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Economics Group

Special Commentary

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Should Developing Economies Worry Us?

Is the Developing World an Accident Waiting to Happen?

Currencies in some developing economies have come under downward pressure in recent days. For example, Argentina, which had been allowing its currency to depreciate at a slow, steady pace against the U.S. dollar, withdrew its support for the peso on Jan. 23. The currency plunged about 12 percent versus the greenback on that day. The Turkish lira has not dropped as suddenly or as dramatically as the Argentine peso, but it is down about 6 percent on balance against the U.S. dollar so far this year. Equity markets in most developing countries have also weakened in the past few days, and stock markets in developed economies have not been immune to the volatility in emerging markets.[1] Is another financial crisis like the 1997-1998 episode that took down many developing economies or, worse, like the 2007-08 global financial crisis, brewing?

Is another major financial crisis brewing?

As we wrote in two reports in October, the economic fundamentals in the developing world have deteriorated at the margin over the past few years.[2] For example, the aggregate current account surplus of developing economies, which peaked at 5 percent of aggregate GDP in 2006, has shrunk to only 1 percent (Figure 1). Moreover, the aggregate current account position has moved into deficit territory over the past few years if China and the oil-exporting nations of the Middle East and North Africa (MENA) are excluded. As we also pointed out in those reports, the rates of economic growth in most developing economies are not as strong today as they were in the 2004-2007 period, and inflation rates have generally been higher in recent years than they were in the past decade.

That said, the economic fundamentals in the developing world today are generally not as weak as they were in the mid-1990s. For example, governments in most developing economies are generally not as indebted as they were heading into the 1997-1998 crisis, and external debt (as a percent of GDP) is also lower today than it was two decades ago (Figure 2). Moreover, most developing economies operated under fixed exchange rates in the 1990s, and many businesses and consumers borrowed U.S. dollars because dollar interest rates were generally lower than interest rates in local currencies. This strategy was attractive as long as the local currency remained pegged to the U.S. dollar. However, once the pegs broke, many businesses and consumers found themselves insolvent because they were unable to pay their dollar debt obligations in depreciated local currency. Today, most developing economies maintain flexible exchange rates, which act as shock absorbers, and borrowing in foreign currencies is not as widespread today as it was in the 1990s (i.e., external debt is lower today).

Economic fundamentals in the developing world are generally not as weak as they were in the mid-1990s.

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[1] The MSCI Emerging Market Free index has nosedived 4 percent since Argentina let its currency slide, and the S&P 500 has weakened more than 3 percent over that period.

[2] See "*Are Developing Economies Heading for a Crash?*" (Oct. 28, 2013) and "*Developing Economies and Crisis Vulnerability*" (Oct. 30, 2013). Both reports are posted at www.wellsfargo.com/economics. See also "*Will Fed Tightening Derail Developing Economies?*" (April 2, 2013), which is available upon request.

Figure 1

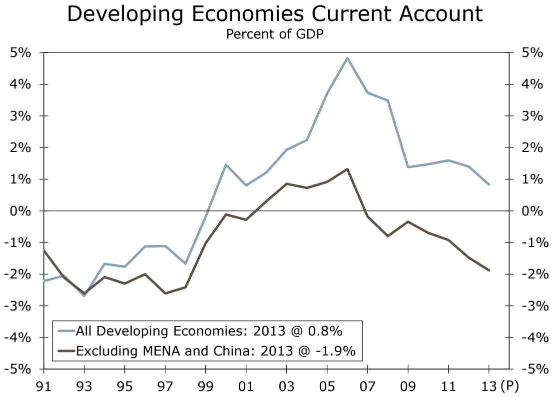
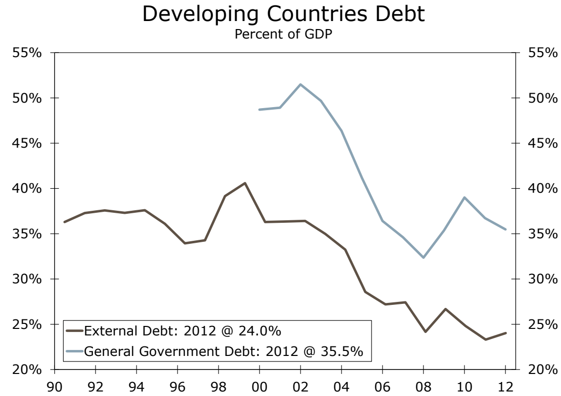


Figure 2



Source: International Monetary Fund and Wells Fargo Securities, LLC

The issues in developing economies are more idiosyncratic than systemic.

In our view, the issues in developing economies today are more idiosyncratic to each individual economy rather than systemic. As highlighted by the IMF censure of Argentina in February 2013, there has been skepticism regarding the underlying strength of the Argentine economy for some time.[3] The loss of foreign exchange reserves over the past few years in Argentina—FX reserves have declined to $30 billion at the end of last year from more than $50 billion in 2011—finally convinced the Argentine government that it could not support the currency indefinitely. The political crisis in Turkey that has intensified in recent months has contributed to the downward pressure on the lira. However, the events in Argentina and Turkey are not related. In contrast, many developing economies in the 1990s had gaping current account deficits, dwindling reserves, and fixed exchange rates. Once Thailand devalued the baht in July 1997, investors realized that there were many other developing economies with the same type of macroeconomic imbalances, and the crisis soon spread to these countries.

How Exposed Are Developed Economies to the Developing World?

Due to strong growth over the past two decades, the developing world today accounts for more global GDP than it did two decades ago. Indeed, the developing world's share of global GDP has risen to 50 percent in 2012 from 37 percent in 2000 (Figure 3). The proportion of advanced economy exports destined for the developing world has trended up to 35 percent from 20 percent over that period.

We do not look for a collapse in growth in the developing world.

In our view, however, the recent volatility in emerging financial markets does not portend another major financial crisis, especially not on a global scale. Yes, the advanced economies are more economically exposed to developing economies than they were 10–20 years ago. Exports to developing economies are now equivalent to about 8 percent of advanced economy GDP (Figure 4). But about one-half of this exposure is to the economies of developing Asia, which, in general, appear to be more fundamentally sound than those of Latin America or the large individual economies like those of Turkey or South Africa.[4] Moreover, we do not believe the recent volatility in emerging markets will lead to a collapse in economic growth in the developing world *à la* 1997-1998 because, as noted above, the economic fundamentals in the developing world are generally not as weak as they were in the mid-1990s.

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[3] For further reading, see "*Strong Growth in Argentina in Q2 2013*" (Sept. 27, 2013), which is posted on our website.

[4] See our Oct. 30 report, which is referenced in footnote No.2, for a rank ordering of the crisis vulnerability potential in 28 developing economies.

Figure 3

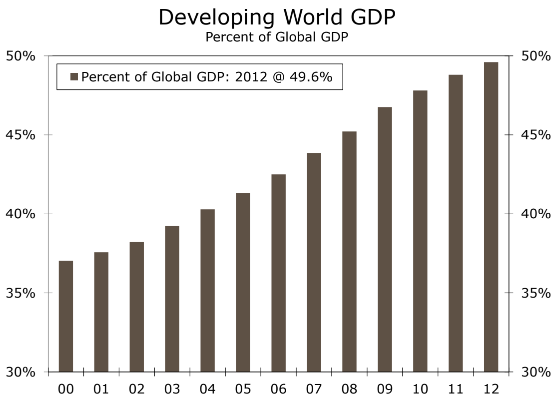
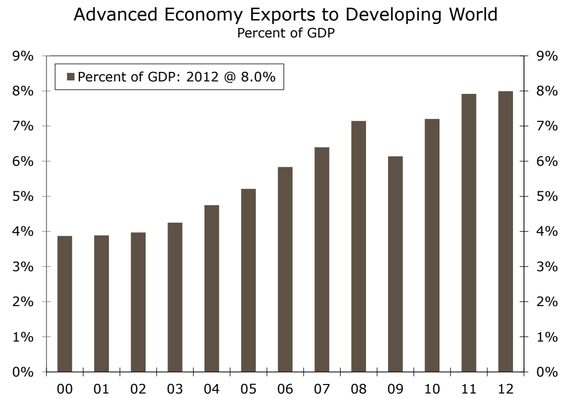


Figure 4



Source: International Monetary Fund and Wells Fargo Securities, LLC

Financial markets, not only in the developing world but in advanced economies as well, could clearly remain volatile for the foreseeable future, and economic growth in some individual economies (e.g., Argentina and Turkey) could weaken markedly over the next few quarters. However, we expect financial markets to settle down eventually, and that the global expansion that began in the second half of 2009 will continue through at least the end of our forecast period (i.e., end 2015).

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