditions of the non-financial corporate sector. The CVI uses firms' balance sheet information covering seven indicators: interest coverage ratio, leverage ratio, net debt-to-EBIT ratio, current-to-long term liabilities ratio, quick ratio, return to assets, and market-to-book ratio. The CVI ranges from 0 (i.e., firms in a particular country are not financially vulnerable in any of the 7 indicators) to 1 (i.e., all firms in a particular country are financially vulnerable in all 7 indicators). Includes 47 EMDEs. Vertical lines indicate interquartile range. For more details, see Feyen et al. (2017).

D. High-low denotes country-year observations of corporate debt to GDP ratio above/below the median. Data are not available for 2016-17 for 5 economies. Includes 16 EMDEs. Y-axis denotes median private investment growth.

E. Denotes year 2017. Distance to frontier score for strength of insolvency resolution. EAP, ECA, LAC, MNA, SAR, SSA include 20, 19, 28, 16, 8 and 44 economies, respectively. AE includes 37 economies. Based on World Bank *Doing Business* report. F. Denotes year 2017. Distance to frontier score for strength of shareholder rights protection. EAP, ECA, LAC, MNA, SAR, SSA include 20, 21, 29, 16, 8 and 44 economies, respectively. AE includes 37 economies. Based on World Bank *Doing Business* report.