

Research Briefing | US

Contagion is the big emerging markets risk for the US

Economist

Gregory Daco
Chief US Economist
+1 646 503 3055

Oren Klachkin
Lead Economist
+1 646 503 3058

- The US economy is insulated from current emerging markets (EM) woes, but it is exposed to EM contagion. While US trade, banking and corporate exposure to the riskiest EM – Turkey, Argentina, South Africa, Ukraine, Mexico, Brazil, and Russia – is limited, a generalized EM slowdown would constrain the economy.
- Since the riskiest EM account for less than 2% of US GDP, with three quarters going to Mexico, a broad-based 10% contraction domestic demand would only subtract 0.1-0.2ppt from US GDP growth. However, we know from experience that a broad-based EM can significantly constrain US growth – in 2015-2016 the GDP drag amounted to 0.6ppt.
- Banking sector exposure to the riskiest EM is limited with claims on these economies representing only 0.8% of total US banking assets. However, claims on all EM is ten times larger, representing a true risk in case of contagion.
- While EM hold about a fifth of all outstanding Treasuries, risky EM only account for 5%, and Treasuries' safe haven status likely insulates the US from rapidly tightening conditions in case of a sudden EM selloff of Treasuries.
- While 45% of US multinationals' revenues come from abroad, less than 20% comes from EM and less than 4% from risky markets.
- In short, while isolated EM colds won't noticeably disrupt the US economy, a generalized and contagious flu could put the economy on bed rest.

While much attention has been devoted to country-specific EM risks, little focus has been placed on the potential risks to the US economy. This *Research Briefing* focuses on the US economy's exposure to the [riskiest](#) EM – [Turkey](#), [Argentina](#), [South Africa](#), Ukraine, Mexico, [Brazil](#), and Russia – as well as risks from a generalized EM slowdown.

Markets are getting more anxious about EMs

US: Stock market performance



Emerging markets' stocks have diverged significantly relative to US equities since the start of the year.

This reflects capital flowing back to the US in the face of growing risk aversion.

Contagion is the big emerging markets risk for the US

Not all EM in the same basket

While economies that had previously depended on cheap liquidity and massive capital inflows are discovering that it is very difficult to maintain their economy afloat in a world where liquidity is more expensive, it is important to remember that emerging economies form a heterogeneous group with country-specific challenges. In particular, those economies that have not addressed long-standing structural issues have faced the most significant headwinds recently.

This is important as history shows us that regional crises generally have had limited effects on the US economy unless trade and financial exposure to the affected region is large, or there is contagion. For example, the 1997 Asian Financial Crisis led to sharp GDP declines across ASEAN nations (between 30 and 40 percent), and weaker growth across the rest of Asia, but the US economy escaped relatively unscathed (advancing 4.5% in 1997 and 1998) until financial contagion spread to Russia and led to sharp losses and the eventual bailout of Long-Term Capital Management (LTCM).

Limited trade exposure barring contagion

US exports to emerging markets have grown rapidly over the past two decades. In 2017, nearly half total US merchandise exports went to EM, up from around 40% in the early 2000s, and representing around 4% of US GDP. As such, it is no surprise that when emerging markets growth subsided in 2015-2016, US exports slowed sharply. We estimate that in 2015, the drag to real GDP growth from reduced US exports to EM was about 0.6ppt (Chart 2).

However, while export exposure to all EM is large, exposure to the riskiest EM – Turkey, Argentina, South Africa, Ukraine, Mexico, Brazil, and Russia – represented just 1.6% of GDP in 2017 (Chart 1) with Mexico representing three quarters of the total. As such, even a massive 10% average contraction in domestic demand across these economies, would only subtract 0.1-0.2ppt from US GDP growth.

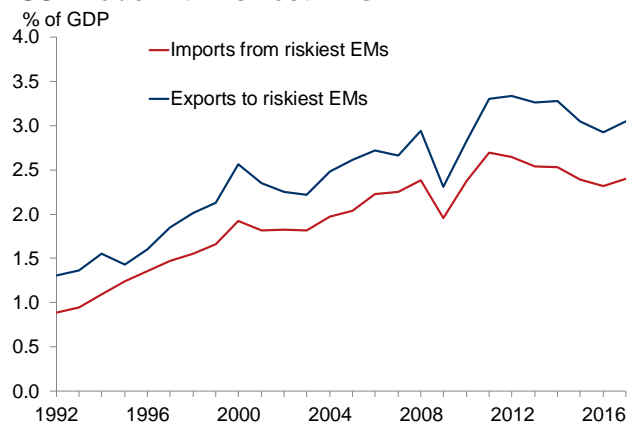
...same goes for US banking exposure

US banking claims on foreigners account for about 23% of total US banking assets, according to BIS data, but these are concentrated in advanced economies. Only about a third of these assets are exposed to EM, and exposure to the riskiest EM is only 3.5% of US banking claims on foreigners. As such, the troubled emerging economies collectively account only for a minuscule 0.8% of total US banking assets (Chart 3).

However, while direct exposure may not appear important,

Chart 1: Only a small share of US trade flows are linked to the riskiest EM

US: Trade with riskiest EMs

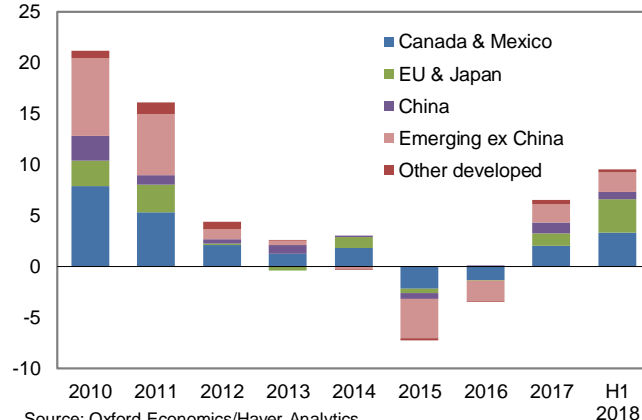


Source: Oxford Economics/Haver Analytics

Chart 2: EM demand as a whole is a major contributor to US export activity

US: Stronger trade flows support US exports

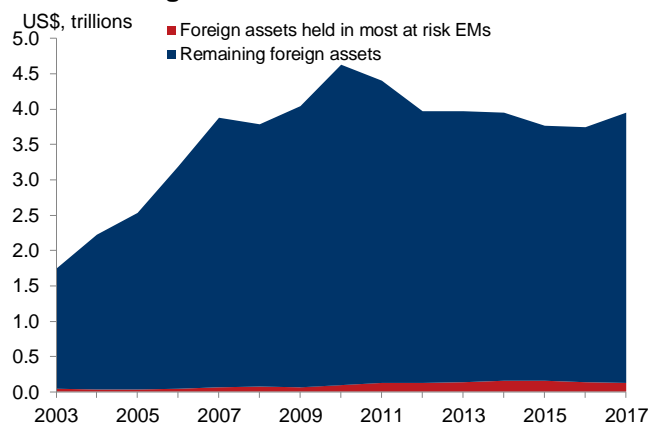
Percentage points contribution to US merchandise export growth



Source: Oxford Economics/Haver Analytics

Chart 3: The banking sector doesn't have much exposure to the current EM troubles

US: Banking sector assets



Source: Oxford Economics/Haver Analytics

Contagion is the big emerging markets risk for the US

the true risk lies in contagion. At an *intra-regional* level, many emerging markets are highly exposed to their neighbors, and financial stress in one economy could flow into other regional markets. This was the case during the 1997 Asian financial crisis, or more recently during the European sovereign debt crisis. At an *inter-regional* level, US banks are quite exposed to European economies, many of which are more highly exposed to some of these troubled economies. As such, contagion via this channel represents a risk.

Safe haven Treasuries not at risk

Since EM holdings of US Treasuries represent roughly 17% of total outstanding US Treasuries, significant market dislocations across all EM could lead to tightening financial conditions in the US. IMF [COFER](#) data show that emerging markets' central banks' reserves are mainly denominated in US dollars and come largely in the form of US Treasuries. As such, if rising EM stress leads these central banks to deploy their foreign exchange reserves in a bid to defend their respective currencies, we could witness a sudden and rapid rise in long-term rates.

However, looking at the US Treasury holdings data, exposure to the riskiest EM is limited. Turkey, Argentina, South Africa, Ukraine, Mexico, Brazil, and Russia held only a 5% of outstanding long-term US Treasuries in 2017 (**Chart 4**). Since then, Russia has [sold off](#) all of its US Treasury holdings – as it has pledged to [diversify](#) out of US dollar assets – reducing the share of US Treasuries held by EM even smaller today.

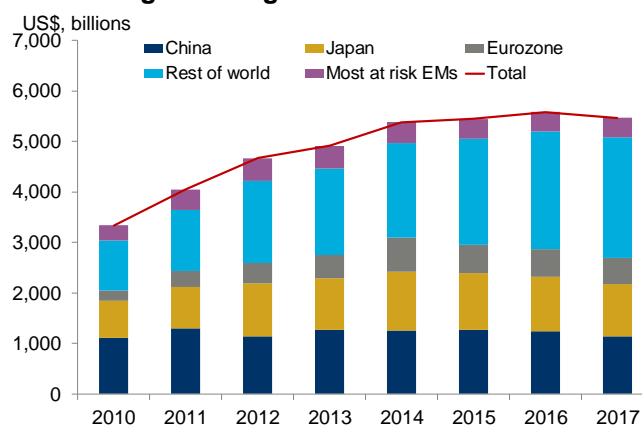
Further, since US Treasury securities remain the world's prime safe haven assets, we believe that even in a sharp risk-off environment with EM central banks supporting their currencies with foreign reserves, safe haven flows into the US would largely outweigh foreign central bank influence on Treasury demand.

Corporate debt not overly concerning

While 30% of outstanding US corporate debt is held by foreign investors, a majority of that debt is held by investors in advanced economies. Within the debt held by foreign investors, about 40% is held by financial intermediary (including in Luxembourg, Belgium, and the Cayman Islands) making it difficult to discern the final debt holder. Nonetheless, we know that EM investor ownership is not concentrated, with country debt holders owning on average 0% to 2% of foreign-owned corporate debt (**Chart 5**). As such, the risk again lies in contagion.

Chart 4: The riskiest EMs hold a small share of US Treasuries

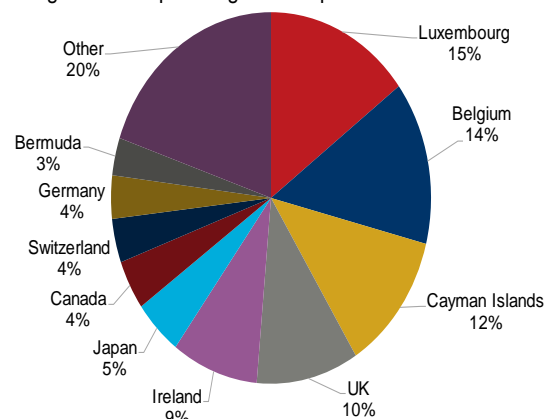
US: Foreign holdings of LT US Treasuries



Source : Oxford Economics/Haver Analytics

Chart 5: No key EM is a major holder of US corporate debt securities

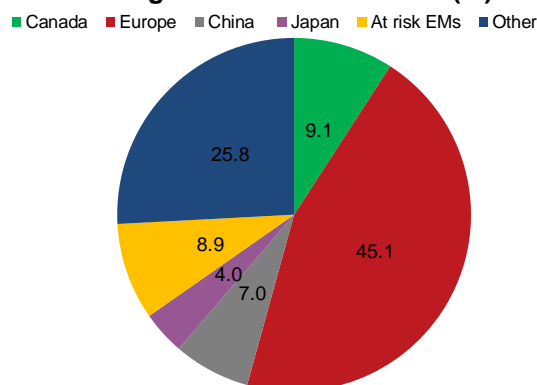
US: Foreign ownership of long term corporate debt



Source: Oxford Economics/Haver Analytics

Chart 6: US multinationals do not generate much of their revenues from the riskiest EMs

US: MNC foreign revenue breakdown (%)



Source: Oxford Economics/Haver Analytics

Contagion is the big emerging markets risk for the US

The role of multinational corporations

S&P500 earnings data shows that about 45% of revenues came from [abroad](#) in 2017 with revenues widely spread geographically. However, while BEA data on multinational enterprises shows 40% of multinational foreign revenues coming from EM, exposure to the riskiest EM was only 9% of foreign exposure (**Chart 6**), representing 4% of total revenues.

MSCI data shows that only 15% of revenue for firms listed on the MSCI US came from emerging markets. Similarly, while around a quarter of US corporate profits come from the rest-of-the-world, it appears these are relatively dispersed across developed and emerging partners

As such, it appears that while US businesses would be exposed to a broad-based slowdown in emerging market, they could easily withstand a couple of isolated crises (without contagion).

Contagion is the main risk

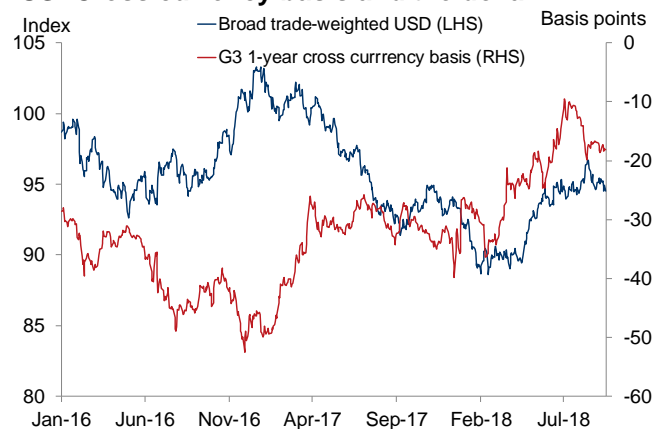
As we have seen, even though the riskiest EM do not have particularly strong direct economic linkages with the US, the US would not be immune from a broad-based EM shock. A material [deceleration](#) in Chinese growth or a full blown US-China [trade war](#) are just two possible scenarios that could have severe negative implications for all EM, and in our view the US economy as well.

Additionally, tightening by the Federal Reserve, together with rising interest rates and less liquidity in the global financial system (**Chart 7**), also represents a major risk for EM. If the EM sell-off were to become more intense and broad-based – especially in an environment of continued Fed tightening – it could ultimately cause a significant hit to the US economy.

In one of the five key scenarios from our [Global Scenario Service](#) we explore a series of developments that would expose EM vulnerabilities more significantly. A near-term spike in US inflation is assumed to prompt faster Fed tightening, triggering market turmoil. A sharp sell-off in equity and bond markets ensues against a backdrop of rising distress in the US corporate sector and with the impact amplified by developments in exchange-traded fund (ETF) markets. The result is a period of significant weakness in global output growth with emerging markets finding themselves more exposed (**Chart 8**), and weakness feeding back onto the US economy. In such a scenario, US GDP would be 2% lower than our baseline forecast by 2020.

Chart 7: Widening USD cross-currency basis may be a signal that global liquidity is drying up

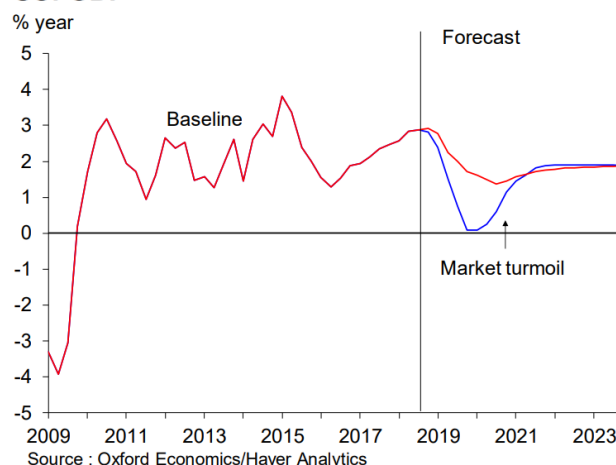
US: Cross currency basis and the dollar



Source: Oxford Economics/Bloomberg

Chart 8: Severe and pervasive EM stress would have a negative impact on the US economy

US: GDP



Source : Oxford Economics/Haver Analytics