

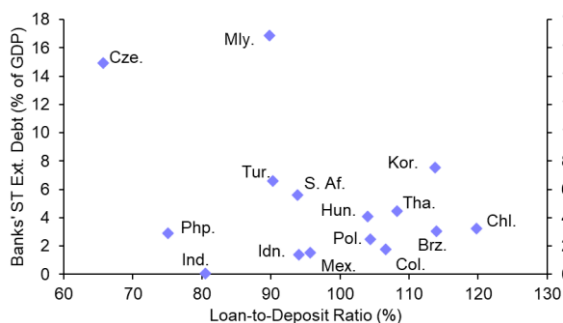


# EMERGING MARKETS ECONOMICS UPDATE

## A closer look at EMs' exposure to bank flows

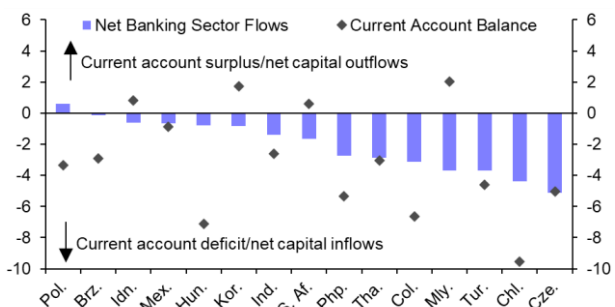
- A key channel through which emerging markets could be affected by the strains in the global banking sector is if lending by foreign banks falls sharply. On this front, EMs' vulnerabilities have eased since the Global Financial Crisis. But there are still areas of concern, particularly in countries that are reliant on banking sector flows to finance large current account deficits. That includes parts of Eastern Europe (particularly Turkey) and Latin America (Chile, Colombia). Risks in Asia look much more contained.
- All our research on the global banking turmoil can be found on our dedicated [webpage](#). One big unknown is whether the sharp rise in interest rates in EMs could cause lingering financial risks to surface – this is certainly something that shouldn't be ruled out. (For more, see [here](#) and [here](#).)
- **Even if home-grown banking problems don't emerge, there could be knock-on effects in EMs.** Fortunately, it looks like direct links between EMs and Credit Suisse are generally small. But **were strains in DM banks to escalate (see our forthcoming *Global Economics Update* that explores how this could happen), the impact could be much more significant. One key way in which this could occur would be a slowdown in banking flows.** This is one reason why economies in Emerging Europe were hit so hard during the Global Financial Crisis; parent banks froze funding to their subsidiaries, resulting in a sharp credit crunch.
- The good news is that EM banks' dependence on foreign wholesale financing looks relatively low. Chart 1 illustrates how the risks stack up now. Banks' loan-to-deposit ratios are shown on the horizontal axis and their short-term external debts on the vertical axis. Countries that sit towards the top-right are more likely to be dependent on foreign wholesale funding to finance their domestic lending.
- Loan-to-deposit ratios in major EMs are generally close to or below 100%, suggesting that lending is financed by domestic deposits rather than wholesale financing. In Emerging Europe in particular, these ratios are much lower than they were in 2008/09. But that's not to say that vulnerabilities have evaporated.
- Banks in Malaysia and Czechia have large short-term external debts while those in Chile, Korea, Brazil and Thailand appear more dependent on wholesale markets and have sizeable short-term external debts. That said, their central banks could deploy (large) FX reserves to help repay these debts. And in Czechia and Malaysia, risks are mitigated somewhat by the large share of external debt denominated in local currency.
- **Another way of thinking about exposure to bank flows is the extent to which these are needed to fund current account deficits.** Chart 2 shows where the risks lie by plotting the current account balance and net banking inflows (recorded as 'other' investment). **Chile, Czechia, Turkey and Colombia stand out for both the size of their current account deficits and large size of banking sector inflows.**
- In this scenario, currencies would come under (much more) pressure and domestic demand would need to weaken to reduce current account deficits and restore external stability. **That would complicate the monetary policy calculation for central banks in these countries.** Sharp currency falls, coming alongside above-target inflation, could force policymakers to keep monetary policy tight (and, possibly, hike further).

Chart 1: Banks' Short-Term External Debt & Loan-to-Deposit Ratio



Sources: Refinitiv, IMF, Capital Economics

Chart 2: Current Account Balance & Net Capital Inflows (% of GDP, 4Q Sum, Latest)



Sources: Refinitiv, Capital Economics





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