

Will dollar denominated debt become an emerging economy epidemic?



Dear readers,

In the past year, the US dollar has appreciated by around 20% on a trade-weighted basis. There are two main reasons for this:

1. the US economy has sustained relatively strong economic growth, particularly in the middle of 2014; and
2. the US Federal Reserve is further along the path to tightening monetary policy than the central banks of the other major global currencies (see Figure 1).

A strong dollar, like oil prices, is a rare thing in economics: its impact can be felt *throughout* the global economy. In the US, a stronger dollar can put downward pressure on net export growth as US products become relatively more expensive in international markets and imports become cheaper for US consumers. But it is the impact of an appreciating dollar outside the US which I think is of greater concern.

In recent years, many emerging markets have borrowed in US dollars to take advantage of exceptionally low dollar interest rates that have resulted from the Fed's massive quantitative easing programmes. Now that the Fed is preparing to tighten monetary policy, and the dollar has strengthened, this dollar denominated debt has become a source of potential vulnerability for many emerging economies.

In this edition of the GEW we've analysed country vulnerability and found that:

- the so called 'Fragile 5' is now the 'Tender 2' as Turkey and South Africa remain particularly vulnerable to a strong dollar;
- India is heading in the right direction as its current account deficit has fallen but Brazil and Indonesia are worth keeping an eye on; and
- most of the governments in our sample have a relatively modest ratio of external public debt to GDP, thus giving them some insulation from the rising dollar.

However, perhaps the main takeaway for our clients is that US dollar credit is becoming more expensive and is likely to have consequential and sometimes amplified impacts on financing in many emerging economies.

Finally, Iran's potential re-entry into the global economic system has been referred to as a 'game changer' for the region; we've taken a closer look.

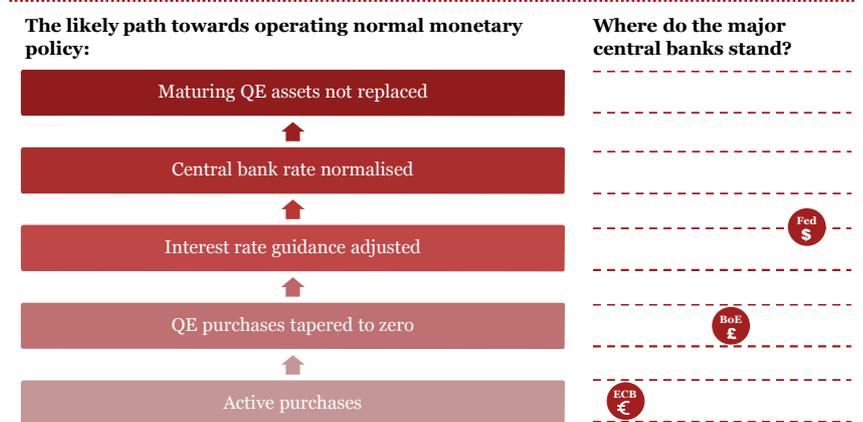


Kind regards,

Richard Boxshall

PwC | Senior Economist

Fig 1: The Federal Reserve is closer to raising interest rates than other major central banks



Sources: PwC analysis, Federal Reserve

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Economic update: US economy falters in Q1

US GDP grows by 0.1% quarter-on-quarter in Q1

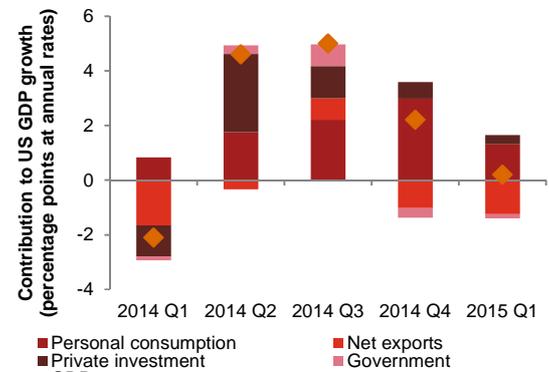
Similar to 2014, the Q1 GDP growth figure in the US faltered this year as the economy grew by just 0.1% quarter-on-quarter. Consumer spending growth came in at 0.5% quarter-on-quarter, reflecting the fact that households are not yet taking advantage of the low oil price to increase spending. Instead, consumers are preferring to increase their savings - the personal savings rate increased from 4.6% in the last quarter of 2014 to 5.5% in 2015 Q1.

The strong dollar takes its toll on US growth

GDP growth was also constrained by the appreciating dollar which contributed to a larger negative contribution to growth coming from net exports than in the previous quarter (see Figure 2).

Despite another year in which Q1 growth in the US has disappointed, and in which the Federal Reserve is expected to increase interest rates later in 2015, we expect growth to pick up in the remainder of the year as cheap oil and rising real wages (real average hourly earnings in March 2015 were 2.2% higher than a year ago) begin to feed through into higher consumer spending growth. As a result we expect the US economy to grow by around 2.4% this year.

Fig 2: Slowing personal consumption growth and net exports contributed to low GDP growth in the US



Source: US BEA

Iran: Wind of change?

Since 2012, Iran's access to capital and trade markets has been severely limited on the back of international sanctions. A key consequence of this was the drop of Iranians' average GDP per capita below the regional average for the first time since 1995 (see Figure 3). But this could all soon come to an end.

The initial framework agreement between Iran and six world powers in April, which is expected to lead to a finalised deal in June, could be a 'game changer' for the region as it will most probably entail a gradual relaxation of international sanctions.

What if...?

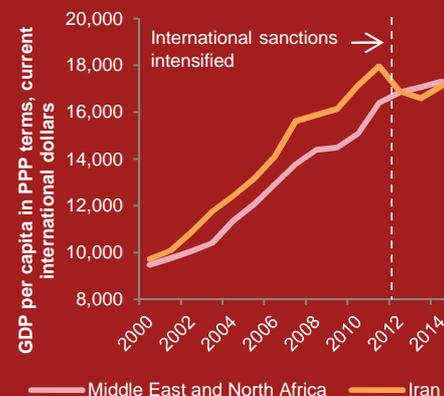
We think the most obvious area that will be impacted by the eventual lifting of the sanctions is Iran's energy sector, which has been starved of Western know-how and expertise for a long time (this is also the case for its airline and car manufacturing sectors).

Iran's oil fields are commercially attractive for two reasons. First, because of their potential: Iran holds the fourth largest oil reserves in the world. Second, because of the relatively cheap cost of extracting oil: the IMF estimates that Iran's (external) break even oil price is \$43 per barrel. In fact, if Iran's oil production reverts to pre-2012 levels, it could increase global oil supply by more than 1% or by around a million barrels a day. Iran also hosts the world's second largest natural gas reserves, which have similarly strong potential.

More trade, more jobs

But there are wider business and

Fig 3: International sanctions have taken a toll on GDP per capita in Iran



Source: IMF

macroeconomic issues to consider. The biggest impact for local businesses would come through re-accessing international payment systems (e.g. SWIFT). In principle this should make it easier for Iran to trade with the rest of the world, so creating jobs for its well-educated workforce and pushing unemployment below the 10% mark. On a longer time frame, exposing local Iranian businesses to international competition could also help strengthen productivity.

International businesses also stand to gain through increased sales. One sector that could flourish is consumer goods, from electronics to clothing, which tend to cater to the needs of young adults and families with children. The CIA estimates that more than

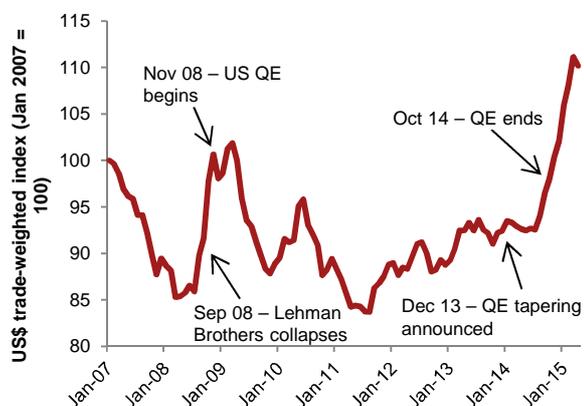
70% of Iran's 80 million population is in the 15-64 age range, which is bigger than the population of Spain and a key source of demand. A more vibrant presence of international consumer goods conglomerates in Iran could also have additional spill-over effects in affiliated industries including advertising, light manufacturing and logistics.

Finally, lifting the sanctions will mean that Iran will regain access to the estimated \$90 billion assets that are currently held abroad. At a business level, sophisticated professional service firms based in the UAE, Iran's biggest source of imports, are well placed to help repatriate some of these assets. Iran also has a growing and cash-hungry tech sector, which could be a potential investment target. More importantly though, as the amounts involved are quite large, capital inflows could have wider macroeconomic effects including stabilising the Iranian rial in the medium-term, reducing the wedge between the official and parallel rates, and putting downward pressure on inflation. Some London-based asset managers have already teamed up with local Iranian firms to prepare for this.

Most economic history books focus on the key reforms that have had a long-lasting impact on countries. The economic advantages of re-integration must be tempting. Will the lure of plugging into global capital and trade flows prove enough to finalise a deal? We'll find out by the end of June.

Payback time! Emerging markets and the rising dollar

Fig 4: In the past year, the US dollar has appreciated by around 20% in trade-weighted terms



Sources: PwC analysis, Federal Reserve

Table 1: Turkey, Peru, Colombia and South Africa are the most vulnerable economies to the strong dollar

Countries	Vulnerability	Foreign currency external debt (% of GDP)	12-month currency movement (%)	Current account balance (% of GDP)
Turkey	High	46%	-19.4%	-5.7%
Peru	High	30%	-10.3%	-4.1%
Colombia	High	25%	-23.2%	-5.0%
South Africa	High	19%	-12.1%	-5.4%
Malaysia	Medium	65%*	-11.0%	4.6%
Chile	Medium	51%	-9.9%	-1.2%
Russia	Medium	37%*	-33.3%	3.1%
Indonesia	Medium	33%*	-11.7%	-3.0%
Brazil	Medium	24%*	-27.9%	-3.9%
Mexico	Medium	22%	-13.8%	-2.1%
Argentina	Medium	27%	-9.6%	-0.9%
Thailand	Medium	27%	-0.5%	3.8%
India	Medium	17%	-3.3%	-1.4%
Philippines	Low	20%	0.3%	4.4%

*Number shows total external debt as a % of GDP

Sources: PwC analysis, World Bank, IMF, Datastream

Table 2: Most governments have resisted the lure of cheap foreign credit

Countries	Short-term foreign currency external debt (% of total foreign currency external debt)	General government external debt (% of GDP)	Projected annual average real GDP growth rate, 2015-20 (%)
Turkey	31%	11%	3.7%
Peru	12%	8%	4.7%
Colombia	13%	10%	4.0%
South Africa	40%	15%	2.8%
Malaysia	N/A	15%	5.0%
Chile	13%	2%	3.5%
Russia	N/A	3%	0.4%
Indonesia	N/A	14%	5.5%
Brazil	N/A	3%	2.3%
Mexico	13%	16%	3.7%
Argentina	40%	14%	1.8%
Thailand	48%	6%	3.9%
India	24%	4%	6.4%
Philippines	15%	11%	6.2%

Sources: PwC analysis, World Bank, IMF

Emerging economies could not resist the elixir of cheap dollar debt

Dollar denominated debt issued outside the US increased from around \$6 trillion before the first round of quantitative easing (QE) was introduced in November 2008 to around \$9 trillion in 2014. Currently, the value of outstanding dollar denominated debt in emerging economies is around \$3.3 trillion, which equates, for example, to more than double the annual economic output of Spain.

But the Fed will tighten monetary policy soon

As the US economy has picked up and QE has come to an end, however, the dollar has appreciated by around 20% on a trade-weighted basis over the past 12 months (see Figure 4). This also reflects the anticipated normalisation of monetary policy (see Figure 1) by the Federal Reserve over the next few years, with an initial policy rate rise expected later in the year.

Strengthening dollar doesn't pose an immediate risk to some emerging economies

Economic theory states that there are three key variables which affect external debt sustainability: the real interest rate, the exchange rate and GDP growth. The US recovery has set in motion changes in most of these variables. With this in mind, we have assessed the vulnerability of 14 emerging markets which have issued significant amounts of dollar denominated debt.

The results of our analysis are, on the whole, positive as most of the key countries in our sample seem reasonably well placed to deal with the risks associated with a stronger dollar. Focussing on the larger emerging markets, our three main findings are that:

- **'Fragile 5' now the 'Tender 2':** Of the so called 'Fragile 5' from 2013 (Brazil, South Africa, Indonesia, India and Turkey), we think that only South Africa and Turkey remain particularly vulnerable (see Table 1). Both economies have suffered relatively large capital outflows in the past 12 months and continue to run high current account deficits. Turkey is the most vulnerable economy in our sample as it has the second largest stock of foreign currency debt to GDP and faces the added pressure of having to refinance around one third of its foreign currency external debt stock this year. Nevertheless financial markets in Turkey remain calm; our quarterly updated country risk premium has only increased by around 0.4 percentage points since the second quarter of last year.¹
- **India in better shape but keep an eye on Brazil and Indonesia:** India, one of the original 'Fragile 5' economies, has improved its position over the past two years as its policymakers have adopted a relatively tight monetary policy. Coupled with lower oil prices, this has lowered its current account deficit from 4.8% of GDP in 2012 to 1.4% of GDP last year. India now seems to be better placed to deal with a rising dollar than it was previously.

While Brazil and Indonesia are not included amongst our high vulnerability countries, we think they are worth keeping an eye on. Both are running sizeable current account deficits which indicate reliance on foreign lending. Also, both currencies have depreciated in double digit terms in the past 12 months. Risks are slightly more exaggerated in Brazil, which is struggling to deal with low commodity prices and is implementing an austerity programme to improve public finances. The Brazilian economy is expected to shrink in 2015, which could be associated with a squeeze in revenues for some businesses. Therefore, businesses with a large amount of dollar denominated debt are likely to tread cautiously to avoid running low on cash holdings that they may need to service their debts.

More generally, the fact that high or medium level vulnerabilities still remain within most of the emerging markets we have looked at shows the importance for businesses of stress testing their current and projected borrowing positions for the possibility of currency and interest rate fluctuations.

- **Governments insulated from the rising dollar:** Our analysis shows that most of the governments in our sample have a relatively modest ratio of external public debt to GDP (see Table 2). The highest ratio is around 16% in Mexico. This suggests that emerging market governments have largely resisted the temptation to take advantage of cheap foreign credit (compared to the private sector) and are therefore less exposed to the effects of a strengthening dollar.

¹Visit www.pwc.co.uk/crp to read our country risk premia quarterly update

Projections: May 2015

	Share of 2013 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2014p	2015p	2016p	2017-2021p	2014p	2015p	2016p	2017-2021p
Global (Market Exchange Rates)		100%	2.7	2.7	3.2	3.0	2.6	2.2	2.5	2.5
Global (PPP rates)	100%		3.2	3.2	3.7	3.5				
United States	16.4%	22.4%	2.4	2.4	2.7	2.5	1.6	0.3	1.8	1.9
China	15.8%	12.7%	7.6	7.0	7.2	5.7	2.1	2.2	1.8	3.0
Japan	4.6%	6.6%	0.0	1.1	1.4	1.3	2.7	1.4	2.3	1.9
United Kingdom	2.3%	3.4%	2.8	2.3	2.3	2.3	1.5	0.2	1.7	2.0
Eurozone	12.3%	17.1%	0.9	1.3	1.6	1.8	0.5	0.1	1.4	1.4
France	2.5%	3.8%	0.4	0.9	1.4	1.9	0.6	0.1	1.1	1.2
Germany	3.4%	4.9%	1.6	1.7	1.6	1.6	0.8	0.2	1.8	1.7
Greece	0.3%	0.3%	0.7	-1.1	1.6	2.5	-1.4	-0.8	0.3	1.4
Ireland	0.2%	0.3%	4.8	3.4	3.4	2.5	0.3	0.2	1.1	1.5
Italy	2.0%	2.8%	-0.3	0.4	1.1	1.3	0.2	-0.1	1.8	1.4
Netherlands	0.8%	1.1%	0.8	1.4	1.6	1.9	1.0	1.2	1.1	1.3
Portugal	0.3%	0.3%	0.9	1.5	1.7	1.8	-0.2	0.1	0.8	1.5
Spain	1.5%	1.8%	1.4	2.3	2.5	2.2	-0.2	-0.8	1.0	1.2
Poland	0.9%	0.7%	3.3	3.4	3.5	3.2	0.2	-0.1	1.7	2.5
Russia	3.4%	2.8%	0.2	-5.0	-0.5	1.9	7.8	15.0	8.0	4.3
Turkey	1.4%	1.1%	2.9	3.5	3.8	3.7	8.9	6.9	6.5	6.2
Australia	1.0%	2.0%	2.6	2.6	3.1	2.9	2.6	2.5	2.6	2.5
India	6.6%	2.5%	5.3	7.0	6.9	6.1	4.4	4.2	5.2	6.0
Indonesia	2.3%	1.2%	1.3	5.8	5.7	5.4	6.3	6.5	6.7	5.1
South Korea	1.7%	1.7%	3.4	3.5	3.7	3.5	1.3	1.6	2.2	2.9
Argentina	0.9%	0.8%	-0.2	0.3	2.3	2.1	25.0	25.0	-	-
Brazil	3.0%	3.0%	0.1	-0.4	1.5	3.1	6.3	7.5	6.0	4.8
Canada	1.5%	2.4%	2.5	2.2	2.2	2.2	1.9	0.9	1.9	2.1
Mexico	2.0%	1.7%	2.1	3.0	3.5	3.9	4.0	3.2	3.3	3.1
South Africa	0.7%	0.5%	1.5	2.0	2.1	3.2	6.1	4.6	5.6	5.3
Nigeria	1.0%	0.7%	6.2	4.0	4.5	6.0	8.1	12.0	10.0	7.3
Saudi Arabia	1.5%	1.0%	3.6	2.6	3.0	4.4	2.7	2.3	3.0	3.4

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index released by INDEC. We will provide a 2016 and 2017-2021 inflation projection once a longer time series of data is available. Also 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	0-0.25% (December 2008)	Rate to start to rise later in 2015	16-17 June
European Central Bank	0.05% (September 2014)	Rate on hold following decrease in September 2014	3 June
Bank of England	0.5% (March 2009)	First rate rise to come by early 2016	11 May



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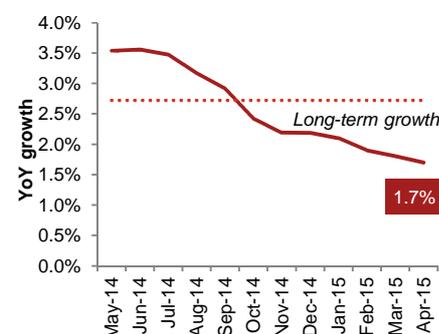


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PwC's Global Consumer Index

The GCI is on a downward trend for the 11th consecutive month, indicating a continuing fall in consumer spending growth. Equity markets have weakened a little but business and consumer confidence recovered slightly. Industrial production has also improved from last month, especially in the US and Europe. However, the continuing low oil prices are yet to translate into a surge in global consumer spending.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit www.pwc.co.uk/globalconsumerindex

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