One thing that is clear is that the structure of the world economy is changing in important ways, with effects that are difficult to predict. The past may no longer be a good guide to the future and relying too much on conventional wisdom—either old or new—may be dangerous.”

—Brookings Institution, 24 Sep 08

The landscape of the global sovereign debt market has changed drastically since the problems in Greece first arose earlier this year. Markets have been incredibly resilient in the face of these issues, with the effectiveness of Europe’s response to the crisis far exceeding what were fairly dire expectations. However, it was the emergence of these problems at the sovereign level that served to highlight a number of risks that had, to that point, been underestimated—from the presumption of currency union infallibility to the stability of a banking system with substantial holdings of sovereign debt no longer considered to be risk-free. This change in collective market psychology—in which a transition was made from an obsessive focus on the growth drivers of a global economic recovery to a careful consideration of the risks posed by the mounting stock of developed world public debt—has been the single most important driver of market movements this year. In line with this shift and drawing from the lessons of past sovereign debt crises, the principal thesis for investing in emerging markets should focus upon the improved flexibility and stronger balance sheet position that most of these nations now enjoy. It should not focus upon the historical emphasis on higher rates of expected growth in emerging markets vis-a-vis the developed world—a thesis that loses relevance in a potential scenario of slowing global growth.

From the vantage point of emerging markets, the pattern of events in the years leading up to the recent US financial crisis offers a clear and disturbing parallel to the lesser developed countries (LDC) debt crisis of the early 1980s. Through most of the 1970s, Latin American nations enjoyed sustained economic growth, borrowing heavily from the capital surpluses of oil-exporting nations to finance their economic expansion (with the US commercial banking system happy to act as financial intermediary). At the outset of the 1980s, the global liquidity conditions that made this debt-driven growth story possible came abruptly to an end. Relying largely on floating-rate debt, the sharp rise in US interest rates and drop in commodity prices that took place at the beginning of the decade triggered a series of events that eventually led to the collapse of growth in most Latin American nations, leaving them to crumble under the weight of their massive debt burden.

However, understanding the current environment in the context of the LDC debt crisis is critical not for what it tells us of the unfolding of financial collapse (we now have our own version of that history), but for what it tells us of the years that follow such a collapse. In the absence of effective policy options, and with still-fragile institutions in place, Latin America fell into a default-devaluation spiral that took ten years to unravel, all the while threatening the solvency of the US financial system. In 1989, under the auspices of the Brady Plan, banks and governments formally (and finally) recognized that these countries could not fully service their debts and restore growth at the same time. The 1980s period for the region—one of negative growth, with wrenching effects on governments and societies—is commonly referred to as the Lost Decade. This phrase also refers to the 1990s period in Japan when the bursting of
asset bubbles (specifically real estate) led to a severe and protracted downturn in the economy. In this case, belated recognition and missteps by the government to adequately address the growing bad-debt problem crippling its banks led Japan to embark upon years of wasteful stimulus spending. This, in turn, led to an accumulation of the largest public debt (as a % of GDP) in the developed world; after nearly two decades, the country has yet to generate a convincing recovery.

As the US turned in quarter-over-quarter annualized growth of 5% to close out 2009, the prospects of our own lost decade may have seemed remote. The stimulus packages engineered by federal governments worldwide started exerting a positive influence on economic data beginning in 2009, and as these effects stretched into 2010, optimism grew that a sustained recovery may well have been underway. From a bottom-up perspective, there was little reason to doubt that this was indeed the case: corporate profits for the largest US companies surged as cost-cutting measures and historic gains in worker productivity paved the way for massive bottom-line outperformance. However, with the gradual rollback of stimulus measures, the debate has grown louder over the strength and sustainability of the recovery.

In contrast, emerging markets remain a notable bright spot in the global recovery story (particularly those economies in Asia and Latin America). With record levels of foreign exchange reserves, improved public and external debt ratios, greater policy flexibility and transparency, and continued access to the balance sheet of foreign banks (coming at the expense of the developed world), many emerging markets are well positioned to take advantage of the shifting economic landscape of a post-crisis world.

To be sure, this did not happen by chance. The sturdy financial footing many of these countries enjoyed heading into the recent crisis was a direct result of more than a decade-long pursuit of reform and development after years riddled by defaults, devaluations and debt restructurings. Ultimately, the lesson drawn from those episodes is that excessive lending leading to a misallocation of resources—accompanied by regulatory forbearance, delayed recognition of losses and an underestimation of the socio-political forces that affect economic policy continuity—act as powerful impediments to real and sustained growth.

Considering the years of turmoil and foregone economic progress endured as these lessons were learned, the turnaround in emerging markets is nothing short of spectacular. Furthermore, since late 2008, the solid fundamentals that characterize emerging markets, coupled with strong technicals have driven spreads on emerging market debt to pre-crisis levels, leading Wall Street to dust off its favorite term—decoupling—and even prompting some media outlets to call emerging markets the new safe-haven.

However, despite the meaningful progress made in many emerging economies, a potential scenario of slower global growth (engendered by fiscal austerity measures and/or a rise in protectionism), would have ramifications on existing and future growth. A financial retrenchment in the developed world, for example, would undoubtedly have widespread and lasting effects. Were this gloomier scenario to precipitate a deeper and more widespread debt crisis (e.g. a re-escalation of sovereign debt concerns in Southern Europe), the additional fiscal cost and financial market volatility associated with new and potentially larger emergency response measures would surely reverberate on strained sovereign balance sheets worldwide.

Given the growing and equally loud debate over sovereign debt risk, we should expect the oft-ignored term “debt sustainability” to grow in significance, taking a place alongside the...
traditional growth and inflation metrics in the arsenal of economic tools. Debt sustainability is a function of the real rate of growth, the primary balance, the real interest rate and the stock of debt to GDP.\textsuperscript{11} In periods of high real rates of growth, policy-makers have the luxury of being somewhat complacent in balancing these four important variables. But in a scenario of lower growth, the need for flexibility to address a sovereign’s indebtedness through channels other than growth will be critical. Worsening fiscal deficits without credible strategies to address long-term debt reduction, for example, will increase perceptions of sovereign risk. This can result in a negative feedback loop wherein higher interest rates (i.e. higher borrowing costs) impede the stabilization of debt ratios and, worse, increase the likelihood of extreme, negative outcomes.\textsuperscript{12} Having further strengthened their balance sheets over the past year by refinancing existing debt at lower rates for longer maturities, and in some cases, in their own domestic currency, most emerging economies are less susceptible to such a fragile debt sustainability dynamic than in years past.

There is a notion that “those who cannot remember the past are condemned to repeat it.”\textsuperscript{13} It remains to be seen whether policy-makers will take this notion to heart, drawing on lessons learned from past crises to shape an effective response to the debt problems of today. However, using what we do know of history as a guide, we are right to question whether the massive accumulation of public debt in the developed world over the past decade—which helped fuel growth rates and bolster market valuations in the short run—might act as a silent and debilitating force in the long run, as the rising debt servicing costs on a still increasing debt stock limit the productive use of domestically and externally generated cash flows.\textsuperscript{14} As long as this problem remains unchecked by policy-makers, one should consider whether today’s high growth countries (particularly those in emerging markets) can sustain the impressive momentum enjoyed over the past ten years.

As such, and in a break with the past, the thesis for investing in emerging markets should not take shape around the higher rates of expected growth in those countries vis-a-vis the developed world. Rather, in a market characterized by uncertainty and concern over rising sovereign debt risk, the more compelling rationale for investing in emerging markets today centers on the improved debt sustainability metrics these nations now enjoy.\textsuperscript{15} This is not to say the emerging market growth story is gone for good. On the contrary, the powerful secular and demographic trends that have driven growth in the past should remain in place for the foreseeable future. However, it is the greater degree of financial flexibility in emerging markets that will enable many of these countries to weather additional market volatility in a scenario of slowing global growth, and to rebound sharply when global conditions ultimately do turn around.

Footnotes
\textsuperscript{1} An excellent review of this period can be found in the FDIC’s “Volume 1: An Examination of the Banking Crises of the 1980s and Early 1990s”, Chapter 5: The LDC Debt Crisis

\textsuperscript{2} The origins of the debt crisis can be partly attributed to the U.S. banking expansion during the 1950s and 1960s in a period of rapid world growth. The emergence of the euro-dollar market gave U.S. banks access to funds which they could on-lend to LDC countries in large scale.

\textsuperscript{3} Carmen Reinhart and Kenneth Rogoff, “Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison”, February 5, 2008; “During the 1970s, the U.S. banking system stood as an intermediary between oil-exporter surpluses and emerging market borrowers in Latin America and elsewhere. While much praised at the time, 1970s petro-dollar recycling ultimately led to the 1980s debt crisis, which in turn placed enormous strain on money center banks.”

\textsuperscript{4} Martin Fackler, “Japan’s Big-Works Stimulus is Lesson”, New York Times, February 5, 2009

“Detailed tables on provisional location and consolidated banking statistics at end-March 2010”, BIS Monetary and Economic Department, July 2010; Emerging economies continue to attract a greater portion of foreign bank credit as the higher-growth rates in those countries helps banks to diversify revenues and sustain margin growth. A breakdown of the data shows that foreign claims on emerging economies increased $142 billion (+4.8%) in Q1’2010, following an increase of $66 billion in Q4’2009 Foreign claims to advanced economies contracted -$293 billion (-1.2%) after a pronounced $1.1 trillion decline the prior quarter. We caution however that “past banking sector stress in advanced economies led to large and protracted reductions in capital flows to emerging economies as banks were rebuilding their balance sheets.” Source: “The Transmission of Financial Stress from Advanced to Emerging Economies”, IMF, June 2009

6 On March 25, 2010 EM spreads (as measured by the ‘Sovereign Spread’ level for the JP Morgan EMBI Global) traded through levels not seen since June of 2008, and proceeded to trade below this level for seventeen of the following twenty-six trading days, at which point markets began to trade weaker given concerns in Europe.

7 To be fair “decoupling” is happening, to some extent, but the typical representation/explanation of this phenomenon is generally myopic and/or misguided. For a concise, insightful look at “decoupling”, we would recommend: Kose & Prasad, “The Financial Crisis and Emerging Markets”, Brookings Institute, September 24th, 2008

8 As an example of this type of story, see: Ellen Kelleher, “Emerging market debt a ‘safe haven’”, March 26, 2010, originally appearing in the Financial Times

9 For a succinct recap of global trade pressures see: Michael Pettis, “The risk is rising of another global trade war”, August 22, 2010, originally appearing in the Financial Times

10 It is important to bear in mind that debt and fiscal figures are not 100% comparable across countries because of differences in definition and classification. Most of time, definitions of debt do not factor in the contingent liabilities that may arise from guarantees to banks or other non-financial corporates.


13 “IMF Fiscal Monitor Series: Navigating the Fiscal Challenges Ahead”, May 14, 2010, page 29: “New econometric evidence on the impact of high debt on potential growth – based on a panel of advanced and emerging economies over almost four decades – shows an inverse relationship between initial debt and subsequent growth. On average, a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.2 percentage points per year, with the impact being smaller (around 0.15) in advanced economies. There is some evidence of non-linearity, with only medium (30 to 60 percent of GDP) to high (above 90 percent) levels of debt having a significant negative effect on growth.”

14 Sebastian Becker and Gunter Deuber, “Public Debt in 2020: A sustainability analysis for DM and EM economies”, Deutsche Bank Research, March 24, 2010; Under a “combined-shock scenario” of a) a low growth environment where economic activity is strongly restricted by private-sector deleveraging, sovereign over-borrowing, international trade disputes, high commodity prices, and/or population ageing issues), b) higher real interest rates as a result of rising concern over surging public debt and the inflation outlook, and c) a longer-lasting deterioration in public finances, which could arise from further financial sector support, slumping tax revenue and/or extraordinary expenses on social security, advanced economies perform much worse than emerging markets in terms of debt sustainability. However, there is an important caveat to this analysis: “we do not differentiate debt by holders (resident vs. non-resident), by currency composition (domestic vs. foreign), by maturity (short, medium, long-term) and/or instruments (e.g. floating vs. fixed interest rate). These factors are all relevant for the conditions under which governments are able to borrow from capital markets...or how vulnerable public balance sheets are to adverse shocks such as higher interest rates, currency fluctuations and/or capital flow reversals.”