Sorry Times *at* Club Med

Why the next emerging market crisis won't involve an emerging market.

BY DESMOND LACHMAN

Once when asked a woman's age, Oscar Wilde replied that she was approaching thirty. He added, however, that she was approaching thirty from the wrong side. On considering whether emerging market economies are converging towards those of the developed economies, one might arrive at a similar conclusion. Yes, emerging market economies have over the past few years made some improvement to their economic fundamentals. However, the main reason for their convergence towards the developed economies is that there are a number of developed countries whose economic fundamentals are deteriorating at an even more rapid pace than those in the emerging markets are improving.

The point is perhaps best illustrated by a reply I received from a seasoned Wall Street trader when I recently asked him where he thought that the next emerging market debt crisis would take place. Without missing a beat, he replied that it would occur in Greece, Italy, or Portugal. For on examining each of those three countries, he found that their public debt levels and their public debt dynamics were appreciably worse than those in the

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major emerging market economies such as Brazil, Russia, India, or China.

In assessing whether an emerging market economy might be "converging," one usually looks at a number of standard yardsticks. Is the country exercising increased discipline over its public finances in a manner that might be reducing the relative size of its public debt? Is the country implementing basic structural reforms that might place its economy on a higher and more sustainable growth path? Is the country granting real independence to its central bank with a view to attaining relative price stability? And is the country implementing policies that might be promoting its external sector and that might be reducing its external vulnerability?

By those very yardsticks, over the past few years, a major emerging-market economy such as Brazil, which as recently as October 2002 was considered to be on the verge of default, has made great strides. Taking advantage of a highly favorable external environment, President Lula's government has followed highly restrained economic policies that have put the Brazilian economy on a sounder footing and that have substantially reduced Brazil's external vulnerabilities.

A striking example of Brazil's efforts to improve its economic fundamentals is the fact that in each of the past four years, the Brazilian government has achieved a primary budget surplus in excess of 4 percent of GDP. This feat has allowed Brazil to gradually reduce its public debt-to-GDP ratio as well as to improve the structure of that debt. At the same time, the Brazilian central bank has been granted monetary policy independence, which has allowed it to bring inflation down to around 5 percent, thereby making Brazil's dismal inflationary past seem like a distant bad dream. To cap it all, Brazil's external sector has been strengthened allowing Brazil to move into approximate balance on its external current accounts, thereby reducing the country's vulnerability to external shocks.

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Italy's Big Troubles

The current sorry state of affairs in Italy perhaps best illustrates how the line of distinction between large emerging market economies and developed market economies is becoming increasingly blurred. Since abandoning the lira in favor of the euro as its currency in 1999, Italy's public deficit has consistently exceeded the 3 percent of GDP Maastricht criterion. It has done so despite the fact that Italy's adoption of the euro has allowed its government to borrow at rates not materially different from the French and German governments. This compares with the full 5 percentage points more that Italy had to pay on its borrowing prior to joining the euro than did France and Germany. As a result, Italy's public debt-to-GDP ratio has now risen to 106 percent of GDP, or to approximately double that of Brazil and Turkey, and it shows every sign of rising further.

The prospect of Italy growing out of its debt problem appears to be highly unpromising. Already the Italian government is mired in recession and its export sector is threatened by the approximate 20 percentage point loss in competitiveness to France and Germany over the past five years as a result of the relatively poor Italian productivity performance. Not having its own currency, Italy can neither resort to exchange rate devaluation nor to interest rate reductions to revitalize its flagging economy.

—D. Lachman

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And Brazil is hardly the only emerging market economy that would seem to have moved towards a convergence path over the past few years. China and India for some years now have been experiencing very rapid non-inflationary and export-led growth that is reminiscent of the way that Germany and Japan changed the global economic landscape in the 1960s and 1970s. The same might be said though to a lesser degree of a number of other Asian and European countries such as the Czech Republic, Indonesia, Korea, and Poland.

While over the past few years there have certainly been a number of success stories among the emerging market economies, there are still a number of emerging market economies that suffer from the same large external vulnerabilities as before. These vulnerabilities, however, are presently being masked by the unusually favorable global environment for the emerging market economies.

Amongst those countries with large economic imbalances that still stand out are Hungary, the Philippines, and Turkey. All of these countries have shaky public finances and large external deficits that make them all too vulnerable to changed global conditions. And then there are countries such as Russia and Venezuela, where high oil prices are papering over fundamental institutional weaknesses that will become all too apparent in a world of lower international oil prices.

In contrast to the improving fundamentals in a number of the major emerging market economies, all too many of the developed economies have allowed their economic fundamentals to deteriorate in a disturbing manner. This is certainly true of the United States, which has allowed an unprecedented "twin deficit" problem to emerge and which has now become the world's largest debtor nation with an insatiable appetite for new external financing. More disturbing still is the steady erosion of the economic fundamentals of the Mediterranean countries of Europe (Greece, Italy, and Portugal), which have all allowed their public finances to drift. As a result, these countries now have budget deficit and public debt problems that make many emerging market economies appear to be the paragons of fiscal rectitude.

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The net upshot is that as talk of default in large emerging market economies such as Brazil and Russia recedes into the distant past as those countries' economic fundamentals improve, questions about the sustainability of the public debt situations of countries such as Greece, Portugal, and Italy will come to the fore. This will be especially the case if these countries continue to stagnate and if their public debt continues to rise. At that point, one will have to wonder how relevant the distinction really is between the large emerging market economies and the mid-sized but troubled developed economies. ◆