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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Should Developing Economies Worry Us?: Part II

Executive Summary

In a recent report we analyzed the export exposure of the advanced economies to the world's developing countries.[1] In this follow-up report, we focus on the United States and compare exposure today relative to two other episodes of emerging market financial crises: the so-called "Tequila Crisis" of 1994-95 and the 1997-98 Asian economic crisis. Not only do we analyze the international trade exposure of the United States to developing economies, but we also examine some financial linkages with the developing world.

American export and financial exposure to the developing world has increased over the past twenty years, but the magnitudes today are still probably not large enough to cause serious implications for the U.S. economy. Although financial markets in developing economies could remain volatile for some time, we do not believe that the tremors in those countries will lead to significant economic and financial weakness in the United States.

Would Exporters Be Hurt by a Downturn in Developing Economies?

The Tequila Crisis began in December 1994 when Mexico, which had racked up large current account deficits and rising levels of external debt in the early 1990s, devalued the peso vis-à-vis the U.S. dollar. Although the overall developing world took in 30 percent of American exports, which was equivalent to 2 percent of U.S. nominal GDP in that year (Figure 1), the crisis was largely confined to Mexico, to which 10 percent of U.S. exports were destined. Therefore, the Tequila Crisis had little discernable effect on U.S. real export growth and, more broadly, on the overall U.S. economy (Figure 2).

The Asian economic crisis had a more marked effect on U.S. export growth than the Tequila crisis.

The 1997-98 crisis became known as the "Asian economic crisis" because it began in Thailand in 1997 and took down Indonesia and South Korea later that year. However, that series of crises ultimately spread beyond Asia. Before it was over, the Russian, Brazilian and, eventually, Argentine economies would be laid low. Thus, the Asian economic crisis had a broader effect on the developing world than the Tequila Crisis. In 1997, more than 30 percent of total U.S. exports, which was equivalent to nearly 3 percent of U.S. nominal GDP, were destined for the developing world. As shown in Figure 2, this crisis had a more marked effect on U.S. real export growth. By summer 1998 real exports had declined 1 percent on a year-over-year basis. However, booming growth in consumer and investment spending in the United States offset the slump in exports so that the year-over-year rate of real U.S. GDP growth remained rock steady around 4 percent throughout 1998.

[1] **See "*Should Developing Economies Worry Us?*" which is available on our website.**

Figure 1

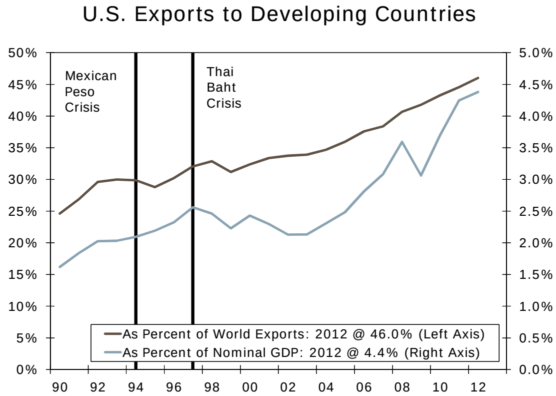
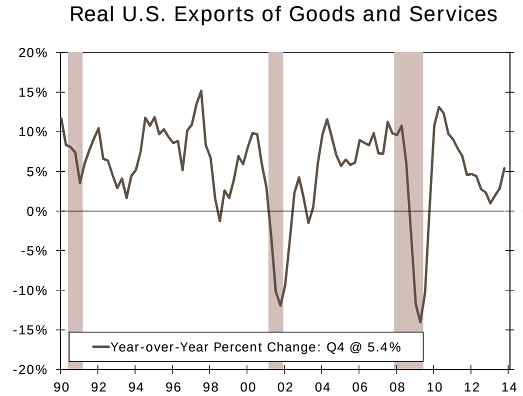


Figure 2



Source: International Monetary Fund, U.S. Department of Commerce and Wells Fargo Securities, LLC

The developing world takes in one-half of U.S. exports today.

The developing world, led in part by China, has generally boomed since the end of the Asian economic crisis. Strong growth in these economies in conjunction with the modest depreciation of the U.S. dollar versus many emerging currencies has stoked U.S. export growth.[2] The percentage of U.S. exports destined for developing economies, which was about 30 percent twenty years ago, is closing in on 50 percent today. As a percentage of GDP, American exports to developing economies have climbed to 4.5 percent presently from only 2 percent twenty years ago. Could American exports once again weaken as they did in 1998? Although consumer and investment spending in the United States were able to take up the slack in 1998, we may not be as fortunate today because the domestic U.S. economy is not nearly as robust as it was in the late 1990s.

Economic fundamentals in the developing world are not as weak today as in 1997-98.

As we wrote in our previous report, however, we view the issues in the developing world today as largely idiosyncratic to individual economies rather than systemic to all developing countries. That is, there may be individual economies (e.g., Argentina, Turkey, Venezuela, etc.) that may experience continued financial market volatility if not outright crisis in the near term. However, the economic fundamentals in the developing world are not quite as weak as they were in 1997-98, and we do not expect a wave of financial crises to sweep around the developing world today. Yes, the deceleration in economic activity in the developing world that we highlighted in a previous report along with the recent appreciation of the U.S. dollar vis-à-vis many emerging currencies may exert some headwinds on U.S. export growth.[3] However, we do not expect significant weakness in U.S. exports emanating from the emerging world.

Do American Banks Have Significant Exposure to Developing Economies?

Another way in which the U.S. economy has exposure to the developing world is via the banking system. Financial crises in developing economies could lead to marked economic weakness in those countries. If American banks have significant exposure to developing countries, a wave of bankruptcies in those economies would lead to financial losses for American banks. Consequently, the ability of those banks to extend credit to U.S. businesses and consumers could become impaired, thereby leading to economic weakness in the domestic economy.

In Q4 1994, on the eve of the Tequila Crisis, developing economies accounted for 3.7 percent of the assets of domestically chartered banks in the United States, with Latin countries accounting for more than half of that exposure (Figure 3). Today, exposure among American banks has grown to 6.2 percent of total assets with most of the increase attributable to developing Asia. In

[2] The Federal Reserve's "Other Important Trading Partners" index, which measure the value of the U.S. dollar versus a trade-weighted basket of emerging market currencies, has declined 10 percent on balance over the past ten years.
[3] For a discussion of slower economic growth in the developing world see "*Are Developing Economies Heading for a Crash*" (October 28, 2013) which is posted on our website.

our view, this distinction between regions is important. In a recent report that rank ordered crisis vulnerability, we found that six of the ten most vulnerable countries were located in Latin America.[4] In contrast, only two countries in developing Asia were included in the top ten list. The percentage of U.S. banking assets directly exposed to Latin America is no higher today than it was prior to the Tequila Crisis.

Exposure among American banks to developing economies is still rather small.

Although there is more exposure among American banks today to developing economies than there was in 1994 and 1997, this exposure should be put into perspective. In late 2006, just as the U.S. housing bubble was beginning to burst, roughly one-third of U.S. banking assets were exposed to American residential real estate, which is about five times as much as today's exposure to developing economies. In other words, a series of full-blown financial crises in the developing world, should one come to pass, should not come close to having the same credit-inhibiting effects in the U.S. banking system as the residential mortgage crisis did a few years ago.

Figure 3

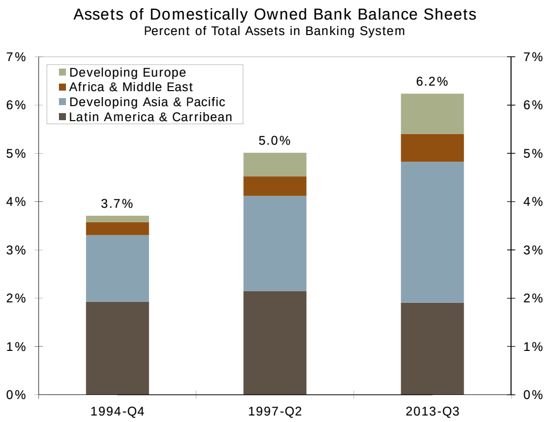
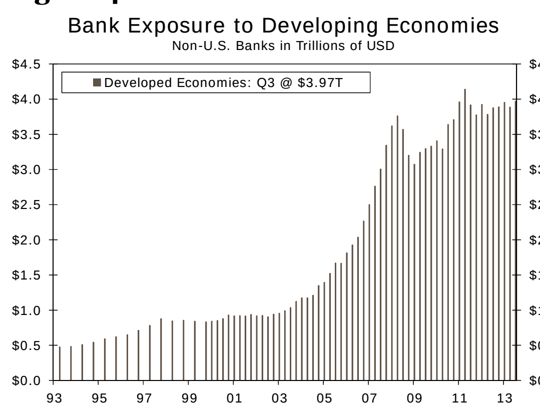


Figure 4



Source: Bank for International Settlements and Wells Fargo Securities, LLC

But perhaps this focus on the direct effects on the U.S. banking system is too narrow. Banks in other advanced economies could have much higher exposure to the developing world than their American counterparts. Significant financial losses for those foreign banks could lead to credit crunches in other advanced economies which could then lead to adverse economic and financial consequences in the United States.

Banks in developed economies outside of the United States currently have about $4 trillion worth of exposure to developing economies, which has risen significantly over the past two decades (Figure 4). Although $4 trillion is clearly a very large number, it represents only 7 percent of the total assets of banks in developed economies outside of the United States. Thus, it is unlikely that developing economies would impart a crippling blow to banks in other advanced economies.

Would U.S. Investors Be Hurt by an Emerging Market Meltdown?

Investing in emerging markets has been in vogue in recent years and, as we will detail shortly, American investors have increased their holdings of emerging market securities. Prices of these securities have weakened recently and further declines could reduce household wealth in the United States.[5] If the wealth hit were large enough, U.S. consumer spending could begin to falter.

Brazil tops the list today of developing economies in which Americans own equity and fixed income securities with Mexico in second place (Figure 5). In aggregate, Americans owned $1.2 trillion worth of emerging market debt and equity securities at the end of 2012 (latest

[4] **See "*Developing Economies and Crisis Vulnerability*" (October 30, 2014), which is posted on our website.**
[5] **Since its 2013 high in late October, the MSCI Emerging Market Free Index has dropped about 6 percent on balance.**

Emerging market securities still represent a small proportion of investor portfolios.

available data). Although American ownership of emerging market securities has more than tripled since the end of 1997 (Figure 6), these holdings represent a small fraction of overall net worth in the United States. For starters, American holdings of debt and equity securities of the other advanced economies totaled $5.5 trillion in Q4 2012, five times the amount they had invested in emerging markets. Furthermore, the net worth of the household sector stood at $71 trillion at the end of 2012. Even if financial markets in developing countries were to totally collapse, the direct effects on the balance sheets of American households would be rather small.

Figure 5

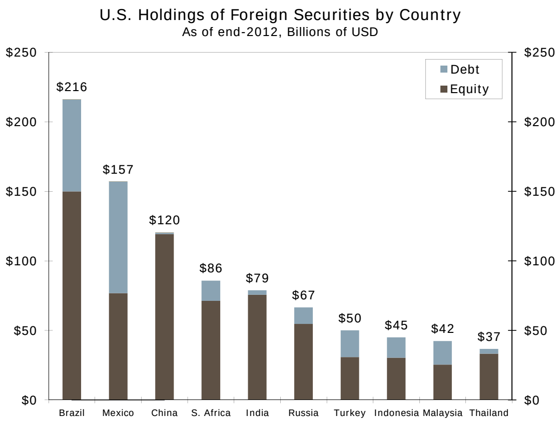
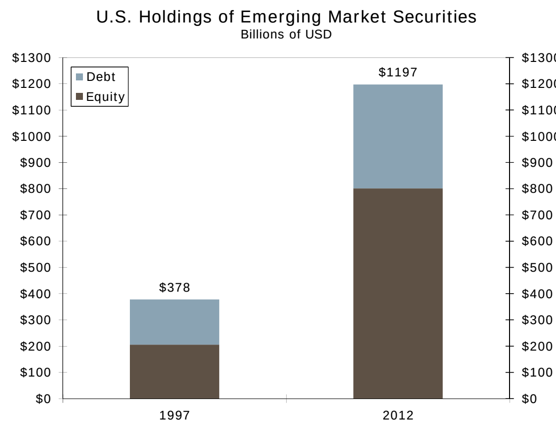


Figure 6



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

Conclusion

Due to strong economic growth in the developing world over the past two decades, the United States is more exposed to these countries than it was prior to the 1994 and the 1997-98 financial crises in developing economies. Exports to developing economies now account for one-half of overall U.S. exports. Meanwhile, exposure among American banks to developing countries is higher today than it was twenty years ago, and American households own significantly more emerging market securities than they once did.

That said, the magnitudes are still probably not large enough to cause serious implications for the U.S. economy. Yes, the United States today sends one-half of its exports to developing economies, but these exports are equivalent to less than 5 percent of U.S. GDP. Moreover, it is our belief that the issues some developing economies face today are idiosyncratic rather than systemic to the entire developing world. Therefore, a wave a financial crises that mows down many developing economies, thereby imparting a significant shock to U.S. export growth, does not seem likely. Exposure of American banks and American households to emerging markets is not very high when viewed in the context of their overall balance sheets. Although financial markets in developing economies could remain volatile for some time, we do not believe that the tremors in those countries will lead to significant economic and financial weakness in the United States.

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