At RWC, our Emerging and Frontier Markets team incorporates multiple factors when assessing external and local financial risk across the investment universe.

This includes hard (USD) and local debt, amongst other data. We firmly believe that it is critical that research centres on the specific dynamics within each country rather than focussing on aggregate numbers.

In this note the team’s economist Cem Akyurek focusses on c. 20 emerging markets to illustrate how detailed data research and analysis, coupled with other relevant variables such as geopolitical risk, allows for a comprehensive assessment of country-specific risk.

This allows us to assess the universe in deep detail, and highlights areas of vulnerability.

We first look at **external debt** trends where we believe the number of vulnerable emerging markets (EMs) is relatively low.

Looking only at debt ratios across EMs gives just a rough indication of vulnerability within each country. Hungary is almost off the chart, and the following four countries - Malaysia, Poland, Czech, Chile - also seem to have high debt ratios.

**FIGURE 1: TOTAL GOVERNMENT AND PRIVATE SECTOR EXTERNAL DEBT (% GDP)**

![Graph of total government and private sector external debt (% GDP)](image)

To develop a better understanding of key risk areas we can look at the change in debt ratios over the last four years (Figure 2). We can see that Hungary has delevered significantly on large current account surpluses, and we believe this will continue to improve going forward. Of the top five EMs that have seen their debt ratio rise significantly, all are major or partial commodity exporters that had large current account deficits financed by USD debt over the past several years (excepting Malaysia). Conditions have improved in Brazil, Russia and Chile, as their current account deficits have evaporated (on low growth and higher commodity prices) and their USD GDP and payment capacity will recover rapidly with recent FX stability (Russia’s USD debt in absolute levels has actually declined). We think Turkey is definitely vulnerable: its current account deficit remains sizable.
Figure 2: % Change in External Debt Ratio, Q1 2012 – Q2 2016

We believe the large bank borrowings of Turkey and Malaysia make them vulnerable. On the other hand, the considerable intercompany loans of Hungary reduce concern here. The governments of Colombia, Mexico and Indonesia all have exposure to external debt that is relatively high despite low overall debt ratios. We believe it is imperative that these countries continue to tighten their fiscal policy.

Figure 3 shows the breakdown of debt by borrower. Intercompany loans are relatively safer and cheaper (parent to local subsidiary), whereas external borrowing by banks could be more vulnerable to rising global rates (also bank borrowing can be short term – so partly a carry trade).

Figure 4 shows how maturity breakdown points to Turkey and Malaysia as trouble spots - a larger share of short term debt makes a country more vulnerable to changes in liquidity conditions.

Finally we look central bank FX reserves as a percentage of external debt repayments due over the next 12 months plus the current account balance. Trouble spots are Turkey, S. Africa and Malaysia. We think Hungary will continue to improve on this metric as well.

Figure 3: Composition of External Debt Ratio by Borrower, As at Q2 2016

Figure 4: External Debt Ratio Maturity Breakdown As Of Q2 2016

Figure 5: Central Bank FX Reserves As A % Of Current Account Balance Plus ST External Debt
Turning to **local debt**, again we believe that only a few EMs look vulnerable – Thailand, Malaysia, Turkey.

Figure 6 includes all borrowing (from banks and non-banks) by the private sector in local currency, broken down by corporates and households. Korea, Malaysia, Thailand and Hungary look high.

**FIGURE 6: CREDIT FROM LOCAL BANKS AND NON-BANKS TO PRIVATE SECTOR (% GDP)**

The change in the ratio of local borrowing since the 2008 financial crisis shows rapid borrowing by Thai, Malaysian and Korean corporates, Turkish consumers and to a lesser extent by Brazilians. Hungarian corporates, on the other hand, have deleveraged.

**FIGURE 7: CHANGE IN CREDIT FROM LOCAL BANKS AND NON-BANKS TO PRIVATE SECTOR (% GDP, 2008 – Q2 2016)**

Figure 8 shows borrowing from banks only. The top three EMs seem to be highly leveraged.

**FIGURE 8: BANKING CREDIT TO PRIVATE SECTOR, % GDP**

Thailand and Malaysia stand out to us as trouble spots, as they are much more leveraged than EMs that have comparable per capita GDP (Figure 9). Therefore, Korea on this metric looks fine and not stretched.

**FIGURE 9: BANK CREDIT TO GDP AND USD PER CAPITA TO GDP**
In addition we would add Turkey to the vulnerable group based on how much leverage has been added in recent years (Figure 10).

**Figure 10:** % change in local banking credit to GDP ratio, Q4 2008 – Q3 2016

In the short term we are comfortable because China’s debt and banking problem is different to most EM cases that have ended up in full blown banking crises in the past. Wholesale funding of the banking system is relatively low and a significant proportion of the loan book is funded by local deposits (local savings or current account surplus). Most EM banking crises have been caused by sharp declines in rollover of wholesale funding, the absence of which reduces the probability of a China debt crisis in the near term. That said, debt crises could happen through a sharp rise in non-performing loans in the banking system if GDP growth collapses, reducing debt servicing capacity. Chinese policymakers have taken measures to ensure a soft landing of the economy, including greater exchange rate flexibility and relatively tighter monetary conditions. They seem committed to financial stability and lower GDP growth or slower pace of credit expansion, which will give them time to address the bad debt problem in the banking sector. In short, a banking crisis in the near term is very unlikely but we will be looking for structural measures next year.

**China**

China’s external debt in FX as compiled by the World Bank is currently very low at marginally under 2% of GDP. This is not a concern and they could sustain much higher levels of external debt.

**Figure 11:** China – external debt, % GDP

We have identified excess local leverage is the problem area for China. But there are several reasons to believe that the risks can be contained in the short term and that the policymakers will have time to address the problem. While policymakers have recently started to emphasize financial stability over growth, we are likely to see more effective structural measures following the party congress to be held later this year including the cleaning up of the bad debts in the banking system.

**Chinese local currency debt of private sector** to banks and non-banks is the highest in the EM universe. The numbers in Figures 11 and 12 are comparable to Figures 6 and 7. Not only is China’s local debt the highest, but the increase over the period, of over 30%, is the largest. As well, total leverage of the private sector is exceptionally high compared to EMs of similar per capita GDP.

**Figure 12:** Credit to non-financial corporates and households from local banks and non-banks, % GDP

Source for data throughout: Haver Analytics and RWC.
Cem Akyurek, Ph.D.
*Head of Macro Research*

Cem is economist to the RWC Emerging & Frontier Markets Team, which now manages c. $2.2bn on behalf of its clients.

Emerging and frontier markets represent the fastest growing countries in the world. We believe the continued growth in these markets presents opportunities across a range of industries.

Cem joined RWC in 2015 and has 20 years of investment and research experience, with a speciality in macroeconomic and quantitative research. Prior to joining RWC Cem worked at Everest Capital and Deutsche Bank.

Cem holds a Ph.D in Economics from the University of Miami, an MA in Economics from Florida Atlantic University and a BA in Economics from Bogazici University, Turkey.

**CONTACT US**

Please contact us if you have any questions or would like to discuss any of our strategies.

E invest@rwcpartners.com | W www.rwcpartners.com

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**RWC London**
60 Petty France
London SW1H 9EU
T +44 20 7227 6000

**RWC Miami**
2640 South Bayshore Drive
Suite 201
Miami
Florida. 33133
T +1 305 602 9501

**RWC Singapore**
80 Raffles Place
#22-23
UOB Plaza 2
Singapore 048624
T +65 6812 9540
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