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Economics Group

Special Commentary

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Are Developing Economies Heading for a Crash?

Executive Summary

Many developing economies suffered painful recessions when a wave of financial crises swept through the developing world in 1997 and 1998. The economies that suffered the most generally had large current account deficits that were financed by foreign capital inflows. When it became apparent that some of the economies would not be able to service all of their debts, foreign investors streamed toward the exits. With current account deficits rising again in many developing economies, is a replay of 1997-98 imminent?

The good news is that the external debt-to-GDP ratio in the developing world has receded significantly since the 1997-98 crisis, and government debt ratios in these economies are also generally lower today. On the other hand, however, it appears that the potential economic growth rate in the developing world has downshifted from the very robust rate that was achieved prior to the global financial crisis. In our view, we do not believe that a wave of financial crises in the developing world is just around the corner, but developments in these economies bear watching in coming years.

Do Current Account Deficits Spell Future Trouble?

Earlier this year, the currencies of some important developing economies came under significant downward pressure. For example, the Brazilian real, the Indian rupee, the Indonesian rupiah and the Turkish lira all depreciated between 10 percent and 20 percent against the U.S. dollar between mid-May and early September as long-term U.S. interest rates rose sharply (Figure 1). As we explained at the time, these four countries are currently incurring sizeable current account deficits that need to be financed by net capital inflows from abroad.[1] The rise in long-term U.S. interest rates that was caused by speculation of imminent Fed "tapering" made financial assets in many developing economies less attractive. As capital inflows to these countries weakened, their currencies came under downward pressure.

Not only did the four currencies mentioned above weaken significantly over the summer, but emerging market currencies in general depreciated vis-à-vis the greenback. The Federal Reserve's "Other Important Trading Partners" (OITP) index, which measures the value of the U.S. dollar against an index of important developing economy currencies, rose 5 percent over the summer (i.e., the dollar appreciated 5 percent on a trade-weighted basis versus these currencies). Although this appreciation of the greenback pales in comparison to the 20 percent jump in the OITP index that occurred during the global financial crisis of 2008 and the 30 percent increase that transpired during the Asian financial crisis of 1997-98, the rise in the OITP index over the summer shows that the dollar's gains against emerging market currencies was broad based.[2]

Emerging market currencies in general depreciated vis-à-vis the greenback.

[1] See our *Weekly Economic & Financial Commentary*, August 30, 2013.

[2] The financial crisis that began in Thailand in July 1997 became known as the "Asian financial crisis." However, the wave of financial crises that followed Thailand was broader than just Asia as it took down Russia in 1998 and Brazil in early 1999. The "Asian financial crisis" arguably contributed to the implosion of the Argentine economy in 2001-2002.

Figure 1

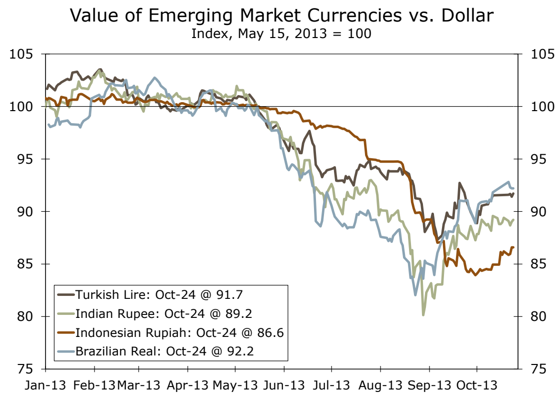
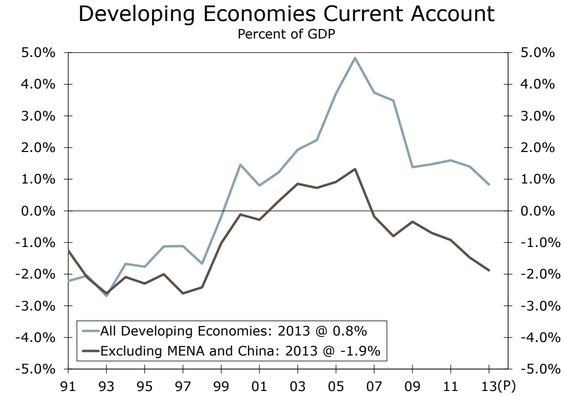


Figure 2



Source: IHS Global Insight, International Monetary Fund and Wells Fargo Securities, LLC

The developing world incurs a current account deficit at present that has widened over the past few years.

Emerging market currencies have recouped some of their losses since early September, but current account deficits in these economies have not gone away. As a group, developing economies have a modest current account surplus of roughly 1 percent of their GDP at present (Figure 2). However, the black ink in their aggregate current account position at present is due entirely to China and the oil exporters of the Middle East and North Africa (MENA). If China and MENA are excluded, the developing world incurs a current account deficit at present that has widened over the past few years.

As we show in the Appendix, a country incurs a current account deficit when it spends more than it produces. A country that finds itself in this position needs to borrow from the rest of the world just as an individual who spends more than her income needs to finance this excessive spending by borrowing. That is, a current account deficit is offset in the country's balance of payments accounts by the net capital inflows that finance it. If investors begin to question the ability or willingness of the country to service its debts, they may refuse to lend further. Following the analogy of an individual who needs to cut back sharply when creditors refuse further financing, a country usually goes through a painful recession to bring its spending in line with its production when foreign investors head for the exits.

Many developing economies indeed experienced deep recessions in the aftermath of the Asian financial crisis. The Thai economy, where the crisis began, contracted more than 10 percent in 1998. Real GDP in Korea (-6 percent) and Indonesia (-13 percent) also fell sharply in 1998. Russia, which defaulted on its sovereign debt in 1998, saw its GDP fall 5 percent that year. Each of these countries, with the exception of Russia, where petroleum is the country's most important export, were running current account deficits heading into that crisis. Many other developing countries, which also were incurring current account deficits, also experienced recession or very weak growth in 1998. The Institute of International Finance estimates that net inflows of foreign capital to developing countries plunged from $337 billion in 1996 to $155 billion in 1998. Although foreign direct investment in the developing world held up rather well during the crisis, portfolio investment by foreigners weakened significantly and lending by foreign banks turned sharply negative. Little wonder that many developing economies contracted sharply in 1998.

If excessive amounts of red ink in the current account can eventually lead to financial crises, should we be worried about the re-emergence of current account deficits in much of the developing world? Are this summer's declines in the values of many emerging market currencies a harbinger of more financial and economic pain to come in the developing world?

Crises Do Not Appear Imminent, But...

Figure 2 shows that the overall current account deficit for the developing world (excluding China and MENA) will be about 2 percent of GDP this year. Although high by the standards of the past decade, this ratio is no higher today than it was in the early 1990s, well before the advent of the crisis. The International Monetary Fund (IMF) forecasts that the aggregate current account deficit of the developing world (excluding China and MENA) will continue to widen, but that it will not reach the 1997 ratio of 2.6 percent of GDP until 2018.[3] However, there is no "magic" ratio that, once breached, necessarily triggers a financial crisis. The willingness of investors to continue to finance a country depends on a number of variables other than simply its current account deficit. Are there any indicators that give us pause when we consider the economic outlook for the overall developing world?

One important consideration would be the external debt positions of these countries.[4] If external debt builds up too much, foreign investors may begin to question the ability of a country to service its foreign debt. As shown in Figure 3, the external debt-to-GDP ratio for the developing world has declined noticeably since the 1997-98 crisis. Furthermore, the ability of the developing world to service this external debt has increased over the past decade. Heading into the 1997-98 crisis, it took about 35 percent of the developing world's exports to service (i.e., to remain current on amortization and interest payments) its external debt. Today, that ratio is about 25 percent.

If external debt builds up too much, foreign investors may begin to question the ability of a country to service its foreign debt.

The drop in the aggregate government debt-to-GDP ratio in the developing world over the past decade has contributed to the decline in the external debt ratio (Figure 3).[5] As fiscal deficits swung to surpluses in the middle years of the past decade, government debt ratios in many developing countries receded. Although fiscal balances in developing economies have generally deteriorated over the past few years, the deficits are still small enough and/or the economies are still growing strongly enough to keep government debt-to-GDP ratios more or less stable in the developing world.

Figure 3

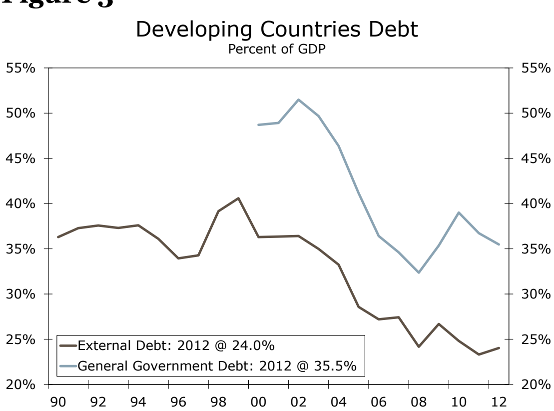
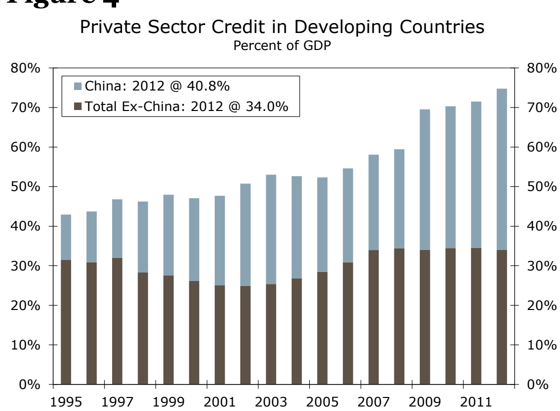


Figure 4



Source: International Monetary Fund, World Bank and Wells Fargo Securities, LLC

Speaking of debt, credit extended to the private sector in developing economies has risen as a percent of GDP since the late 1990s, especially in the past few years (Figure 4). However, the net increase in the private-sector credit-to-GDP ratio since the 1997-98 crisis is due entirely to China.

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[3] **See the IMF World Economic Outlook database, which can be accessed at www.imf.org.**

[4] **External debt is the debt that a country's consumer, business and public sectors owe to creditors who are located outside of the country.**

[5] **Although issuance in local currencies is not as rare today as it was a few years ago, governments in many developing countries need to issue debt in convertible currencies like U.S. dollars and euros. If a government of a developing country issued debt in U.S. dollars, increases in government debt would translate one-to-one to increases in external debt. Conversely, external debt would decline one-for-one as the government paid off its foreign currency-denominated debt.**

As we detailed in a recent report, we are not overly concerned about the level of debt in the Chinese economy today, although we did conclude that "there may be some yellow lights that are starting to blink on and off, and we believe that the debt situation in China, especially in the non-financial business sector, bears watching."[6] Excluding China, the amount of private-sector debt outstanding in the developing world does not appear to be unduly concerning.

A wave of financial crises à la 1997-98 does not appear imminent.

In sum, current account deficits in many developing economies are smaller at present than they were heading into the 1997-98 crisis, and ratios of external debt, government debt and private debt in the developing world do not appear to be especially worrying at present. As long as the underlying economic fundamentals in developing economies remain solid, most of these countries should not have problems servicing their debts, at least not in the foreseeable future. In other words, a wave of financial crises à la 1997-98 does not appear imminent.

Economic Fundamentals Have Deteriorated Somewhat

But do the underlying economic fundamentals in developing economies remain solid? Together, Figure 5 and Figure 6 suggest that there has been some modest deterioration in underlying fundamentals in the developing world. Between 2003 and 2007, the period immediately preceding the Global Financial Crisis (GFC), real GDP growth in the developing economies averaged 7.7 percent per annum (Figure 5). In this pre-GFC period the average annual rate of CPI inflation equaled 6.1 percent (Figure 6).

However, since the global economy exited recession in 2010, the average GDP growth rate in the developing world has been only 5.8 percent, which represents a noticeable slowdown relative to the pre-GFC period. Yet the average CPI inflation rate over the past three years has actually been a bit higher than it was during the pre-GFC period. In other words, there appears to have been a slowdown in the rate of potential (i.e., long run) GDP growth in the developing world relative to the pre-GFC period. Otherwise, the slower pace of economic growth in these economies over the past few years should have been associated with lower inflation.

Figure 5

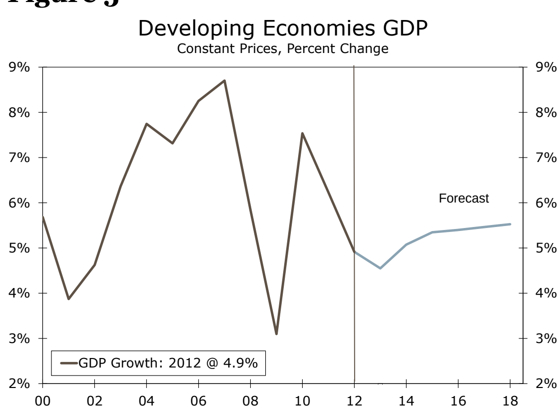
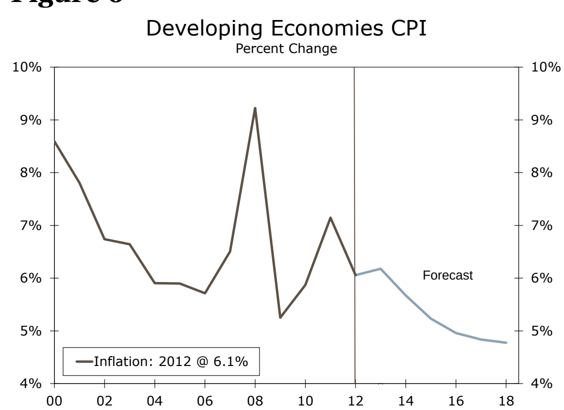


Figure 6



Source: International Monetary Fund and Wells Fargo Securities, LLC

Moreover, it appears that this slowdown in potential GDP growth in the developing world may be long lasting. As shown in Figure 5, the IMF forecasts that real GDP in the developing world will grow roughly 5.5 percent per annum between 2014 and 2018, which is more than two percentage points below the annual average economic growth rate in the pre-GFC period. Specifically, the days of sustained double-digit economic growth in China appear to be a thing of the past. In India, real GDP growth averaged 9 percent per annum during the pre-GFC period. The annual average growth rate over the past three years has been roughly one-half of its pre-GFC pace due, at least in part, to the lack of momentum in the pace of economic reform. Looking at the 2014-2018 period, the IMF does not forecast a return to 9 percent growth in India.

[6] **See "*Does China Have a Debt Problem?*" (September 23, 2013) that is available upon request.**

Economic growth in the developing world averaged 3.5 percent per annum during the debt-plagued decade of the 1980s. In the crisis-filled decade of the 1990s, real GDP growth in developing economies again averaged 3.5 percent per annum. Therefore, the 5.5 percent annual average GDP growth rate that the IMF forecasts for 2014 through 2018 certainly is stronger than the growth rates that the developing world averaged in the last two decades of the twentieth century. If the IMF's forecasts are realized, however, growth in the developing world would turn out to be disappointing relative to the standards of the pre-GFC period.

Growth in the developing world could turn out to be disappointing relative to the standards of the pre-GFC period.

Conclusion

Many developing economies incurred widening current account deficits during the 1990s. As the foreign debt that financed those deficits continued to rise, foreign investors began to question whether those economies would be able to service the debt. When it became apparent that Thailand would not be able to service all of its debts, foreign investors streamed toward the exits. Interest rates rose sharply, the Thai government eventually abandoned its currency peg to the U.S. dollar, and the Thai economy plunged into a deep recession. As investors started to look around, they noticed that many other developing economies resembled Thailand. Financial crises soon spread to other Asian economies and then eventually to Russia and Latin America. Fifteen years after the 1997-98 financial crisis current account deficits in the developing world are rising again. Should we be alarmed?

In our view, a wave of financial crises in the developing world is not imminent, but developments in those economies bear watching. Before the crisis in 1997 most developing economies maintained fixed exchange rates. Believing that the pegs were immutable, many businesses and households borrowed dollars because U.S. dollar interest rates tended to be lower than local currency interest rates. When the pegs ultimately broke and the local currencies depreciated sharply versus the U.S. dollar, those businesses and households became insolvent as the local currency value of their liabilities skyrocketed.

Today, most developing countries allow some flexibility in the value of their currencies vis-à-vis the dollar, which significantly reduces the incentive to borrow in foreign currencies. Indeed, our analysis shows that external debt in the developing world is significantly lower today (as a percent of GDP) than it was ahead of the 1997-98 crisis. The aggregate government debt-to-GDP ratio in the developing world has also declined over the past decade. Therefore, a wave of financial crises that takes down many developing economies does not appear imminent.

That said, the economic fundamentals in the developing world appear to have deteriorated at the margin. Although we do not believe that a wave of crises in the developing world is imminent, are there individual economies that may be more vulnerable to financial crisis at present than others? We plan to address this question in a forthcoming report.

APPENDIX

The national income identity can be written as:

$$Y = C + I + G + X - IM \tag{1}$$

where Y = output

C = personal consumption expenditures

I = investment spending

G= government spending

X = exports

IM = imports

Rearranging (1) yields:

$$(X - IM) = Y - (C + I + G) \tag{2}$$

The term on the left-hand side of (2) is net exports, which is essentially equivalent to the current account position of the country. The right hand side of (2) represents the amount by which domestic output differs from domestic spending. If spending exceeds output, then the country will be incurring a current account deficit. That is, the country must import its excess spending, and this spending must be financed by capital inflows from abroad. If output exceeds spending, then the country will incur a current account surplus as its excess output will be exported.

Output (Y) produces an equivalent amount of income. Therefore, (1) can also be written as

$$Y = C + S + T \tag{1a}$$

That is, income (Y) can either be consumed (C), saved (S), or used to pay taxes (T). Substituting (1a) into (1) and rearranging yields:

$$(X - IM) = (S - I) + (T - G) \tag{3}$$

A country that is a net saver, that is, one in which private savings (S) exceeds investment (I) and where public savings is positive (i.e., $T - G > 0$, will incur a current account surplus. A country that is a net dis-saver will run a current account deficit.

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