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Domino theory

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Where could emerging-market contagion spread next?

THE drought of foreign capital is beginning to wreck many economies in central and eastern Europe. Currencies, shares and bonds are tumbling, and some economists fear that one or more of these countries could default on its foreign debts. Emerging-market crises have a nasty habit of spreading as investors flee one country after another. Some Middle Eastern markets, notably Dubai, are already in trouble. But which of the larger emerging economies are most vulnerable?

To answer that question in the past, economists used to pay most attention to the solvency of governments, and hence their debt-to-GDP ratios. But today, the biggest risk in the emerging world comes not from sovereign borrowing, but from the debts of firms and banks. As foreign capital dries up, they will find it harder to refinance maturing debts or to raise new loans.

If one green bottle should accidentally fall...

Country	Current-account as % of GDP*	Short-term debt as % of reserves*	Banks' loan/ deposit ratio	Overall risk ranking†
South Africa	-10.4	81	1.09	17
Hungary	-4.3	79	1.30	16
Poland	-8.0	38	1.03	14=
South Korea	1.3	102	1.30	14=
Mexico	-2.5	39	0.93	12=
Pakistan	-7.8	27	0.99	12=
Brazil	-1.5	22	1.36	10=
Turkey	-2.3	70	0.83	10=
Russia	1.5	28	1.51	9
Argentina	0.2	63	0.74	8
Venezuela	0.8	58	0.75	7
Indonesia	1.2	88	0.62	6
Thailand	0.3	17	0.88	5
India	-2.4	9	0.74	4
Taiwan	7.9	26	0.87	3
Malaysia	11.3	15	0.72	2
China	5.2	7	0.68	1

Sources: HSBC; Economist Intelligence Unit *2009 forecast †Higher score implies higher risk

Our table (based largely on figures provided by HSBC) uses three indicators to judge how vulnerable economies are to the global credit crunch. The first is the expected current-account balance for this year. Large deficits need to be financed, but banking and portfolio inflows are now scarce, and even foreign direct investment, which used to be seen as less volatile, has fallen sharply this year. Many of the smaller east European economies had double-digit deficits as a share of GDP in 2008, although deep recessions will reduce them this year. Among the countries in the table, Pakistan, South Africa and Poland are tipped to run current-account deficits of 8% or more of GDP this year—the size of Thailand's deficit before its crisis in 1997.

As well as financing a current-account shortfall, a country has to repay or roll over existing debts. If external finance is not available, it must run down its reserves. Thus a useful measure of financing risk is short-term debt (due within 12 months) as a percentage of foreign-exchange reserves. Anything above 100%, implying that debts exceed foreign exchange, should ring alarm bells. (At the start of 1997 Thailand's short-term debt was 130% of its reserves.) The ratio is estimated at over 250% in both Latvia and Estonia, but in all the larger emerging economies it is below 100%. However, HSBC forecasts that South Korea's short-term debt will exceed its shrinking reserves before the year is out. The reserve cover in Indonesia, South Africa and Hungary is also looking thin. Russia's reserves have plunged by more than one-third as the central bank has tried to prop up the rouble, but it still has a comfortable cushion.

The third indicator, the ratio of banks' loans to their deposits, is one measure of the vulnerability of banking systems. When the ratio is over 1.0 (as in, say, Russia, Brazil, South Korea and Hungary), it means that the banks depend on borrowing, often from abroad, to finance domestic lending and so will be squeezed by the global credit crunch.

To get an overall sense of financial vulnerability we have ranked all the countries on each of the three measures and then taken their average score. If all emerging economies were included, the smaller east Europeans, such as Latvia, Ukraine and Romania, would dominate the top of the risk league. Among the 17 larger economies shown in the table, South Africa and Hungary look the most risky; China the least. Hungary has already had to go cap in hand to the IMF for a loan. South Africa may yet have to. Despite higher gold prices, weaker mineral exports are causing its current-account deficit to swell, possibly to more than 10% of GDP this year, at the same time as net foreign direct investment is expected to slump, so the country needs to borrow even more. The rand, which has already fallen sharply, remains one of the most vulnerable emerging-market currencies.

Not again

In contrast, the Asian emerging markets generally look the safest, taking all six slots at the bottom of the table. The main exception is South Korea, which, thanks to its large short-term foreign debts and highly leveraged banks, is deemed to be as risky as Poland. (Vietnam, though not included in the table, also scores high on the risk rating). South Korea is in much healthier shape than during the 1997-98 crisis. For example, it is expected to move back to a small current-account surplus this year and its reserves are much larger. But its banks and its currency still look vulnerable. The won has already fallen by almost 40% against the dollar over the past year, swelling the local-currency value of its foreign debts. Increased financial jitters in east Europe could make it harder for South Korea to roll over the $194 billion debt which falls due this year. But currency-swap agreements with America, Japan and China will give it plenty of firepower to draw on.

The overall score in the table only ranks countries' relative risks. To assess the absolute risk of a crisis you need to estimate external-financing needs (defined as the sum of the current-account balance and the stock of short-term debt) over the next 12 months. Jonathan Anderson, at UBS, has calculated the gap between this and the stock of foreign-exchange reserves for 45 countries. The good news is that only 16 of them have a financing "gap"; in all the others, reserves are more than sufficient to cover a year's worth of payments, even if there were no new capital inflows. Virtually all of those 16 countries are in central and eastern

Europe. They include only two large emerging economies from outside the region: Pakistan, which already has an IMF programme, and South Africa. By contrast, South Korea should not have a financing gap, thanks to its expected move back into current-account surplus. Most emerging economies' large reserves will help to keep them out of danger. Unfortunately, the longer that the credit crunch continues, the more those reserves will start to dwindle.