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Global Economy Watch

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Is US dollar debt in emerging markets a cause for concern?

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Dear readers,

Emerging markets often suffer when the Federal Reserve tightens monetary policy. When US assets begin to deliver a better rate of return, investors look less favourably on riskier emerging markets. Also, emerging markets often have debt dominated in US dollars (see Figure 1), which becomes more expensive to pay. The 1994 'tequila' crisis in Mexico, the 1997-98 Asian financial crisis and the taper tantrum of 2013 all took place against a background of rising (or the threat of rising) US interest rates.

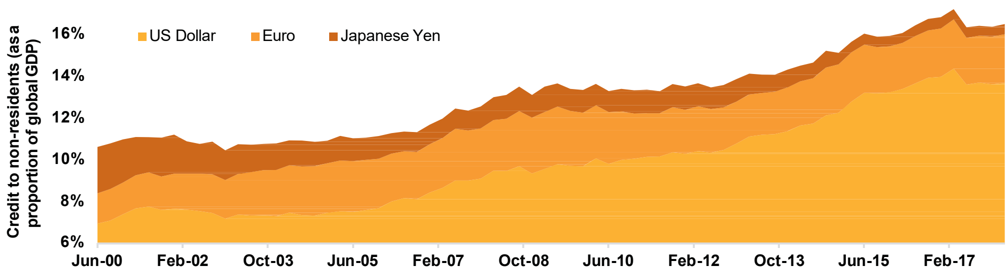
The Fed is currently again in the process of tightening US monetary policy. Our risk dashboard of large emerging economies vulnerable to tightening US monetary policy shows that Turkey and Argentina top the rankings. Both of these economies have experienced economic volatility in the past few months. But the situation in both countries appears to have stabilised, at least for the moment, with the IMF bailing out the Argentinian economy and the Turkish authorities committing to a medium-term programme which includes boosting productivity and exports and cutting back on public spending.

We also take a look at a watershed moment for the Chinese economy. After almost 20 years of accumulating and then running down the largest current-account surplus in the world, the Chinese external account posted a deficit in the first quarter of 2018. Given structural, demographic and political factors, the surplus is unlikely to be rebuilt on the same scale, and a future of smaller surpluses or regular deficits will have important implications for the government's control over the economy and the function of the Chinese economy in the global system, especially at a time of heightened concerns about the rules governing international trade.

Finally, we continue to monitor the performance of the largest advanced economies. Although the US is surfing a wave of tax cuts and the beginnings of an acceleration in wage growth, the economy also appears to be entering classic "late cycle" territory, and the chances of a return towards trend growth rates of around 2% per annum are rising. Meanwhile, the Eurozone is losing momentum, even before the ECB begins to raise interest rates.

Overall, the global economy is on a shakier footing than it was a year ago.

Fig 1: US dollar, Euro and Japanese Yen credit extended to non-residents as a proportion of the global economy



Sources: PwC analysis of BIS data and Refinitiv.
Note: We have converted the Euro and Japanese Yen liquidity using a 4 quarter rolling exchange rate against the US Dollar.

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Economic update: Some advanced economies are coming off the boil

The US is in late cycle territory…

The US economy grew by 3.5% on an annualised basis in the third quarter of 2018, after 4.2% in the second quarter. Job creation remains rapid, despite the unemployment rate falling close to a 50-year low. Corporate profits are rising at double-digit rates. These are all impressive numbers. Yet the US economy is probably much closer to the next downturn than the previous downturn; it is in "late cycle" territory.

Its performance has been distorted by the passage of tax cuts at the end of 2017. By injecting stimulus at a time when growth was already strong, they have given the economy a sugar high. But it will burn off this energy quickly, with growth set to slow in 2019. Without the one-off boost from lower taxes and facing higher borrowing costs, households will struggle to match the vigour of 2018, while businesses must also contend with higher oil prices and more reciprocal tariffs on exports and imported intermediate goods.

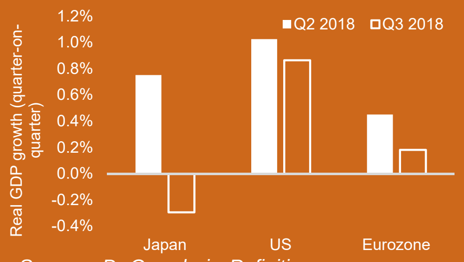
…and Europe and Japan are slowing down too

The Eurozone and Japan cannot be said to be late in their respective cycles, as the European Central Bank ("ECB") and the Bank of Japan ("BoJ") are still contributing monetary stimulus to their economies. However, the ECB is close to ending the bond-buying phase of its quantitative easing programme ahead of the start of an eventual tightening cycle, while the BoJ has reduced its annual bond-buying by half, even if it has yet to update its official target.

Stimulus is looking passé because growth has picked up and is now slowing again. The Eurozone posted its best growth since the financial crisis growing by 2.3% in 2017. But for this year we project 1.9%. Quarterly growth slowed from 0.7% in each of the third and fourth quarters of 2017 to 0.4% in the first and second quarters of 2018 and just 0.2% in the third. It is plausible that the expansion in 2017 was simply too strong to sustain and growth is now returning to its trend rate.

Japan also enjoyed a strong 2017 but the economy shrank in the third quarter of 2018 thanks to weak spending on the back of a natural disaster. Both the Eurozone and Japanese economies benefited in 2017 from a synchronised improvement in the global economy, but have not maintained growth at this high trajectory in 2018.

Fig 2: The US continues to roar ahead whereas GDP growth rates have slowed down in the Eurozone



Sources: PwC analysis, Refinitiv

What has happened to China's current account surplus?

For many years, China ran a huge current-account surplus with the rest of the world. It exported far more goods and services than it bought from everyone else. This surplus rose from nothing in 2000 to more than $100bn (or 10% of Chinese GDP) by the time of the global financial crisis. However, this surplus has gradually begun to diminish and in the first half of 2018, China actually posted an external deficit. The consequences of this shift could be very significant for the global economy.

The erosion of the surplus is a consequence of economic development. Since the opening up in 1978 and economic reform programme China's embrace of a more market-driven economic policy helped to lift hundreds of millions out of poverty. The size of the Chinese middle class – those earning between US$11,500-43,000 a year* – has been estimated at 225m. Many of this cohort are choosing to spend some of their earnings on travelling the world. Outbound tourism counts as a debit on the services balance and China has amassed an annual services deficit of more than $250bn in 2017, by far the largest in the world. This trend is likely to continue – and indeed increase – in the coming years, which China's current-account services balance further into deficit. For example, China announced deals equivalent An example of this are the myriad of deals announced at the China International Import Expo to the tune of $57.8 billion which contribute to reducing the current account balance into deficit.

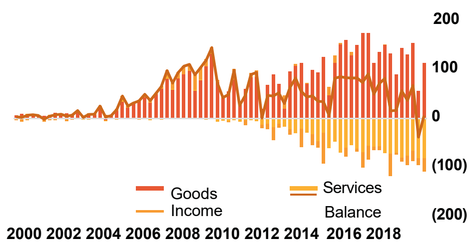
Movements elsewhere in the current account have been less dramatic. The income account (which measures earnings on foreign investments minus those made in the country by foreigners) has recently often dipped into deficit, likely reflecting lower interest income earned. As the world's manufacturing powerhouse, China remains a huge net exporter of goods, but its share of global exports has stalled. The reasons for this are complex, but involves a combination of greater domestic consumption of goods that would previously have been exported (itself a factor of China's growing wealth) and higher labour costs, resulting in some low-end manufacturing moving elsewhere (e.g. Vietnam or Bangladesh for clothing and footwear).

The ongoing trade dispute with the US is also likely to weigh down on the external account, although the magnitude of this remains uncertain. China runs a wide merchandise trade surplus with the US. US import tariffs are an attempt to reduce this imbalance and, at the time of writing, cover imports worth approximately US$230bn, or around 45% of the 2017 total. The effect on Chinese exports will be determined by the extent to which US firms and consumers are able to find cheaper alternatives, the length of the stand-off and how quickly Chinese firms adjust their supply chain strategies. Looking further out, the Chinese population is ageing and older people tend to run down the savings that they have accumulated during their working lives which will boost their consumption, including in imported goods. Taken together, these political, demographic and structural factors all suggest that it is likely that China will continue to post smaller external surpluses, or even move into deficit in the future years.

Were China to record current-account deficits, it would need to fund them. To do this it could sell some of its enormous stash of foreign-exchange reserves, increase its foreign borrowing or allow greater foreign investment. All of these options are possible, but they would have implications. They would increase the private sector's influence on the economy. They would make China more exposed to cross-border capital flows and to swings in the global economy and financial markets. The renminbi could become more volatile. Any or all of these changes would represent major cultural shifts for the Chinese authorities.

It appears that the weaker currency can benefit the Chinese currency in two ways. First, a weaker renminbi counters some of the loss of competitiveness arising from the US tariffs. Second, the government is still trying to engineer the economy's shift from exports and investment to consumption. All else being equal, that would trigger greater spending on imports, which would push the current account further towards deficit. But a weaker renminbi would encourage some purchases of domestic goods over imports. In the longer term, the Chinese government also appears willing to countenance more foreign investment. In July, it relaxed foreign ownership rules in parts of the agricultural,

Fig 3: China's disappearing current account surplus



Source: Eikon from Refinitiv

banking and manufacturing sectors.

The decline in China's external surplus looks real. It reflects the ongoing maturity of the economy, particularly the rising wealth of the population and its changing demographics. It has the potential to further promote the development of a market economy and encourage its integration into the global economy. It could be a watershed moment.

**'225m reasons for China's leaders to worry', The Economist (2016).*

Does US dollar debt pose a risk to emerging markets?

A key side-effect of the Federal Reserve's quantitative easing programme which started almost ten years ago was that US dollar ('USD') capital flows were diverted offshore, particularly towards the faster growing emerging markets. Businesses, households and governments took advantage of the liquidity on offer by issuing USD-denominated debt. Crucially, this meant that borrowers in emerging markets were exposed to risks from fluctuations in the USD, with a stronger dollar adding to their debt repayments in domestic currency terms.

Figure 5 shows the true extent of USD credit extended to non-residents (i.e. those outside of the US) which increased from about 9% of global output at the end of 2008 to almost 14% in the first quarter of this year. In absolute terms this amounts to an increase of $5.5 trillion (which is equivalent, for example, to more than three times the size of the Canadian economy). A similar, but less pronounced story was also recorded for Euro and Japanese yen denominated lending, but as the chart shows, this was much less pronounced.

However, the current strong performance of the US economy – which has led to the Fed to increase its policy rate and continue to unwind its quantitative easing programme – has meant that capital has started to flow back onshore to the US. Reflecting this point, the USD has appreciated by more than 10% in the past three years when measured against a weighted basket of its trading partners (see Figure 4). As a result, some emerging market currencies have weakened significantly against the USD over this period.

What does this mean for USD borrowers in emerging markets?

To set the context, foreign currency debt typically makes up a small component of overall debt levels in most of the emerging economies. But we still think that it is important to monitor foreign currency debt levels as research shows that it is highly correlated to booms and busts in the financial cycle which can have implications for businesses, households and governments seeking credit.

In a nutshell, a stronger USD rate implies tightening financial conditions in the emerging economies that have borrowed in that currency. To understand the extent of the risks the borrowers face we have ranked some of the larger emerging economies in our risk dashboard in Table 1. This shows that:

- **Turkey** and **Argentina** top our risk ranking. These are economies where policymakers have already responded to pressures they have been facing to their external balances. In Argentina, a $56 billion IMF bailout has been agreed. And Turkey, which has more US dollar debt in absolute terms than Brazil, the government has announced a medium-term plan intended to control the budget and, boost productivity and export levels. In both cases, central banks have responded by tightening monetary policy.
- Chile is ranked third on our risk dashboard. Even though it holds relatively high levels of US dollar debt, Chile's economy remains relatively hedged from the appreciation of the USD as it is one of the world's largest exporters of copper, which is traded in US dollars.
- Mexico also has a relatively high risk rating, driven mainly because of its holdings of USD debt. However, part of this risk has been mitigated by securing the renewal of its trade deal with the US, which means that it will continue to remain part of the supply chain of large US corporations.

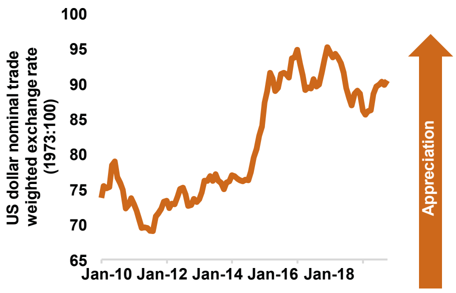
Does a higher rank on our risk dashboard lead to slower economic growth?

At a high level, we would expect those emerging economies which have a larger stock of debt in USD to cut back spending at a time of rising Fed interest rates. Depending on the magnitude of the cutbacks we would expect this to slow down economic growth. However, at the same time we would also expect a weaker exchange rate to counteract the slowdown in economic activity, by increasing net exports.

In Figure 6 we test this hypothesis, and find that the economies that are higher up on our risk dashboard are, on average, expected to grow slower in 2018 compared to last year. This would suggest that the net export boost is not enough to counteract the general cutback in spending.

In summary, our analysis suggests that Turkey and Argentina are two of the economies that are most vulnerable to the strengthening of the USD and the tightening of monetary policy in the US. Broadly speaking, we also find that the emerging economies that are the most exposed to this risk are expected to experience a deceleration in economic growth.

Fig 5: Since 2014, the USD has appreciated by about 18%



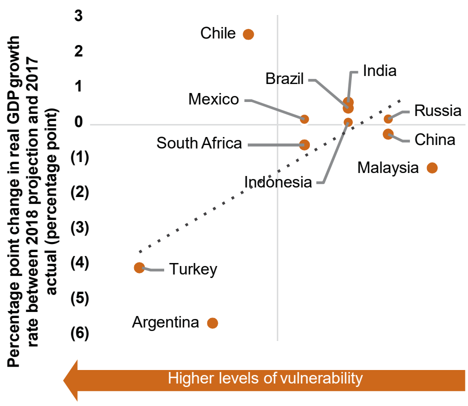
Sources: PwC analysis, Refinitiv

Table 1: PwC's US dollar debt vulnerability risk dashboard

Country	Vulnerability	USD debt* (% of GDP)	Nov. 16-Nov. 18 currency movement (%)	Current account balance (% of GDP)
Turkey	High	27%	-44%	-5.7%
Argentina	High	25%	-58%	-3.7%
Chile	Medium	34%	-6%	-2.5%
Mexico	Medium	22%	-5%	-1.3%
S. Africa	Medium	10%	-7%	-3.2%
India	Medium	4%	-9%	-3.0%
Brazil	Medium	10%	-13%	-1.3%
Indonesia	Medium	17%	-14%	-2.4%
China	Low	4%	-3%	0.7%
Russia	Low	12%	-4%	6.1%
Malaysia	Low	12%	-	2.9%

*defined as total USD credit extended by banks and purchases of debt securities by both banks and non-banks.
For each indicator, we have allocated a red, amber, green colour based on how many standard deviations away they are from the sample mean.
Sources: PwC analysis of data from the BIS Global Liquidity Indicators, Refinitiv and the IMF

Fig 5: There is a negative relationship US dollar debt vulnerability and relative economic growth rates



Sources: PwC analysis

Projections: December 2018

	Share of 2017 world GDP		Real GDP growth			Inflation		
	PPP	MER	2018p	2019p	2020-2024p	2018p	2019p	2020-2024p
Global (Market Exchange Rate ("MER"))		100.0%	3.2	3.0	2.7	2.9	2.6	2.4
Global (Purchasing Power Parity ("PPP") rates)	100.0%		3.8	3.6	3.4	3.3	3.1	2.8
G7	30.6%	46.0%	2.1	1.8	1.4	2.0	1.9	1.9
E7	37.6%	26.6%	5.4	5.3	5.1	3.6	3.8	3.4
United States	15.3%	24.3%	2.8	2.3	1.6	2.5	2.2	2.1
China	18.2%	15.0%	6.5	6.3	5.9	2.3	2.4	2.6
Japan	4.3%	6.1%	0.9	0.8	0.6	0.5	1.1	1.3
United Kingdom	2.3%	3.3%	1.3	1.6	1.8	2.5	2.2	2.0
Eurozone	10.2%	13.9%	1.9	1.7	1.5	1.6	1.6	1.6
France	2.2%	3.2%	1.6	1.7	1.8	1.7	1.5	1.8
Germany	3.3%	4.6%	1.8	1.5	1.4	2.0	1.7	1.8
Greece	0.2%	0.3%	2.0	2.1	1.5	0.8	1.2	1.7
Ireland	0.3%	0.4%	5.1	3.3	3.0	0.9	1.3	1.9
Italy	1.8%	2.4%	1.0	0.9	0.8	1.1	1.4	1.2
Netherlands	0.7%	1.0%	2.7	2.3	1.9	1.6	1.9	1.6
Portugal	0.2%	0.3%	2.1	1.9	1.3	1.1	1.7	1.4
Spain	1.4%	1.6%	2.8	2.4	2.0	1.7	1.7	1.4
Poland	0.9%	0.7%	4.5	3.5	3.0	1.9	2.5	2.3
Russia	3.2%	1.9%	1.8	1.7	1.5	4.0	4.2	4.2
Turkey	1.7%	1.1%	3.2	0.2	2.4	16.0	19.0	7.0
Australia	1.0%	1.7%	2.9	3.0	2.8	2.2	2.5	2.5
India	7.4%	3.3%	7.4	7.6	7.7	4.8	5.0	5.0
Indonesia	2.6%	1.3%	5.2	5.3	5.2	3.8	3.9	4.3
South Korea	1.6%	1.9%	2.9	2.8	2.8	1.6	1.9	2.0
Argentina	0.7%	0.8%	-2.4	-1.3	2.8	33.0	-	-
Brazil	2.6%	2.6%	1.6	2.5	2.2	3.7	4.2	4.3
Canada	1.4%	2.1%	2.0	1.9	1.7	2.4	1.9	2.0
Mexico	1.9%	1.4%	2.1	2.2	2.7	4.2	3.9	3.0
South Africa	0.6%	0.4%	1.2	1.5	1.8	4.8	5.3	5.4
Nigeria	0.9%	0.5%	2.0	1.6	2.5	11.9	10.8	9.0
Saudi Arabia	1.4%	0.9%	1.7	2.2	2.1	3.2	2.5	2.3

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina has launched a new CPI measure, which only contains data from April 2016. Therefore we only project inflation for 2018 and will provide projections for the future years once a longer series is available. Note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.

Interest rate outlook of major economies

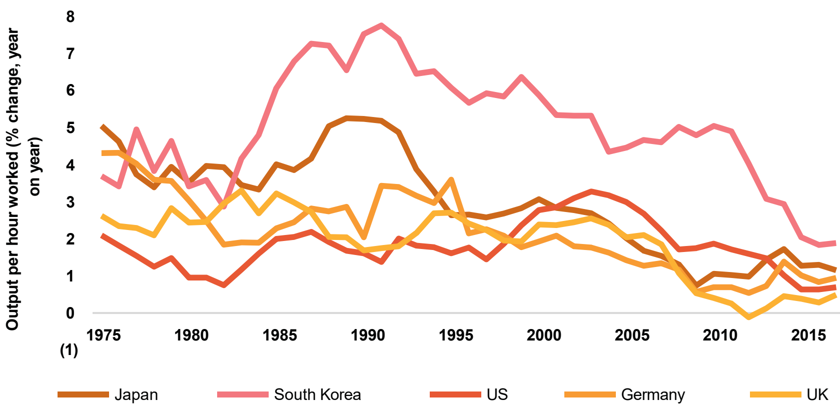
	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	2-2.25% (September 2018)	Further gradual tightening during the year	December 18-19
European Central Bank	0.00% (March 2016)	No rate rise for the foreseeable future	December 6
Bank of England	0.75% (August 2018)	Not rate rise expected for the rest of the year	December 20

Chart of the month

The chart on the right shows the plight of advanced economies which have experienced poor labour productivity growth rates when compared to history.

Several reasons have been offered as explanations for this trend including mismeasurement, low levels of interest rates and secular stagnation.

Advanced economies need help in boosting their rates of productivity growth



Source: Conference Board

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