Currencies and Sovereign Debt Issues

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9/1/2018

Turkey and Other Emerging Market Countries

The Turkish lira has declined 43.7% year-to-date. Turkey had $466.7 billion of external debt at the end of the first quarter. Much of the debt is denominated in euros or US dollars and is owned by European and American banks. Turkey also has a current account deficit which is currently at 5.5% of GDP in 2017.

According to JP Morgan analysts, Turkish companies and government entities have $146 billion of external debt payable in foreign currencies that matures during the twelve months ending July 2019. The central government and public-sector entities have another $33 billion of external debt payable during the same timeframe.

The combination of a declining currency and debt service denominated in foreign currencies has been a problem for many countries in the past. As their currencies decline, it becomes more difficult to service external debt denominated in foreign currencies. The process often leads to an exaggerated currency devaluation and debt defaults.

Turkey is not the only country to have a low level of reserves to cover projected current account deficits and the servicing of debt owed to other countries. Countries that have less than one year's central bank reserves to cover external commitments include: Ukraine, Argentina, Jordan, Ecuador, Poland, Romania, Indonesia, Malaysia, and South Africa.

While Brazil and India have better foreign currency reserve positions, their economies are relatively large. India has the 6th largest economy in the world at $2.6 trillion and Brazil has the 8th largest economy in the world at $2.06 trillion. Both India and Brazil have experienced steady devaluations of their national currencies this year, along with Argentina and South Africa.

Cross-border financial relationships have led to financial contagion during the Asian financial crisis of 1997-1998 and during our last financial crisis of 2008-2009. If the emerging market currencies continue to decline, it will result in a higher level of credit defaults in those countries and have an impact on American and European entities that own their debt.

Italy

Financial markets appear to be more concerned about Italy in recent months. The yield on the

10-year Italian Government bond has increased from 1.80% in May to 3.22% now. The yield on the 10-year US Treasury is now slightly lower at 2.84%.

The Italian Government's debt is now at 2.3 trillion euros and the government debt/GDP ratio is currently at 132%. It is estimated that Italy's commercial banks currently hold 10% of their loan portfolios in non-performing loans in addition to approximately 400 billion euros of Italian government debt. It would be difficult for the Italian government to help the commercial banking system given its own debt problems.

Italy's GDP is at $1.93 trillion, which is just under 10% of the US GDP of $19.39 trillion. However, Italy has the 9th largest national economy in the world and much of its government debt is owned by European banks.

Italian newspaper Corriere della Sera recently reported that US President Donald Trump told the Italian Prime Minister Giuseppe Conte in a meeting in Washington that the United States was ready to offer Italy help in funding its public debt next year. The offer was prompted by the increase in interest rates on Italian Government bonds and concerns that Italy may have trouble refinancing its maturing debt. However, the offer by President Trump seems to ignore the poor financial situation of the United States Government.

United States

The general consensus of investors is that everything is fine in the United States but some of the economic numbers tell a different story. US GDP during the second quarter increased at an annualized rate of 4.2%, helped by stimulus provided by a US Government budget deficit that is projected to be $804 billion for fiscal year 2018. US Government debt outstanding now exceeds $21.3 trillion.

During the month of July, the US trade deficit (excluding services) increased to $72.2 billion. Persistent trade deficits of this magnitude normally lead to a currency devaluation, but the US continues to enjoy its privilege of providing the world's reserve currency for now.

Professor Stan Collender of Georgetown University and founder of thebudgetguy.blog recently wrote an opinion that was published in USA Today. He opines that the nation's finances will only get worse. There are three big budget issues that the White House (and Congress) have not addressed:

1. The Congressional Budget Office is projecting that the annual deficit will increase and exceed $1.5 trillion by 2028, assuming no changes in tax and spending laws and no recession.
2. There is no plan to pay for more tax cuts (currently under consideration), a Space Force, a border wall, infrastructure, etc.

3. There is no plan for how it will manage the US economy out of the next recession. The traditional federal response of tax cuts and spending increases could drive the annual deficit towards $2 trillion which would be alarming to many.

It remains to be seen to what extent problems in emerging market economies will impact the global economy and financial markets, but for now, it appears that any potential negative impact is not priced into the US financial markets.

If you have any questions or comments, please contact me.

Sincerely,
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