A first assessment of the external vulnerability of emerging market economies

To date, most emerging countries are showing better economic and financial performance than expected, considering the significant tightening of financial conditions which we have witnessed across the global. However, this resilience should not lead us to complacency. One factor that often puts pressure on emerging economies is the appreciation of the dollar, and since the beginning of the year it has gained almost 3% in value against a large basket of currencies.

In this regard, recent IMF estimates indicate that a 10% appreciation of the dollar, in nominal effective terms, causes a 1.9% drop in the real GDP of these countries two quarters later (compared to a 0.5% drop for advanced countries) and the recovery of the lost growth takes around 10 quarters in emerging economies (versus three in developed economies).[1] However, the agency itself points out that the impact of increased global risk aversion is not equal in all countries and past experience shows that the economies hardest hit were, above all, those with a more fragile external position involving very high and recurring current account deficits, high levels of foreign debt and/or an excessive reliance on short-term debt financing.[2]

External Vulnerability Tracker

Faced with this circumstance, we have produced a tracker which shows the external position of the major emerging countries,[3] highlighting their weaknesses. It is not intended to be a model for assessing country risk, nor a tool for assigning probabilities of economic or financial crises, but it does offer important clues about each country's dependence on foreign savings (and, consequently, its relative vulnerability), based on a series of variables that are common to all of them. For instance, the fact that

External Vulnerability Tracker

2023	Current account balance	Foreign debt	S/T foreign debt	S/T foreign debt	DFI inflows	Risk premium of foreign debt issued in dollars	Foreign vulnerability ranking (*) (**)				
	(% of GDP)	(% of GDP)	(% of foreign debt)	(% of reserves)	(% of GDP)	(%)	2023	2018	2008	2007	2001
Turkey	–4.8	44.9	32.6	227.0	0.5	5.6	1	1	4	4	3
Argentina	–2.5	49.2	16.5	184.6	1.5	20.2	2	2	7	5	1
Malaysia	2.1	64.6	41.8	100.4	1.6	0.3	3	3	5	9	15
Hungary	–1.3	82.0	9.8	48.6	–0.8	4.0	4	5	1	1	8
Chile	–1.6	70.6	8.5	52.3	3.6	1.4	5	6	6	7	10
Egypt	–2.6	45.8	9.5	62.3	2.0	7.0	6	14	20	21	19
South Africa	–2.6	47.5	15.9	53.6	0.6	3.7	7	4	3	3	2
Colombia	–4.4	54.3	13.4	44.5	2.6	4.2	8	10	13	14	14
Thailand	0.3	39.9	37.1	37.7	–1.9	1.5	9	9	8	6	9
China	1.5	13.7	53.0	45.0	–0.5	1.3	10	8	15	12	17
Poland	1.1	48.3	15.4	38.1	2.4	0.2	11	7	2	2	12
Morocco	–0.3	47.5	14.0	27.7	1.0	3.0	12	13	19	18	16
Indonesia	–0.5	29.6	11.9	35.0	1.1	1.5	13	11	9	10	4
Mexico	–0.7	31.1	10.7	30.8	2.2	1.6	14	12	12	13	18
India	–1.6	17.9	20.8	23.8	0.7	1.5	15	15	11	15	21
Russia	2.2	28.3	15.0	18.3	–1.0	2.9	16	20	14	11	6
Brazil	–1.7	26.2	12.4	20.1	2.1	2.6	17	18	18	17	11
Philippines	–3.7	24.1	14.0	18.1	0.8	0.7	18	17	10	8	5
Peru	–2.0	33.0	–	–	3.3	2.1	19	19	16	16	13
Algeria	2.2	28.3	21.6	2.5	0.5	4.8	20	16	17	20	20
Saudi Arabia	4.2	20.6	19.8	10.1	–0.8	–	21	21	21	19	7

Notes: ** The vulnerability ranking assigns a position depending on the average value of the variables included in the table for each country: the top spot corresponds to the highest average (greatest external vulnerability) while the 21st position corresponds to the lowest average (lowest external vulnerability).*
*** The comparison dates are years in which the main emerging countries experienced major financial crises, resulting either from idiosyncratic risks such as currency devaluations or changes in government, or from significant monetary policy shifts in advanced economies.*
Source: *CaixaBank Research, based on data from Oxford Economics, via Refinitiv.*

1. See IMF (July 2023). External Sector Report: «External Rebalancing in Turbulent Times».
2. See IMF (June 2017). «Assessing Country Risk: Selected Approaches».
3. The countries chosen belong to the IMF's «emerging market economies» classification. In addition, we have included Morocco and Algeria due to their relevance to Spain's foreign market.

China appears in 10th position out of 21 countries does not mean that the tracker is giving its external financial position a «bad score»; it simply indicates that there are variables which are in a less favourable position than in the other countries considered. Indeed, the IMF, in its External Sector Report, places China in the group of economies with an external position that is consistent with its medium-term fundamentals.[4]

The traditional variable for determining an economy's funding needs (or lending capacity) is the current account balance:[5] if it is negative, the country pays more to other countries than it receives, and the opposite if it is positive. In other words, domestic savings do not cover the country's investment needs. However, whether the balance is positive or negative is not necessarily conclusive *per se*, as it may reflect very different situations. As an example, Turkey and Colombia have large current account deficits, but they have very differing degrees of external vulnerability.

In fact, to understand the fragility of a country's external position, it is also necessary to take into account each country's economic situation, together with other variables that capture their financial links with other countries. In this regard, it is important to know a country's level of foreign debt, understood as the amount of its debt (both sovereign and private) which is in foreign hands, expressed in dollars and in terms of GDP. The higher this ratio, the more vulnerable a country is to a change in sentiment among foreign investors, as the outflow of capital could potentially jeopardise its ability to meet its pre-existing obligations with its creditors, as well as weakening the local currency's exchange rate. Similarly, the higher the percentage of that debt which is due to mature in the short term, and the higher it is relative to the country's foreign currency reserves, the greater those fears will be.

Another variable that provides a good indicator of investor sentiment is the risk premium of sovereign debt, understood as the «extra» return which investors demand from issues of debt denominated in dollars carried out by a given country compared to an issue with a similar maturity horizon carried out by the US Treasury. Finally, we include foreign direct investment (FDI), in terms of GDP, since it provides information on the behaviour of a particular source of financing over the medium and long term, which is less volatile in the face of episodes of financial instability and thus helps to reduce external vulnerability.

What information does the tracker give us?

First of all, leading the vulnerability ranking we find the «usual suspects». These are countries whose economic and financial imbalances have become chronic over the last 20 years as a result of ineffective economic policies, with unstable governments that are highly prone to taking on debt and to intervening in the foreign exchange markets. In short, these aspects have degraded these countries' credit ratings and exacerbated their external vulnerability, with Turkey and Argentina topping the list. In fact, in both cases their currencies have depreciated by 30% and 50% against the dollar, respectively, so far this year. Malaysia is an exceptional case, since despite historically having a current account balance in surplus,[6] in recent years its foreign debt has increased significantly and, in the short term, it will reach levels that would be difficult to cover with the country's existing foreign currency reserves. As a result, its currency is now at its weakness ever against the dollar. However, the country still enjoys the confidence of foreign investors (inflows of FDI have increased in recent years) and the main rating agencies assign it the highest scores within the «investment grade» category.

Secondly, the top five positions in the ranking are held by countries whose short-term debt exceeds 50% of the level of their reserves, a threshold which signals a high risk of default on their foreign debt. This drives up the premiums demanded by investors, and the worse the country's credit rating, the bigger the increase in the premium.

Thirdly, several of the top-ranking countries have received some form of financial assistance from the IMF since the pandemic, such as Argentina, Egypt, or South Africa, which highlights the weakness of their external positions and their difficulties in accessing international capital markets.

In addition, if we look at changes in the ranking over time, we see improvements in the case of countries where major fiscal consolidation reforms have been introduced (such as Saudi Arabia), in those which have benefited from commodity export earnings (such as Brazil and Angola), or those that have reduced their vulnerability to foreign exchange rates by increasing debt issues in their local currency (such as Russia).

In short, this tracker provides key information on the structural external vulnerability of a number of countries. However, this is not the only potential source of financial instability and there are other factors that also provide information about a country's fragility, such as geopolitical risks and the rise in the price of essential goods, among others. We also cannot overlook the sharp rise in debt levels, both globally and in emerging economies. Indeed, the IMF itself warns that almost 20% of emerging economies have sovereign bonds that are being traded under unfavourable conditions (with currencies that are very weak against the dollar, with very high risk premiums and with difficulties in accessing international capital markets) and that over half of low-income countries are either over-indebted or exposed to a very high risk of over-indebtedness.[7] However, this issue is important enough that it deserves to be addressed in another report.

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4. The IMF assesses the extent to which a country's external position is in line with its medium-term fundamentals, taking into consideration aspects such as structural and fiscal reforms, as well as the flexibility of the local currency exchange rate in helping the economy to absorb external shocks.
5. The current account balance encompasses all of a country's transactions with the outside, in a given period, arising from the exchange of goods and services (trade balance), the collection or payment of investment dividends (income balance) and transfers.
6. Since 2008, its current account surplus ratio has fallen by almost 14 pps due to the negative impact of the fall in global demand on Malaysian exports (which are heavily commodity-focused), following the successive crises experienced in recent years and the fall in commodity prices.
7. See IMF (13 September 2023). «Global debt is returning to its rising trend».