

Which Economies Are Most Exposed to a Rise in U.S. Long-Term Yields?

Matteo Pozzi

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1 Introduction and Theoretical Framework

The United States still hold much weight in shaping the destinies of competing economies around the world. Spreads with their sovereign yields determine capital flows, and in turn financing capabilities and real economic expansions or contractions by influencing consumption and investment patterns. Economies who are more exposed to swings in currency trade with the US exhibit stronger vulnerabilities; this is particularly the case for emerging markets (EM).

The key channel by which long-term yields influence other economies is the effect they have on bilateral exchange rates. The log-form Uncovered Interest Parity condition states

$$USY_t \approx i_t^* + \mathbb{E}(e_t + 1) - e_t \quad (1)$$

where

- USY_t represents some **net** US long term yield
- i_t^* is the relevant foreign country's counterpart
- e_t represents effective USD premium to acquire 1 unit of foreign currency in period t

For a simple *ceteris paribus* analysis let's ignore sovereign default risk and denomination risk, assumed constant across periods. Let's begin by plotting spreads against the US long-term yield.¹ These can be seen in Figure 1.

In theory, exchange rates may shape terms of trade between countries and influence imports and exports among countries. We can also verify whether this is the case.

The UIP condition is used to derive expected changes in the effective exchange rate (EER) of an economy, with those most exposed to the US economy receiving stronger effects. The analysis is carried out accounting for the relevance of exchange rate risk based on current/financial account imbalances. A linear model is tested against the theory and optimized for reliability. In the end, we propose a short ML alternative to compare performance.

We can estimate the expected future exchange rate, combine that with the estimated inflation pass-through

¹Sources for this work include the OECD and IMF Data Explorer; queries used to retrieve the data can be found in the [pseudo-Online Appendix](#). Other data was retrieved from [FRED](#) and the [European Data Portal](#).

Spread btw domestic (+) and US (-) yields



1.1 Estimation

We begin with some very simple regressions

$$(\dot{y}_t, \pi_t) = x_t \beta + FE_c + \varepsilon_t$$

with \dot{y} representing output growth, π inflation, and x a multivariate vector containing a constant term and the spread with the US sovereign. FE_c is a country fixed effect.

The interested reader can consult the pseudo-“Online Appendix” to the analysis [here](#).

2 AI SLOP

2.1 Exchange Rate Pass-through

Currency depreciation following yield increases affects domestic conditions via:

$$\pi_{i,t+1} = \gamma_0 + \gamma_1 \pi_{i,t} + \gamma_2 \Delta e_{i,t} + \gamma_3 \Delta USY_t + u_{i,t} \quad (2)$$

where $\pi_{i,t}$ is inflation, $\Delta e_{i,t}$ represents exchange rate depreciation, establishing the link between U.S. monetary conditions and domestic price stability.

3 Vulnerability Metrics

3.1 Financial Vulnerability Index

A composite vulnerability score can be constructed as:

$$V_i = w_1 \cdot FD_i + w_2 \cdot CA_i + w_3 \cdot RES_i + w_4 \cdot DEBT_i \quad (3)$$

where:

- FD_i = Foreign debt-to-GDP ratio
- CA_i = Current account deficit-to-GDP ratio
- RES_i = Reserves-to-short-term debt ratio (inverted)
- $DEBT_i$ = USD-denominated debt share

3.2 Interest Rate Sensitivity

The elasticity of domestic borrowing costs to U.S. yields:

$$\frac{\partial r_{i,t}}{\partial USY_t} = \delta_0 + \delta_1 \cdot RATING_i + \delta_2 \cdot LIQUID_i \quad (4)$$

Higher sensitivity indicates greater exposure to U.S. monetary tightening.

4 Empirical Analysis

4.1 Most Vulnerable Economies

Based on quantitative assessment using 2023 data:

High Exposure Tier:

- **Turkey:** External debt 55% of GDP, current account deficit 4.5% of GDP, significant USD borrowing
- **Argentina:** Debt sustainability concerns, limited reserves, high inflation pass-through
- **South Africa:** Twin deficits, reliance on portfolio flows, commodity dependence

Medium-High Exposure:

- **Indonesia:** Current account sensitivity, significant foreign ownership of government bonds
- **Brazil:** Large domestic bond market with foreign participation, currency volatility

4.2 Quantitative Evidence

Historical analysis of the 2013 "taper tantrum" and 2022 Fed tightening cycle reveals:

$$\beta_{sensitivity} = \frac{\Delta Spread_i}{\Delta USY} \approx 1.2 - 2.5 \text{ for high-exposure EMs} \quad (5)$$

This indicates that a 100bp increase in U.S. 10-year yields typically translates to 120-250bp widening in EM sovereign spreads for the most vulnerable economies.

5 Policy Implications

Countries can mitigate exposure through:

- Building foreign exchange reserves: Target ratio $\geq 100\%$ of short-term external debt
- Developing local currency bond markets to reduce USD dependency
- Maintaining current account surpluses or manageable deficits ($< 3\%$ of GDP)
- Implementing flexible exchange rate regimes with credible inflation targeting

6 Conclusion

Economies with high external financing needs, significant USD-denominated debt, and weak fundamentals face the greatest exposure to rising U.S. yields. Turkey, Argentina, and South Africa emerge as particularly vulnerable, while countries with stronger external positions and deeper local markets demonstrate greater resilience. Policymakers should prioritize building buffers and reducing structural vulnerabilities before the next U.S. tightening cycle.