

GLOBAL ECONOMICS FOCUS

20th Oct. 2011



Sovereign Debt: are the emerging markets immune?

- Emerging markets are not immune from the deepening debt crisis in the developed world, but most are well-placed to deal with the fallout. China faces a difficult structural transition of its own but, along with the rest of emerging Asia, has policy options to respond to a downturn in the West. We expect Latin American economies to slow by more than most anticipate in 2012, but they should rebound in 2013. The exception is Eastern Europe, where a number of countries are at risk of sliding into recession.
- The direct impact of debt crises and weak growth in the G7 is likely to be transmitted along one of three channels. The first is weaker export demand. **The economies of Eastern Europe (notably Hungary and the Czech Republic) are most vulnerable to a slump in the euro-zone, while Mexico is highly exposed to a slowing US economy.** The larger Asian economies are less dependent on G7 demand but, if global demand weakens, nowhere will remain unscathed.
- The second channel of contagion is via reduced capital flows. Turkey is the major emerging economy most reliant on foreign financing – its current account deficit is on track to hit 10% of GDP this year. Domestic demand in Latin America would also weaken if capital inflows were to slow.
- The third channel is the banking sector. **Banks in Eastern Europe in particular are heavily dependent on financing from Western European parents, which could dry up if the euro-zone was hit by a banking crisis** (as we think possible).
- When we turn to the scope for a policy response, the economies of Eastern Europe once again look most vulnerable. Budget deficits remain large and there is little room to cut interest rates. By contrast, we expect rates in Asian and Latin American economies to fall over the coming quarters and there is room for fiscal stimulus too if needed. This should cushion any slowdown in external demand.
- **More generally, few emerging economies suffer from the debt and deficit concerns plaguing the Western world.** Admittedly, external debt burdens in some Eastern European economies (notably the Baltic States and Hungary) are high and point to years of austerity ahead. **Among the larger emerging economies, contingent government liabilities in Brazil and China are a concern.** But with nominal GDP growth likely to remain high, debt projections on both countries look sustainable with only small changes in current policy. The path ahead for emerging economies will inevitably be bumpy but the difference with the outlook for the developed world is perhaps as stark as it has ever been.

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Sovereign Debt: are the emerging markets immune?

Emerging markets are, for once, spectators to the sovereign debt crisis that is shaking global markets. But there is no guarantee that they will remain safely on the sidelines. Many economies in the emerging world are still closely tied to Europe and the US through trade and, in some cases, financial links. In the first section of this *Focus* we outline which areas of the emerging world are most at risk from contagion. A second and perhaps bigger question is whether the emerging economies are storing up problems of their own in the form of rising public and private sector debt. We turn to this issue in the second section below.

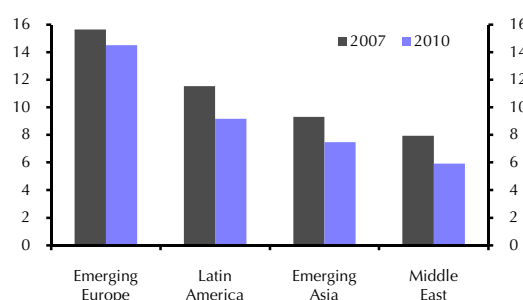
Better placed, but not immune

The market turbulence of the last few weeks illustrates how rapidly shocks in developed economies can affect confidence in the emerging world. The direct impact of debt crises and weak growth in the G7 is likely to be transmitted along one of three channels.

The first is trade. A slow recovery in developed economies over the last three years means that most emerging markets are less reliant on exports to Europe and the US than they were at the time of the global financial crisis. (See Chart 1.) But the degree of exposure varies widely. For a number of the most open economies in Eastern Europe, including Hungary and the Czech Republic, exports to the euro-zone are equivalent to more than 40% of GDP. In Mexico, exports to the US are equivalent to around a quarter of GDP. These countries would be hit hard by a slump in European and US demand.

Commodity producers are particularly vulnerable since any slowdown in demand is likely to be compounded by falling prices. Among the major emerging economies, Russia and, to a lesser extent, Brazil appear most at risk. But these are the exceptions to the general rule that the most exposed economies tend to be small. And for the bulk of Asia and emerging Europe a drop in commodity prices would act as a *boost* for growth.

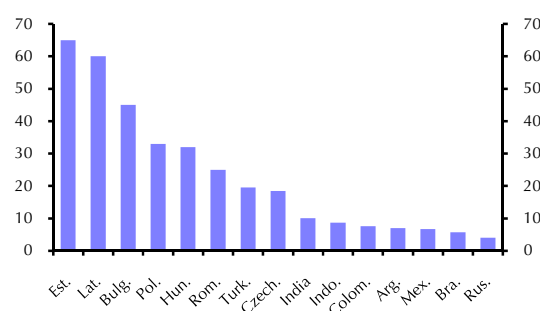
CHART 1: MERCHANDISE EXPORTS TO US & EURO-ZONE
(% OF GDP)



Sources – World Bank, Capital Economics

The second channel of contagion is capital flows. In a number of emerging economies, external financing needs – that is, the amount needed to finance current account deficits and to service external debt – are substantial. (See Chart 2.) In the event that a deepening of the debt crisis in the G7 leads to a sharp rise in investor risk aversion, capital inflows to emerging economies are likely to slowly sharply or even reverse for a while.

CHART 2: EXTERNAL FINANCING REQUIREMENT
(% OF GDP, 2011)



Source – Capital Economics

The vulnerabilities here are concentrated in Latin America and Emerging Europe. Rapid capital inflows have supported growth in a number of Latin America countries (notably Brazil) over the past couple of years. A pullback would hit domestic demand. This is the main reason we have pencilled in below-consensus growth forecasts for the region in both 2012 and 2013.

But the countries of Eastern European countries still have the largest external financing needs within the emerging world. The same was true in 2008 and helps explain why these were among the hardest hit emerging economies during the global financial crisis.

In Turkey, the main concern is a widening current account deficit, which is on track to hit 10% of GDP this year. Elsewhere in the region, current account deficits have narrowed substantially over the past couple of years. But even so, external financing requirements remain substantial. This is a reflection of the large volume of short-term foreign debt held in the region's bank sector.

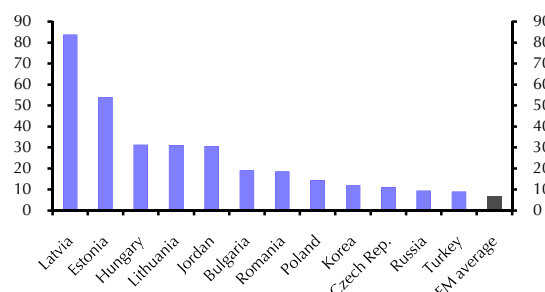
In normal circumstances, this debt tends to be rolled over as a matter of course by parent banks in Western Europe which means that the risk of funding being suddenly withdrawn is fairly low.

But such links through the banking sector open up a third channel for contagion. The events of 2008-09 demonstrated how a major shock to the financial system in the developed economies can be transmitted to the emerging world via a freeze in interbank markets. In the event that a sovereign default in the US and Europe called into question the health of Western banks, there is surely a risk that history will repeat itself.

Banks in the Baltic States and in Hungary, Romania and Bulgaria look particularly vulnerable. (See Chart 3.) The bad news is that it does seem likely that Europe's sovereign debt crisis will morph into a banking crisis. For the countries concerned in Eastern Europe, disruption to banking sectors provides another reason to be concerned about the outlook.

The good news, however, is that these are relatively small economies. In the worst case scenario, they would have to turn to the IMF to cover financing gaps and to recapitalise their banks, but these needs should be easily met. (For more on this see our *Emerging Europe Focus* "Euro-crisis: how big is the contagion threat?", 21st July.)

CHART 3: BANKS' FOREIGN LIABILITIES (% GDP, 2010)



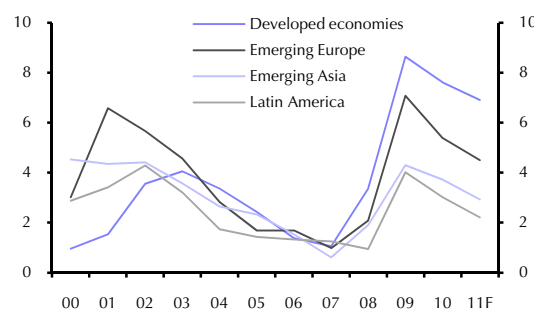
Sources – IMF, Thomson Datastream, Capital Economics

In short, then, a crisis in the US and Europe will be felt around the emerging world. Major exporters are exposed, as are those that have come to rely on foreign finance to support growth and their banks. In the last two instances, the risks are concentrated mainly in Eastern Europe.

Can policymakers respond?

When we turn to the potential for a policy response, Eastern Europe is again the focus of concern. Government debt levels in the region are not unduly high. (We discuss the budget and debt position of major emerging economies in more detail below.) But emerging Europe in general has continued to run relatively large deficits over the last couple of years, leaving little room for governments to respond to another downturn. By contrast, budget deficits in Latin America and Asia are much smaller, giving governments more scope to loosen the purse strings once again if required. (See Chart 4.)

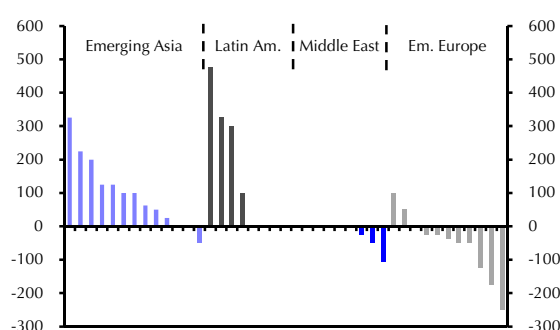
CHART 4: BUDGET DEFICITS (% OF GDP)



Source – Capital Economics

The differences between regions are even starker when we look at the scope for a monetary policy response. Chart 5 shows the change in the benchmark interest rates since 2009 in each of the more than 40 emerging markets that we cover (with each tick along the horizontal axis representing a different country).

**CHART 5: CHANGES IN BENCHMARK RATE SINCE 2009
(BASIS POINTS)**



Source – Bloomberg

Note – The sample of 41 countries includes 16 (mainly in the Middle East) whose currency regimes do not permit independent rate moves.

Rates have risen almost everywhere in Asia and most of Latin America, meaning that there is now plenty of room for them to be cut as growth starts to slow. Brazil and Indonesia have already cut. Others in these regions will follow.

Policymakers in Eastern Europe have much less room to manoeuvre. For a start, rates there have continued to *fall*, meaning that scope for further easing is limited. Moreover, in a number of countries (notably Hungary and Romania, but also Poland) monetary policy is constrained by household's comparatively high level of foreign currency debt, which means that central banks must keep at least one eye on exchange rates when setting interest rates.

The upshot is that even though Emerging Europe is most at risk from a slowdown in developed economies, the policy response there is likely to be smaller than elsewhere. (See Table 1.)

Putting all of this together, then, the net result is that growth in Asia and Latin America is likely to slow by more than most expect next year but, beyond a few isolated cases such as Argentina and

Venezuela, neither region is facing a prolonged downturn. Indeed, given the global backdrop, Asia in particular is likely to perform relatively well over the next year or two. (See Charts 6 and 7, over the page.)

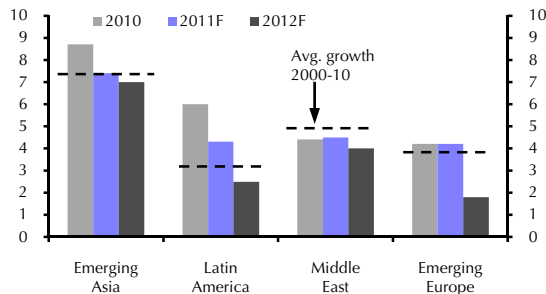
TABLE 1: POLICY RATE FORECASTS

| Country | Current | End-11 | End-12 | End-13 |
|---------------------------------|---------|--------|--------|--------|
| Asia | | | | |
| China | 6.56% | 6.56% | 6.06% | 5.31% |
| India | 8.25% | 8.50% | 8.00% | 8.00% |
| Indonesia | 6.50% | 6.50% | 6.00% | 6.00% |
| Korea | 3.25% | 3.25% | 2.75% | 2.75% |
| Malaysia | 3.00% | 3.00% | 2.50% | 2.50% |
| Philippines | 4.50% | 4.50% | 4.00% | 4.00% |
| Taiwan | 1.875% | 1.875% | 1.625% | 1.50% |
| Thailand | 3.50% | 3.50% | 3.00% | 3.00% |
| E. Europe/ N. Africa | | | | |
| Russia | 8.25% | 8.25% | 7.75% | 8.00% |
| Czech Rep | 0.75% | 0.75% | 0.75% | 1.00% |
| Egypt | 8.25% | 8.25% | 7.50% | 7.50% |
| Hungary | 6.00% | 6.00% | 6.00% | 6.00% |
| Poland | 4.50% | 4.50% | 4.00% | 4.25% |
| Romania | 6.25% | 6.25% | 6.25% | 6.50% |
| Turkey | 5.75% | 5.75% | 5.75% | 6.75% |
| Latin America | | | | |
| Brazil | 12.0% | 11.0% | 10.0% | 11.0% |
| Chile | 5.25% | 5.25% | 4.00% | 4.50% |
| Colombia | 4.50% | 4.50% | 4.00% | 4.50% |
| Mexico | 4.50% | 4.50% | 4.00% | 4.25% |
| Peru | 4.25% | 4.25% | 3.50% | 4.50% |

Source – Capital Economics

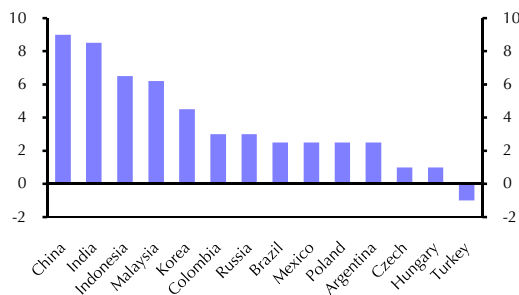
By contrast, the outlook for emerging Europe is far more challenging. As financing conditions deteriorate, we think it is more likely than not that Turkey will slide into recession at some point over the next 12-18 months. (By contrast, the consensus still expects GDP growth in Turkey of 4% or so in 2012 and 2013.) Meanwhile, strong links to the euro-zone banking system continue to cloud the outlook for smaller economies such as Hungary and Romania.

CHART 6: GDP GROWTH FORECASTS



Source – Capital Economics

CHART 7: GDP GROWTH (% Y/Y, 2012F)



Source – Capital Economics

Public debt is low and falling

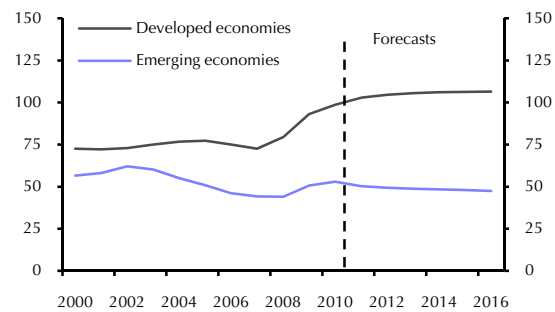
So far, we've been discussing the danger that growth in the emerging world will be dragged down by the debt problems in the US and Europe. Perhaps the more important question is whether emerging markets' growth will be underdone by debt problems of their own.

We remain relatively upbeat on the medium-term prospects for the emerging world, which is in stark contrast to our view on the developed economies. The difference is in large part explained by emerging markets' healthier balance sheets. Government debt levels in emerging economies are lower today than a decade ago and roughly half the level of those in the advanced economies relative to GDP. (See Chart 8.)

We expect debt in emerging markets overall to stabilise relative to GDP whereas it will continue to rise in the developed economies. The benign outlook on debt reflects two points: fiscal policy is

under less strain in emerging markets today and nominal GDP is growing rapidly.

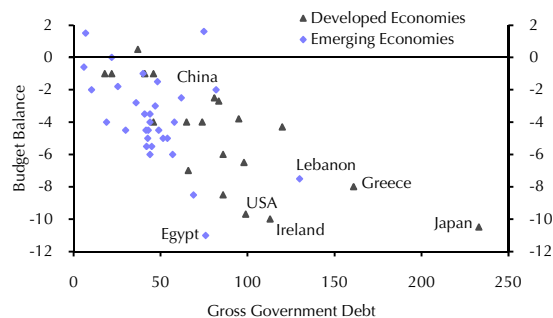
CHART 8: GROSS GOVT. DEBT (% OF GDP)



Sources – IMF, Capital Economics

Of course, we are not necessarily interested in the average emerging economy. Most countries in the emerging world have debt levels below 50% of GDP and deficits under 5% of GDP. But there are some exceptions to this general rule, such as Egypt and Lebanon. (See Chart 9.)

CHART 9: GROSS GOVERNMENT DEBT & BUDGET BALANCE (% OF GDP, 2011F)



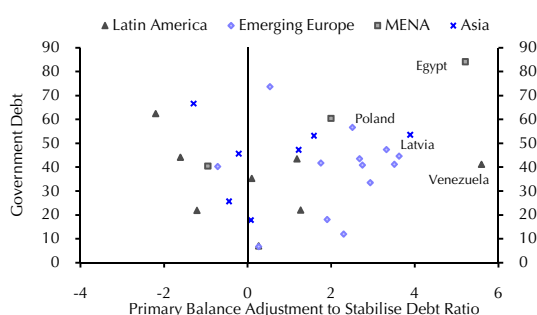
Sources – IMF, Capital Economics

What's more, there are a number of countries where, without action by policymakers, the government debt ratio looks set to rise over the coming years. In Poland, Hungary and the Czech Republic, we estimate that fiscal policy needs to tighten by around 2% of GDP in order to stabilise the debt position. In Egypt, the required tightening is closer to 5% of GDP. (See Chart 10.)

Nonetheless, these are relatively small economies. India stands out among the larger emerging economies for having a large general government deficit (8.5% of GDP in 2011). Yet rapid growth in its nominal GDP and low interest rates on

government debt means that even with such a large deficit, the debt burden should still fall relative to Indian GDP.

CHART 10: CHANGE IN PRIMARY BUDGET BALANCE NEEDED TO STABILISE DEBT/GDP (% OF GDP)

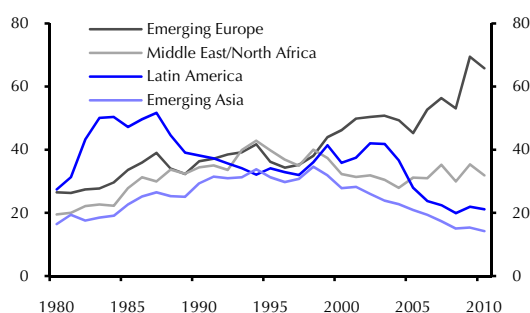


Sources – Thomson Datastream, Capital Economics

Not only has the level of debt in emerging markets fallen over the last ten years, but the structure of debt has generally improved. A decade ago, only half of Latin American debt was issued in domestic currency. Now the share is around three quarters.¹

Most emerging markets have also reduced their reliance on foreign creditors over the last two decades. (See Chart 11.) The exception again is Emerging Europe. There, the solution to the debt problem is likely to involve further austerity, coupled with default via the back door – a good example of which is Hungary’s recent plans to restructure problematic Swiss franc loans.

CHART 11: EXTERNAL DEBT (% GDP)



Sources – IMF, Thomson Datastream

But elsewhere fiscal risks are lower and, of course, foreign exchange reserves, particularly in Asia,

give policymakers plenty of ammunition if capital does start to leave.

Indeed this is probably the first debt crisis in which Asian and Latin American governments are more concerned about what is going to happen to their foreign assets than their foreign liabilities. China’s foreign exchange reserves alone are worth 50% of its GDP. Other emerging economies have smaller reserve holdings than China but on average the total value of foreign assets held by public and private sectors are even higher, at around 100% of GDP. Ever since 2008, emerging markets as a group have been net investors in the rest of the world.

So we are in an upside-down situation where not only are emerging markets arguably a better bet for stable medium term growth but they are starting, with reason, to worry about the safety of assets held in developed markets, including western sovereign debt.

Still reasons to be cautious

Nonetheless, if we are right about the difficulties facing Europe and the US, the next few years will not be easy for emerging markets either. We see four main points of concern.

First, as we have discussed, emerging Europe looks vulnerable to a downturn in the west, particularly one emanating from the euro-zone, which is its key export market and a source of capital for its banks. We are expecting a recession in Turkey during the next year or so and very weak growth across the region more generally.

Similarly, commodity producers such as Russia could struggle more than most expect if weaker demand growth knocks down commodity prices.

Second, there is a risk that in focusing on government debt we are overlooking bigger dangers. After all, the current problems in much of the West originated in the private sector. The size of governments’ contingent liabilities did not become apparent until the crisis hit.

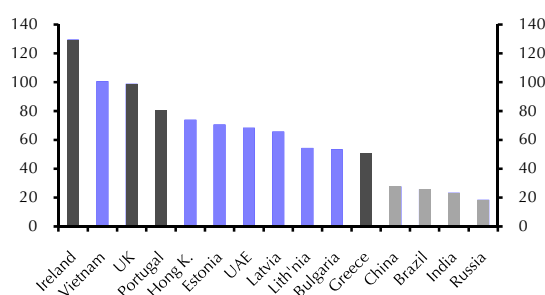
But there were plenty of warning signs in rapid growth in private sector leverage. In the decade

¹ See Burger, Warnock and Warnock (2010)

leading up to the crisis, the value of outstanding credit in the Greek economy increased by an amount equivalent to 50% of GDP; the increase in Portugal was 80% of GDP and in Ireland credit grew by 130% of GDP.

Chart 12 shows the emerging markets where credit has increased fastest relative to GDP over the past decade. Top of the list is Vietnam, followed by the Baltic States and the UAE – both of which have already experienced debt crises in recent years.

**CHART 12: INCREASE IN CREDIT AS A % OF GDP
(SINCE 2000, % PT)**



Sources – Thomson Datastream, Capital Economics
Note – Rise in credit ratio is measured from trough to peak since 2000.

Credit growth in the major emerging markets has not been so dramatic, but still it deserves attention. For example, high interest rates in Brazil mean that household finances are under a lot of strain even though overall credit growth has not been that fast. The average interest rate on household loans in Brazil is around 40%, and with growth set to slow, arrears are likely to rise.

The good news is that capital adequacy buffers in Brazil remain high, which should limit any contingent fiscal risks stemming from problems in the banking sector. Even if non-performing loans were to double from 5% currently to 10%, we estimate that the cost to the government of recapitalising the banking sector may only raise public debt by 3-5% of GDP (to around 65-70% of GDP). If one-in-four loans were to go bad, the eventual cost to the public purse could raise government debt by around 10% of GDP (to around 75% of GDP). This would place Brazilian government debt at levels comparable to those

currently seen in the US and UK, something that would surely entail a nasty shock for the country's bond markets.

But – unlike the G7 economies – Brazil has potential for comparatively rapid nominal GDP growth, which should help to ease any future debt problems. Indeed, despite being more worried than most on the build up of contingent liabilities in the private sector, we still think that gross government debt should fall to below 50% of GDP by 2025. (See our forthcoming *Latin America Focus* “How healthy is Brazil’s fiscal position?”.)

China’s difficult transition

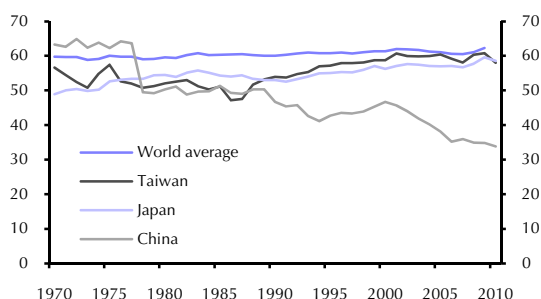
In China, official government debt is low, under 20% of GDP. But that it because the official figures ignore a large number of government liabilities. These are mostly in the banking system in the form of loans to government entities that are unlikely to be repaid without some bailout of the state-owned firms and local governments concerned. All told, gross government debt is probably over 80%.

As with Brazil, that’s not outrageously high for a rapidly growing economy, particularly when interest rates are low and the government holds so many assets. But the unacknowledged bad debts will be a burden on the banking system for years to come and will hold back efforts to liberalise the financial system so that it can play a better role in allocating credit.

More broadly, the debt problems in the West present a huge challenge to China. Exports will not provide much of a boost to growth over the next few years. Nor will household spending, which accounts for only a third of GDP. The economy will therefore continue to rely on investment channelled through a dysfunctional banking system.

Unless China makes rapid and sustained progress in boosting spending by households, the likelihood is that this investment will produce serious bouts of overcapacity. The government has pledged to support household spending, but to no effect. The share of spending coming from households has continued to shrink. (See Chart 13, over the page.)

CHART 13: HOUSEHOLD CONSUMPTION (% OF GDP)



Sources – World Bank, CEIC, Thomson Datastream

The latest consensus forecasts for China project steady 9% growth for several years to come. We think reality will be far more volatile. We wouldn't be surprised to see growth drop to 7% or below at some point in the next few years, which would be the slowest in 20 years.

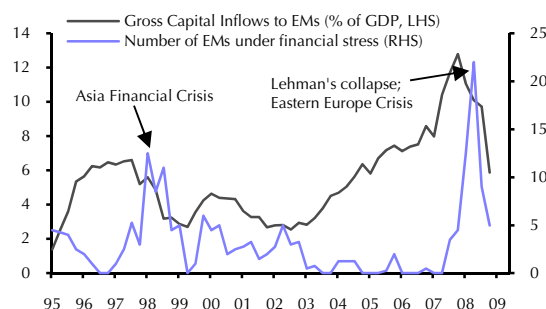
Dealing with capital flows

The fourth and final risk comes from capital flows. Global investors have been pulling capital out of the emerging world in recent weeks. But our relatively upbeat view on growth means that they are likely to remain strong over the next two-to-three years.

The arrival of foreign capital can be a positive. It can finance investment in what, outside Asia at least, are savings-constrained economies, and it facilitates the transfer of technology and knowledge.

But capital inflows can also bring problems, inflating asset bubbles or financing unsustainable consumption. It is notable that the past two periods of rapid inflows to emerging markets culminated in the Asian Financial Crisis of 1997-98 and the East Europe crisis of 2008-09. (See Chart 14.) We suspect that managing capital inflows will turn out to be the defining challenge for emerging economies this decade.

CHART 14: NUMBER OF EMERGING MARKET COUNTRIES UNDER FINANCIAL STRESS AND CAPITAL INFLOWS



Source – IMF

Summary

Overall, the difference in the outlook for the developed and emerging worlds is now as stark as it has ever been. Most emerging economies will still be hurt by weaker growth and, if it happens, renewed financial crisis in the G7. But they are, in general, not encumbered by serious debt problems of their own and, on the whole, they have space for a policy response.

That said, growth in emerging markets is typically volatile and there is no reason to expect the next few years to be any different. Dealing with weak G7 growth will be among the challenges, particularly for economies that have prospered on the back of developed world demand. Emerging Europe looks most exposed, due to its tight trade and financial links to the euro-zone. But China too faces a structural shift which would have been difficult at any time, let alone against a backdrop of weak export demand.

Finally, the more favourable growth outlook relative to the developed could itself bring problems as global investors shift more of their portfolios into emerging markets. Asset price bubbles are likely to be a recurring problem in parts of Latin America and Asia over the coming decade.