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Economics Group

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Is Turkey a Canary in the Emerging Market Coal Mine?

Some other individual emerging market (EM) economies could have their own financial problems à la Turkey. But we think any financial crises in the EM world would be individual episodes rather than systemic.

Are External Debt Problems in Developing Economies Systemic?

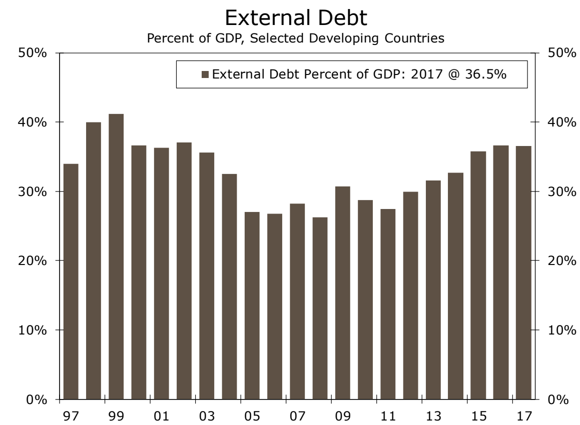
Turkish assets have been hammered over the past few days due largely to concerns about the amount of Turkey's foreign currency-denominated debt, and fear of "contagion" has led to selling pressure on other emerging market (EM) assets more broadly. Are other EM economies vulnerable to an external debt crisis *à la* Turkey? Is Turkey the canary in the EM coal mine like Thailand was in 1997?

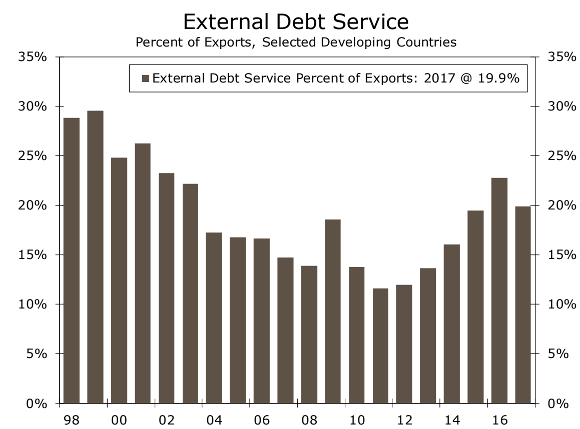
In this report, we update an analysis that we did last year.[1] Yes, the external debt of a sample of 19 large developing economies (less China) has swelled from less than $2 trillion in 1997 to more than $5.0 trillion today. Those economies have grown over the past two decades, which has increased their capacities to incur debt, so we should scale their external debt by their GDP. But there still may be cause for concern because their collective external debt-to-GDP ratio is 37 percent, which is higher than in 1997 (top chart).

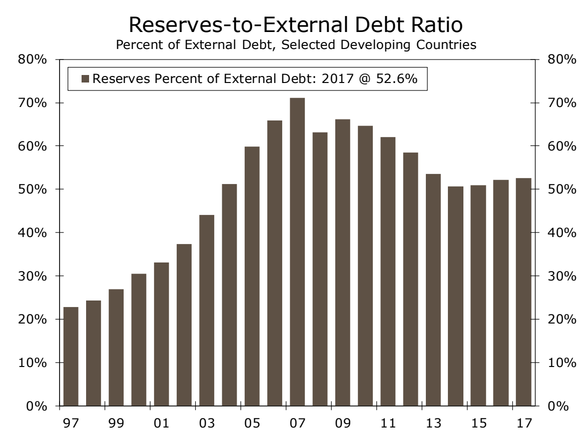
But in our view, many developing economies are better equipped to deal with their external debt loads than they were 20 years ago. For starters, most developing economies allow their currencies to float at present, rather than maintain fixed exchange rates, as they did heading into the financial crises of 1997-1998. Consequently, central banks can allow the exchange rate to adjust gradually downward, and they do not need to jack up interest rates to defend their currencies to the same extent as they would under fixed exchange rate regimes. Less monetary tightening means that their economies are more resilient than they would be under fixed exchange rates.

Furthermore, the ability of many EM economies to service their external debt is a bit better today than it was two decades ago. In 1997, the debt service-to-export ratio of the developing economies in our sample was nearly 30 percent (middle chart). It is only 20 percent today. In addition, EM economies have larger war chests of foreign exchange reserves, which they can use to counter some of the downward pressure on their currencies. Reserves as a percent of external debt stand at 53 percent today, more than twice as high as it was twenty years ago (bottom chart).

That said, some individual economies other than Turkey could potentially face financing challenges. In the report we wrote last year, we developed a simple methodology that we used to order countries that may be most vulnerable to a financial crisis. Interestingly, our methodology ranked Turkey as one of the most vulnerable countries to financial crisis, and we refer interested readers to our earlier report to the full list of countries. Vulnerable counties could experience their own external debt crises if their currencies continue to come under downward pressure and/or if the Fed hikes rates further. But we think that any other Turkey-like financial crises would be country specific rather than systemic *à la* 1997-1998.







Source: Institute of International Finance, International Monetary Fund and Wells Fargo Securities

[1] **See "Do Developing Economies Have a Debt 'Problem'?" (June 27, 2017), which is available upon request.**

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How Exposed Is the U.S. Economy to EM Economies?

The exposure of the U.S. economy to the developing world has increased over the past two decades, but the U.S. expansion likely would not be derailed by financial crises in EM economies, should they occur.

U.S. Economy Has Limited Exposure to the Developing World

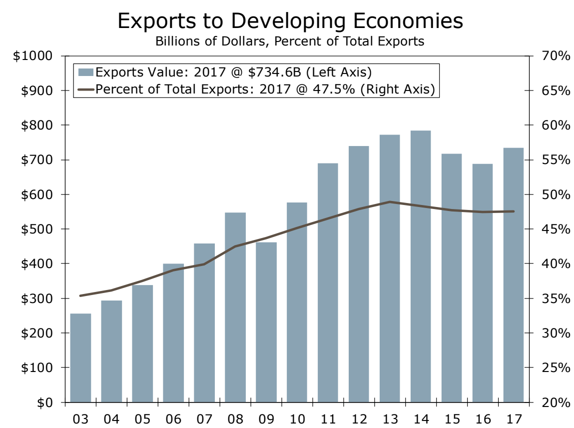
In a recent report we argued that emerging market (EM) economies are generally better able to service their external debt than they were 20 years ago.[1] Consequently, we do not think that a wave of Turkey-like financial crises will sweep through EM economies as they did in 1997-1998. But what if we are wrong? What if financial crises were to engulf a significant number of EM economies in coming months? How much exposure does the U.S. economy have to the developing world?

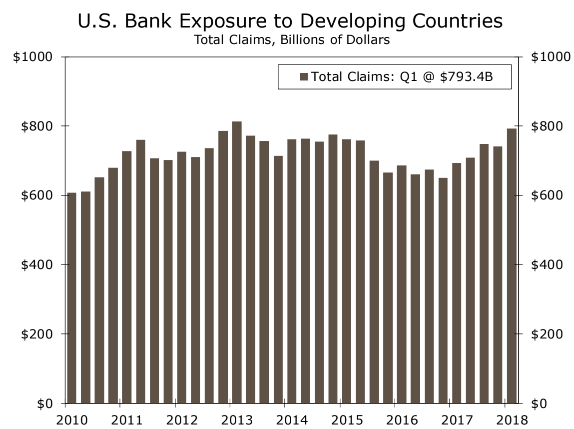
Let's start with trade exposure. American exports to developing economies shot up from about $250 billion in 2003 to more than $700 billion last year (top chart). Today, developing economies account for roughly one-half of U.S. exports. But exports of total goods and services are equivalent to only 14 percent of U.S. GDP. American exports of goods and services to developing economies would need to weaken significantly to have a meaningful effect on U.S. GDP growth. As a point of reference, the value of American exports of goods to developing economies declined only 4 percent between 1998 and 1999 in the wake of the severe economic and financial crises that swept through the developing world 20 years ago.

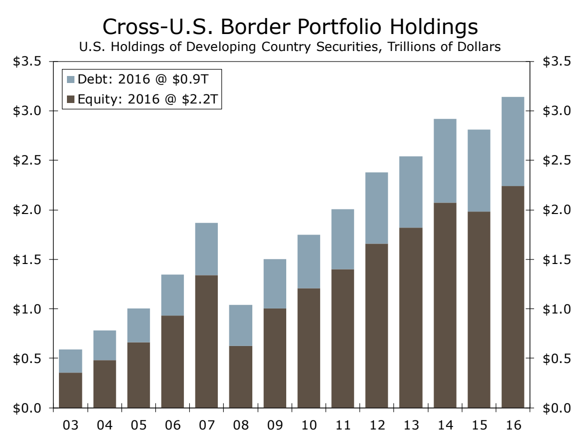
What about American banks? How much exposure do they have to EM economies? Data from the Bank for International Settlements (BIS) show that the exposure of the American banking system to developing economies totaled nearly $800 billion at the end of Q2-2018, which is obviously a sizeable amount (middle chart). However, the financial assets of the U.S. banking system exceed $15 trillion, so exposure of American banks to developing economies represents only 5 percent of their financial assets at present. Unless all EM assets become completely worthless, which is not very likely, the American banking system should be able to weather whatever storm that financial crises in developing economies were to throw its way.

What about American investors? Do they have significant exposure to emerging market economies? At the end of 2016 (latest available data), Americans owned about $3 trillion worth of EM stocks and bonds (bottom chart). Sharp declines in the value of those assets probably would not go unnoticed by American investors. But American households held $75 trillion worth of financial assets at the end of 2016. A complete rout of EM financial markets, should one occur, would not lead to catastrophic losses for most American households.

In sum, the U.S. economy has only limited exposure to EM economies. Twenty years ago, the financial crises that swept through the developing world had only marginal effects on the U.S. economy. Although American exposure to the developing world has increased over the past two decades, financial crises in EM economies today likely would not derail the U.S. economy.







Source: U.S. Department of Commerce, U.S. Department of the Treasury, BIS and Wells Fargo Securities

[1] **See "Is Turkey a Canary in the Emerging Market Coal Mine?" (August 15, 2018).**

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Which Major Economies Have Exposure to EM Economies?

The Eurozone appears to have the most financial and economic exposure to EM economies. However, if external debt issues in the developing world are not systemic, then we are not overly concerned about that exposure.

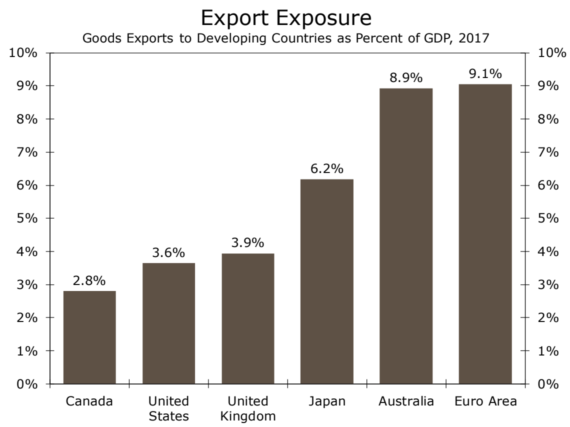
The Eurozone May Be the Most at Risk

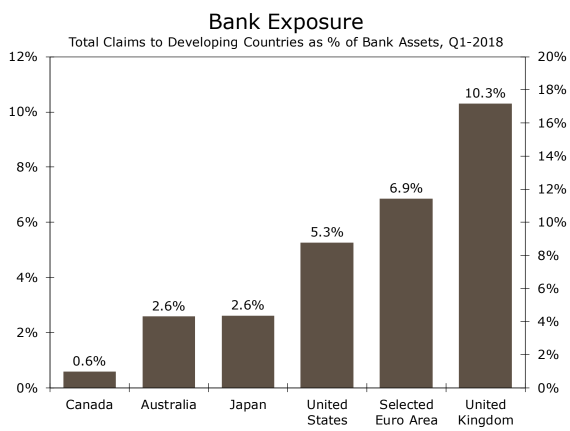
In the third of three reports on the fallout from financial crises potentially sweeping through the developing world, we analyze the amount of economic and financial exposure that major economies have to emerging market (EM) economies.[1] In terms of exports, the euro area and Australia have the most to lose among major economies, as exports of goods to EM economies are equivalent to 9 percent of their respective GDPs (top chart). Developing Asia accounts for the vast majority of Australia's export exposure to EM economies, while the export exposure of the Eurozone is more broadly distributed among EM regions. On the other end of the spectrum, exports to the developing world are equivalent to only 3 percent of Canadian GDP.

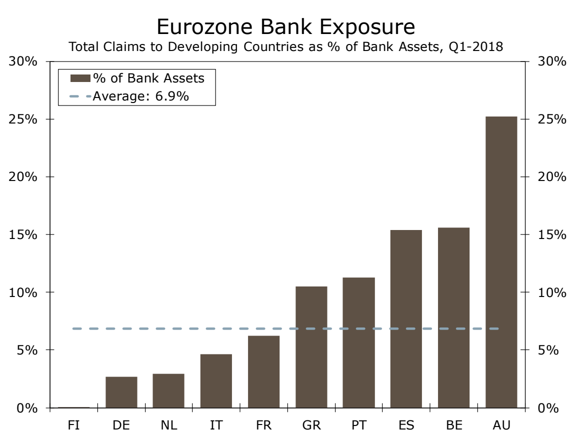
Moving on to bank exposure, the United Kingdom appears to have the most to lose among major economies, with claims on developing economies representing 10 percent of the financial assets of British banks (middle chart). U.K.-based banks have broad exposure to EM economies, but their exposure to developing Asia is especially pronounced. In our view, developing Asia probably is the least vulnerable among EM regions to external debt crises due in part to the vast war chests of foreign exchange reserves that many countries in developing Asia possess. In other words, the risk to U.K.-based banks from potential external debt crises in EM economies likely is not as high as first meets the eye.

Claims on EM economies account for about 7 percent of the financial assets of the banking system in the euro area. The Eurozone of course consists of 19 individual economies, and we have banking data for 10 of these countries. (These 10 individual economies account for 95 percent of Eurozone GDP.) The Eurozone country with the most absolute amount of bank exposure to EM economies is Spain, which has more than $640 billion worth of claims on EM economies. But Spain also has some fairly large banks, which may be able to absorb some losses on their EM financial assets. So what we are really interested in is the amount of EM exposure that each country has as a percentage of its banking system assets. By that measure, Austria, which has extensive banking ties with countries in Central and Eastern Europe, has the most relative exposure to EM financial assets among Eurozone countries.

To reiterate the gist of our first two reports, however, we do not think that the financial issues that Turkey is now facing are systemic to the entire developing world. Individual economies, such as Turkey and a few others, could indeed face financial difficulties in coming weeks and months. But we do not think that a wave of financial crises will engulf the developing world *à la* 1997-1998. Consequently, we are not overly concerned about the economic and financial exposure that the Eurozone has to EM economies.







Source: U.S. Department of Commerce, U.S. Department of the Treasury, BIS and Wells Fargo Securities

[1] **See "Is Turkey a Canary in the Emerging Market Coal Mine?" and "How Exposed Is the U.S. Economy to EM Economies?"**

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