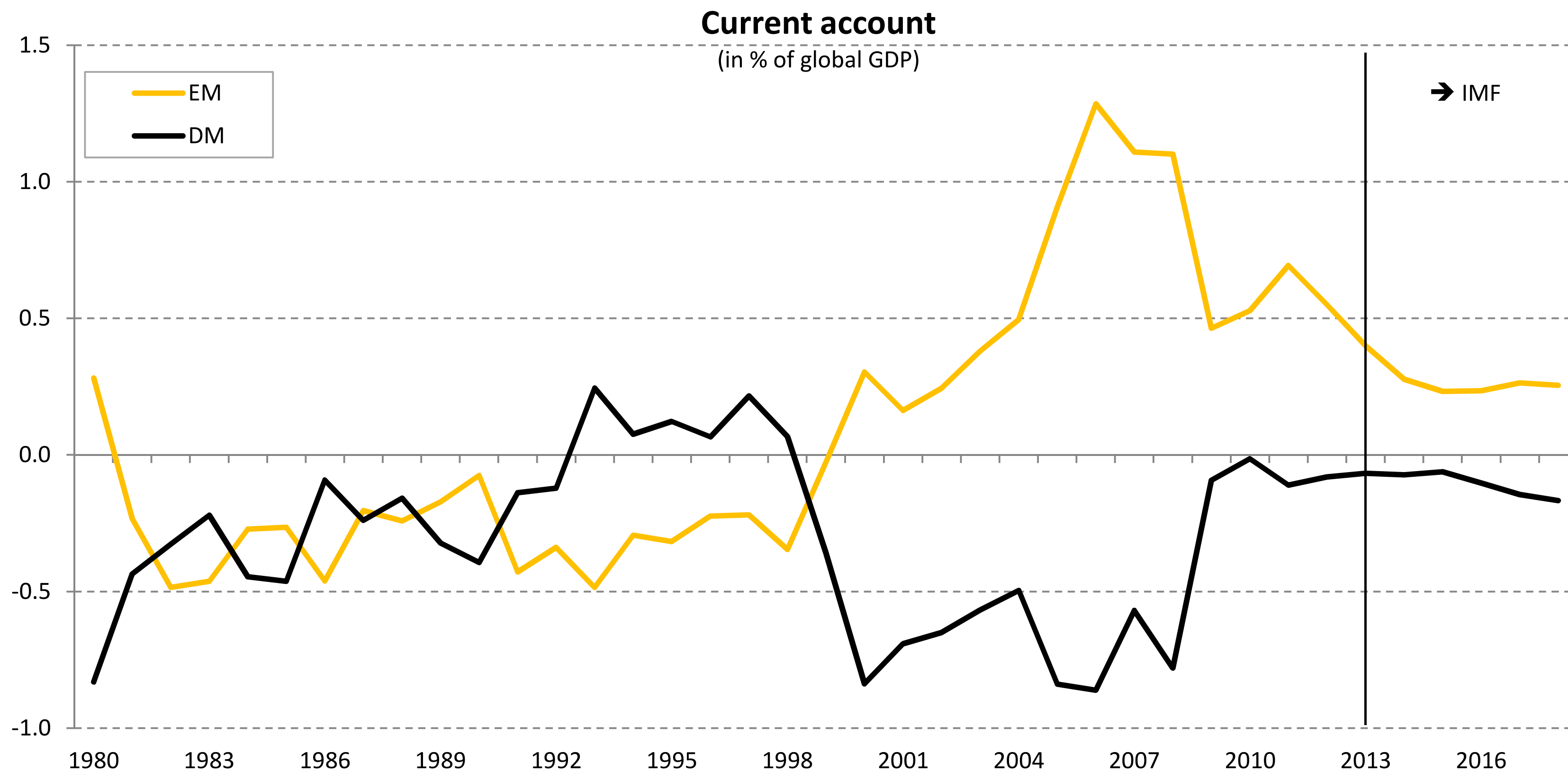
Petercam

Assessing the external vulnerability of EM

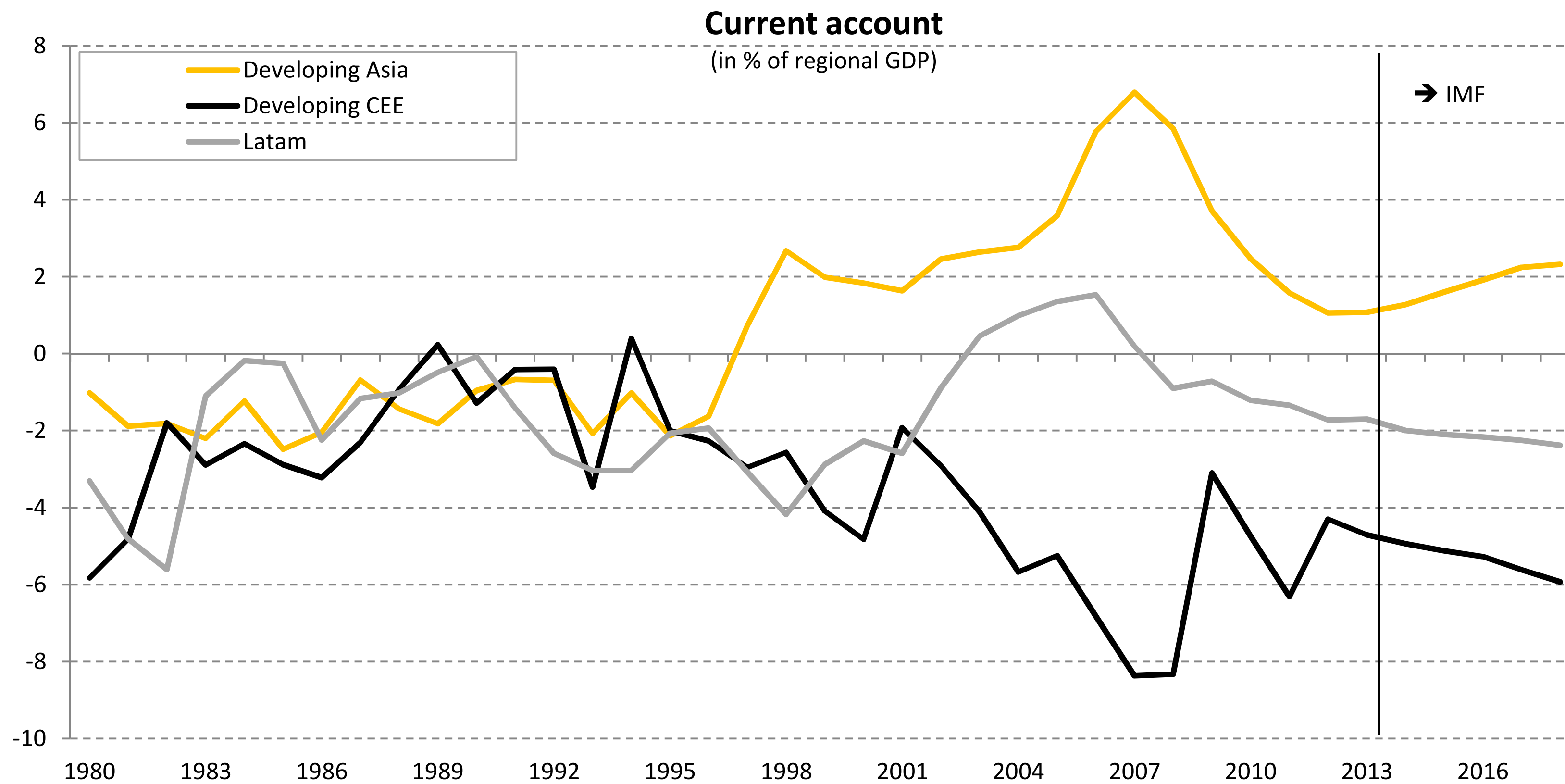
Petercam

Aggregate current account surplus ....



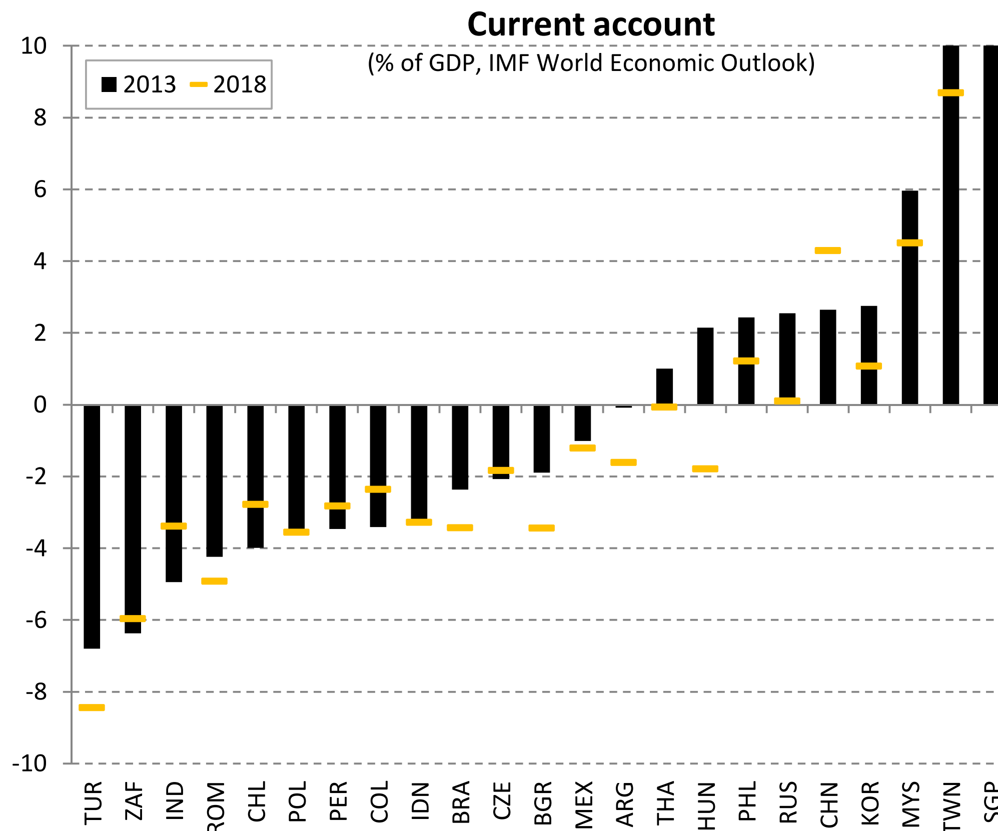
Petercam

...reveals big regional differences



Petercam

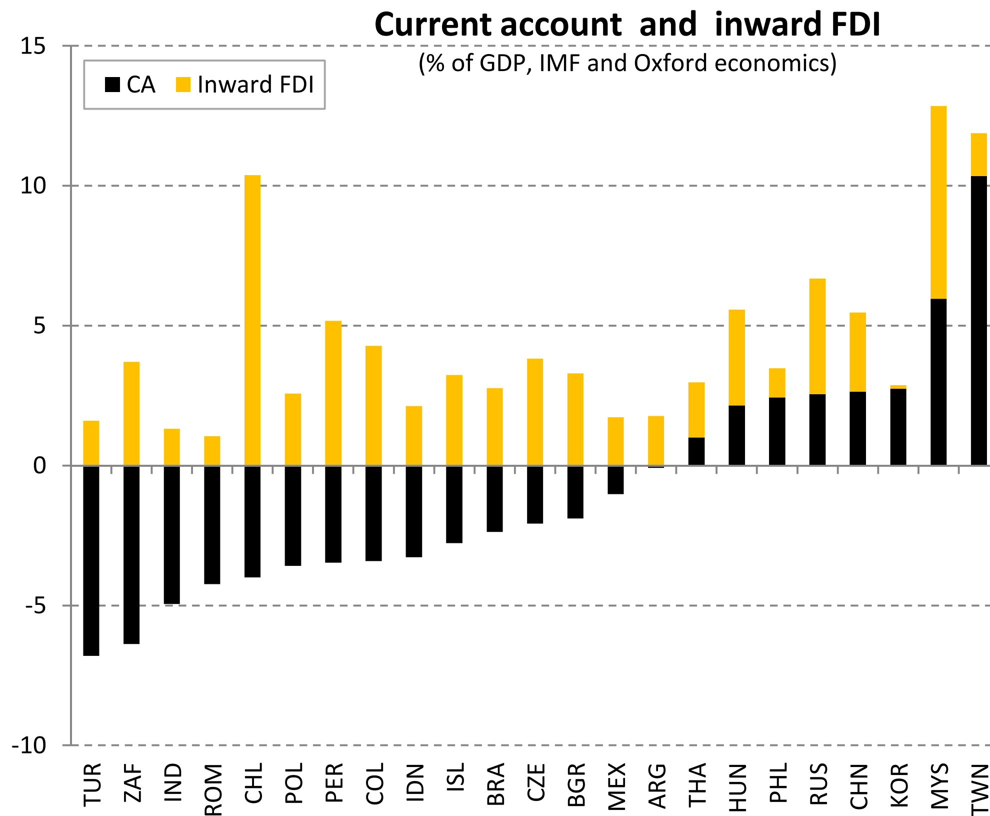
...and country differences



- **3 countries report CA deficits of 5% of GDP or more:**
  - Turkey
  - South Africa
  - India
- **According to IMF estimates Romania's CA deficit is set to deteriorate further from a relatively high level**
- **Several other countries report CA deficits of around 3%.**
- **A CA deficit as such is NOT a sin. It's actually what one would expect of an EM as international capital seeks for productive investment possibilities.**

Petercam

Some countries rely heavily on volatile money flows



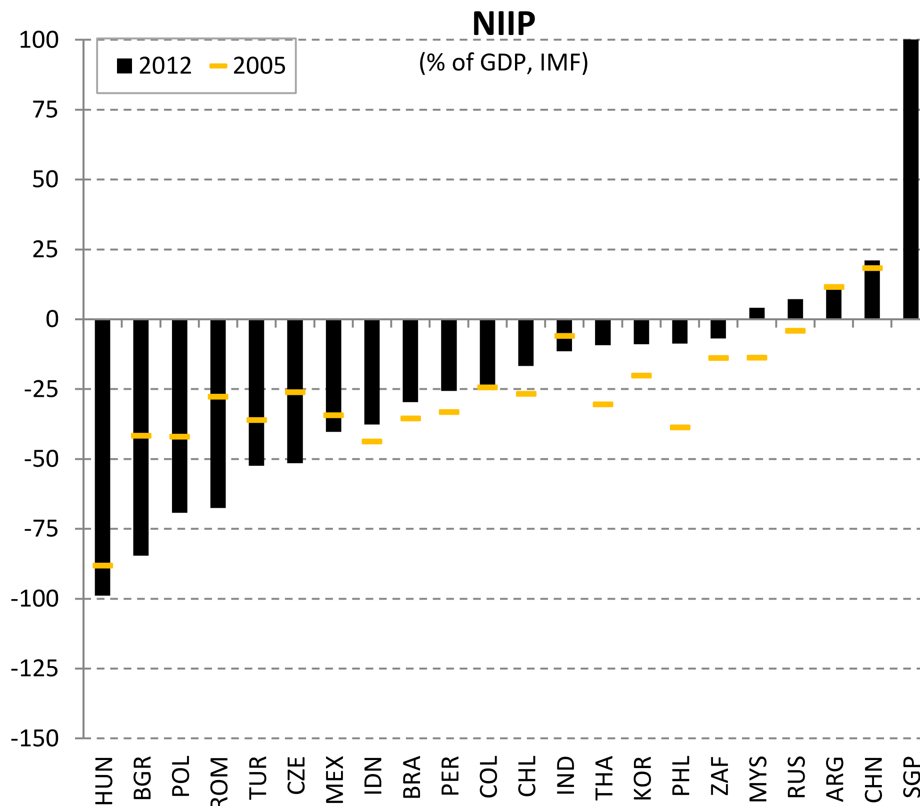
- **The countries that report the biggest CA deficit also rely on less stable funding:**
  - Turkey
  - South Africa
  - India
  - Romania

- **Several other countries report CA deficits but in most cases these deficits are easily matched by inward FDI flows, the most stable source of capital flows.**

Petercam

Debtors and creditors

Net international investment position

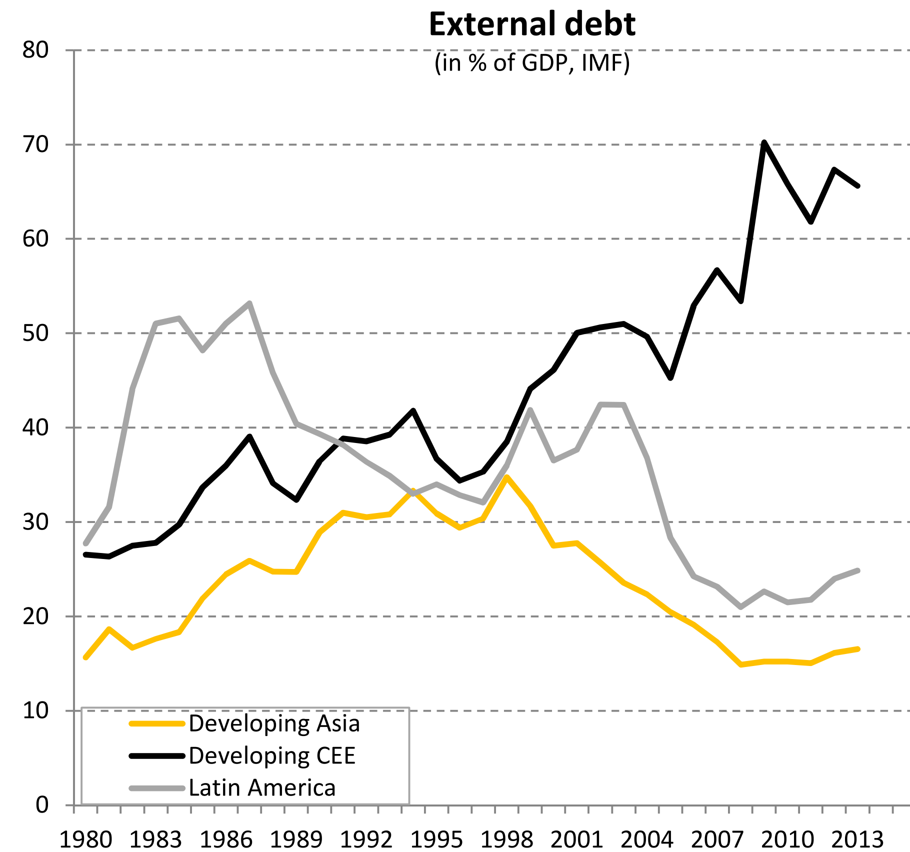


- **When countries report CA deficits they invest more than they save (CA balance ~ S – I). As a result, the country builds up debt vis-à-vis the rest of the world.**
- **The NIIP reports a country's net (assets – liabilities) debt stock. Most EM countries are net debtors to the rest of the world**
- **Some countries have entered dangerous territory in this respect:**
  - Hungary (under IMF supervision)
  - Bulgaria
  - Poland
  - Romania
  - Turkey (to a lesser extent)

Petercam

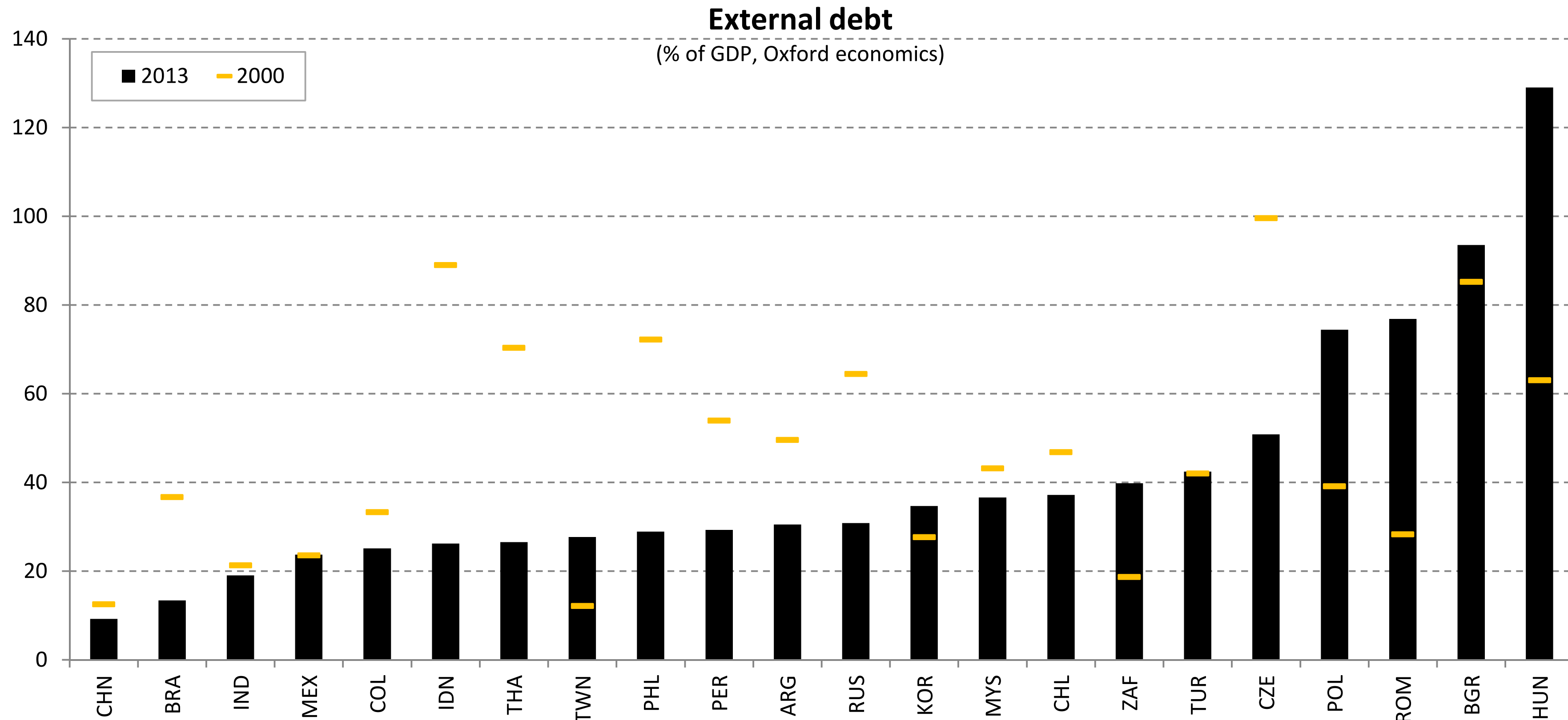
External debt has come down on an aggregate EM level

But not in CEE

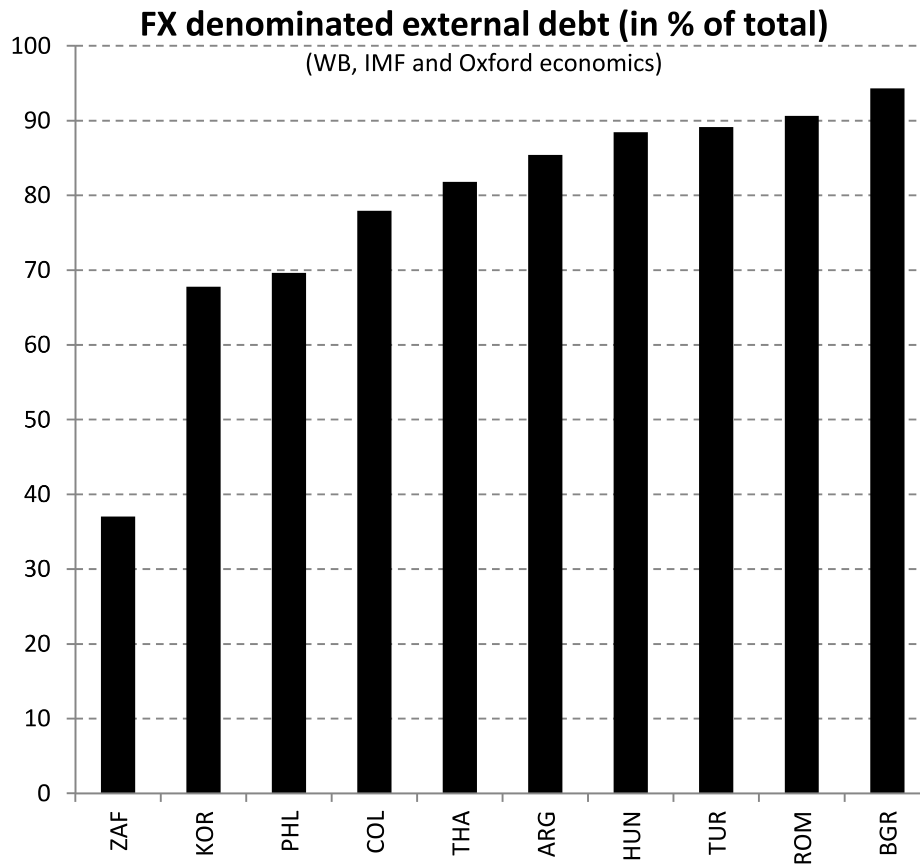


Petercam

External debt in several CEE countries has been rising steadily

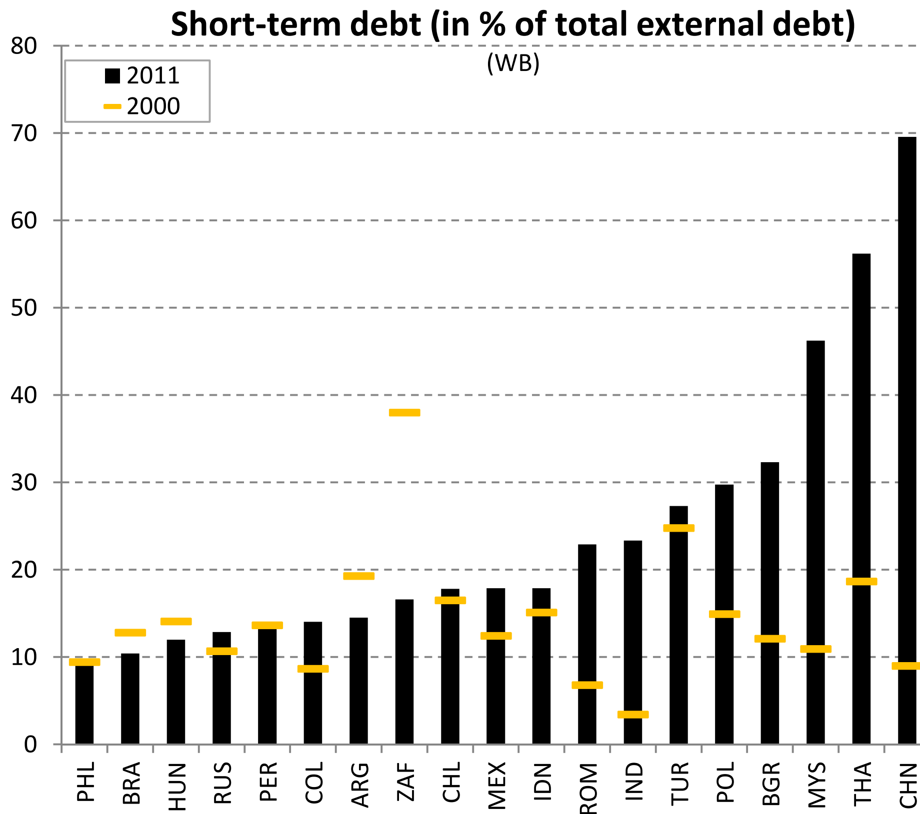


FX denominated debt



- **According to WB figures, most of the external debt is also denominated in foreign currency.**
- **This is potentially dangerous as a strong fall of the domestic currency will result in rapidly rising debt figures and difficulties to service the existing debt burden.**
- **It cannot be excluded that at some point in time this can give way to a self-fulfilling panic reaction leading to larger currency depreciation and eventually default.**

Short-term debt

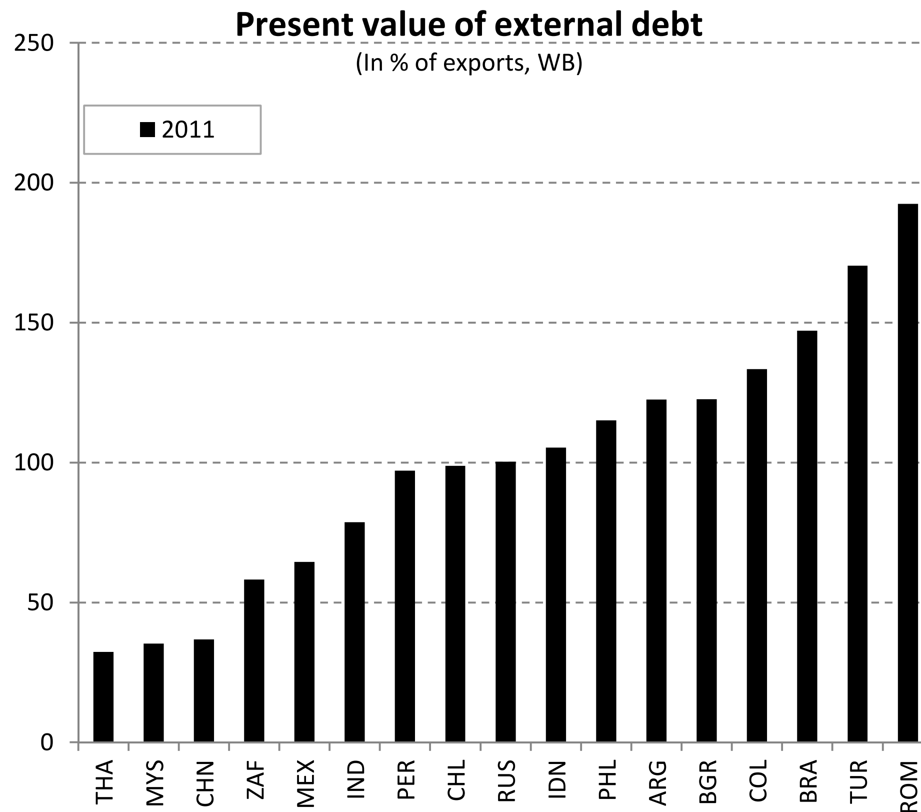


- **Logically, debt is issued to finance the purchase of assets. A sound principle is that the maturity of the loan matches the economic lifespan of the asset bought.**

- **If the loans mature (significantly) earlier than the economic lifespan of the asset then there is a maturity mismatch. In combination with an economic shock hitting the economy, this can give way to a self-fulfilling panic reaction.**

- **This indicator is best viewed together with the actual outstanding amount of external debt. Although there is no absolute treshold the following countries look vulnerable in this respect:**
  - Romania
  - India
  - Turkey
  - Poland
  - Bulgaria

External debt sustainability



WB definition of external debt sustainability:

- *"A country achieves external debt sustainability if it can meet its current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears and without compromising growth".*
- *"Bringing the present value of external public debt down to about 150 percent of a country's exports would help eliminating this critical barrier to longer-term debt sustainability"*

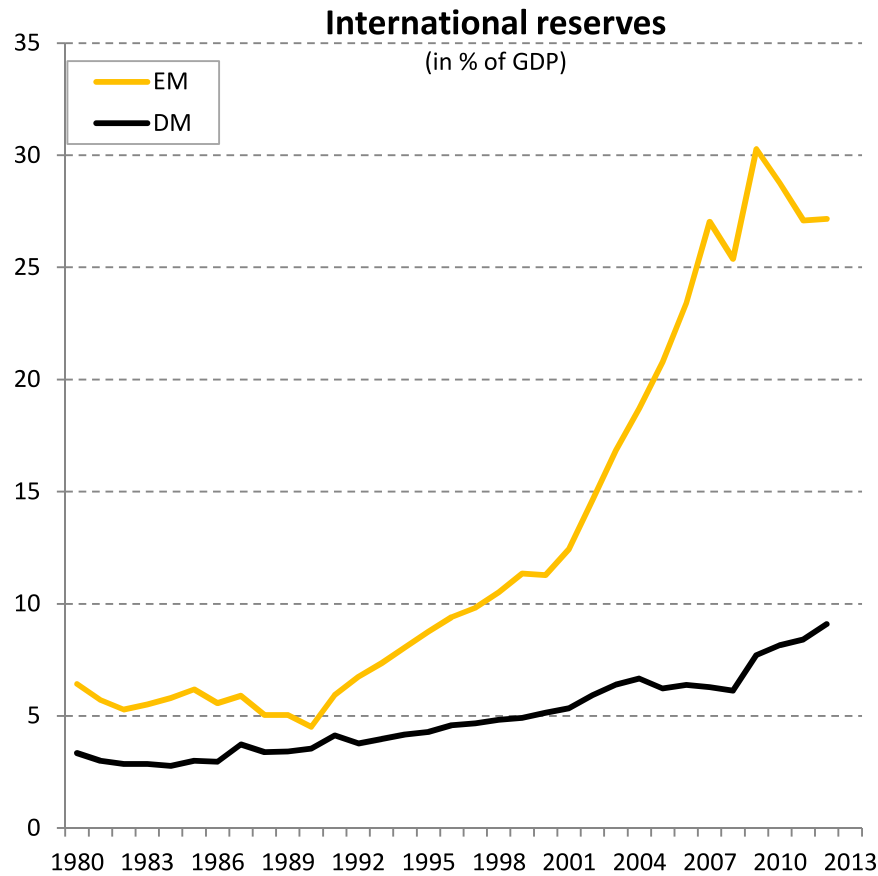
2 countries fail to meet this criterium:

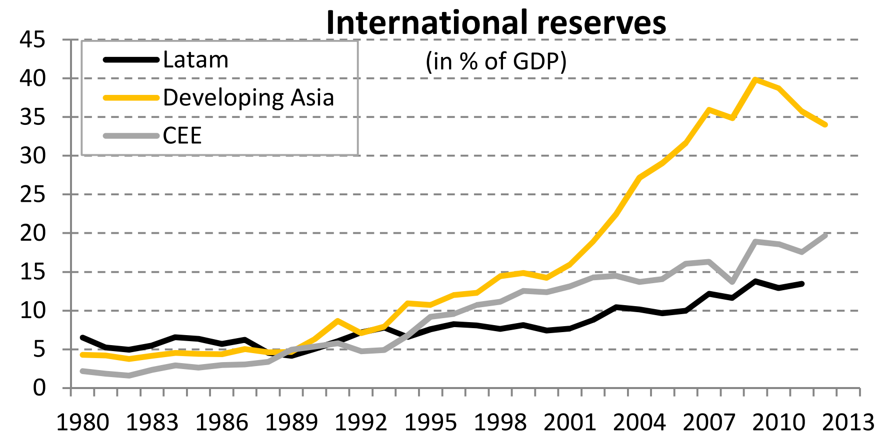
- Romania
- Turkey

The presence of international reserves reduces the chance of a self-fulfilling panic reaction following external debt unsustainability.

Large accumulation of international reserves in EM

With China as frontrunner

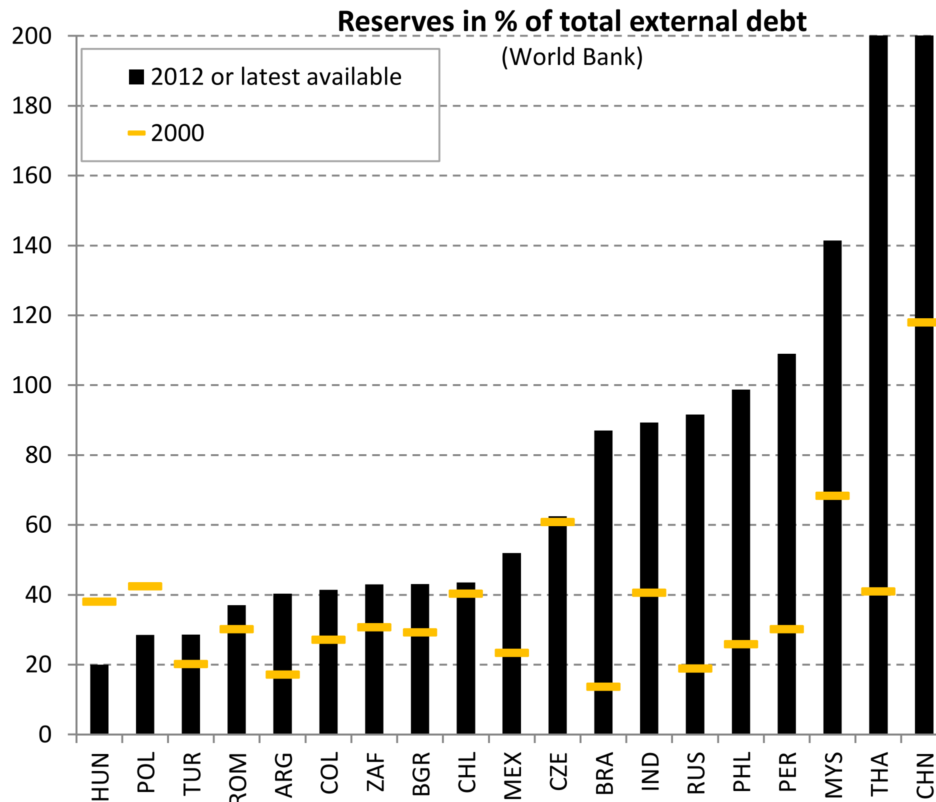




Petercam

International reserves

Reserves in % of total external debt



- **The presence of international reserves reduces the chance of a self-fulfilling panic reaction following external debt unsustainability.**
- **The countries that were found to have high external debt levels appear to have rather limited reserves to offset this vulnerability:**
  - Hungary
  - Poland
  - Turkey
  - Romania
  - Bulgaria
- **This was already clear from the net international investment positions**

Petercam

Conclusion

- **A CA deficit as such is not a sin. It's actually what one would expect of an EM as international capital seeks for productive investment possibilities. Some EM countries, however, report big CA deficits (~5% of GDP or more) that are not matched by FDI inflows (the most stable source of inward capital flows). The accumulation of CA deficits results in a gradually deteriorating NIIP.**

- **Most of the external debt is denominated in foreign currency. This is potentially dangerous as a strong fall of the domestic currency will result in rapidly rising debt obligations and difficulties to service the existing debt burden. It cannot be excluded that at some point in time this can give way to a self-fulfilling panic reaction leading to larger currency depreciation and eventually default. The same rationale holds when there is a broad-based maturity mismatch between debt obligations and assets.**

- **The presence of international reserves reduces the chance of a self-fulfilling panic reaction following external debt unsustainability by preventing a sharp fall in the currency and thus a sharp increase in the external debt level.**

- **The EM countries that come out of the analysis as most vulnerable are:**
  - Turkey
  - Hungary
  - Bulgaria
  - Romania
  - India
  - South Africa
  - Poland