

The Banker: Viewpoint: Time To Think About The Next Debt Crisis – Kenneth S Rogoff Argues That While It May Be Too Soon To Be Overly Worried About Debt Crises, Problems Could Arise.

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As emerging markets enjoy today's benign global environment, it is worth remembering that whereas lightning may seldom strike twice in the same place, the same cannot be said for international debt crises. Countries that default once on their external debts typically go on to do so again and again. Argentina's cataclysmic recent default, for example, is already the country's fifth in the past 180 years. Other countries have run afoul of international capital markets even more frequently. Over the past two centuries, Turkey has defaulted six times, Brazil seven times, Mexico eight times, and Venezuela nine.

Exactly how and why countries become trapped in debt crisis cycles is still a subject of much controversy. Some blame fickle international investors. I, however, would place more emphasis on how each messy default undermines an emerging market's nascent political and legal institutions, not to mention wreaking havoc on its financial intermediaries. Weak domestic institutions combined with thin local capital markets force corporations and governments to turn abroad for funding, thereby making the country even more vulnerable to crisis. And so the cycle continues, with creditors eventually demanding generous spreads to compensate for risk.

THE REAL LOSERS

Of course, no developing country leader wants a debt crisis during his or her term in office; there are few surer ways to lose one's job. But at the same time, most are subject to such intense short-term pressures that there is little scope for worrying about how large debt build-ups may lead to future crises. At the end of the day, the big losers from debt crises are neither foreign creditors - who usually receive large enough spreads to compensate for risk - nor government leaders. The real losers are a country's citizens, who are thrown out of their jobs and who see the real value of their paychecks squeezed by currency devaluation.

It is worth recalling that today's emerging markets didn't invent serial default. Back in the days when now wealthy European countries were themselves emerging markets, many became trapped in serial default cycles of their own. France, Germany, Austria, Greece and Portugal, for example, have each defaulted a handful of times over the past five hundred years. French monarchs engaged in default like clockwork every 30 years from the mid-1500s until the end of the 18th Century. Indeed, Spain, not Venezuela, appears to be the all-time record holder, with 13 defaults between 1500 and 1900.

NO NEED TO WORRY?

Why talk about emerging market debt defaults right now when the global financial skies seem so bright and sunny? Haven't emerging market debt spreads come down drastically from their 2002 highs, as middle-income countries ride a cycle of booming commodity prices, tame long-term interest rates, and enjoy solid global growth? Haven't more flexible exchange rate systems, combined with improved policies - notably in Brazil and Turkey - insulated the world against a replay of the global debt crises of the past 20 years? Perhaps.

Whereas it is probably too soon in the current capital flow cycle to worry excessively about an immediate wave of major sovereign debt crises, it is surprisingly easy to think of five or six solid reasons why problems could arise over the next few years. First, start with the fact that many emerging markets still have very high ratios of external and/or public debt to GDP even if, thanks to generalised pressures on the US dollar, things are not quite as bad as a year ago. Brazil, for example, is still projected to have year-end ratios of public debt to GDP of 55%, and external debt to GDP of 45%. Many other chronic defaulters are sitting with still higher levels of debt. Whereas 45%-55% debt ratios may seem modest by Europe's Maastricht Treaty criterion, it is folly to use a 60% benchmark for emerging markets that have frequently run into trouble at far lower debt levels.

Second, although commodity prices have been riding a huge upward swing, what goes up can go down. Commodity prices are notoriously volatile. For example, a hard landing in China or a sudden slowdown in US consumption would surely boomerang on global commodity prices. One only has to recall the 1970s, when experts extrapolated continuing high commodity prices into the distant future, only to see them crash when the US Federal Reserve began to fight inflation in earnest in the early 1980s. Third, it is very difficult for emerging markets to resist following procyclical fiscal policies, and this time is hardly different. In many countries, the improvement in fiscal policy is at least partly a cyclical illusion.

GLOBAL INTEREST RATES

Fourth, the global interest rate raising cycle hasn't really hit emerging markets yet, partly because long-term rates have not been rising proportionately to short rates (when they have been rising at all). As productivity picks up worldwide, and as inflation rises back to normal central bank target levels, rates will rise. Fifth, if and when the US current

account bubble ever bursts, we will surely see a sharp fall in global demand for developing country exports.

Last but not least, what will happen to highly indebted emerging markets when a truly cataclysmic terrorist event shakes global goods and financial markets? Harvard political scientist Graham Allison is perhaps alarmist in his new book, when he argues that there is a very significant chance of a nuclear bomb being detonated in a major American city over the next 10 years. But even the most sober experts see a near certainty of some kind of terrorist horror, if not necessarily nuclear. Is this type of risk priced into any credit spreads?

So what is to be done? Perhaps recent technical improvements will help, such as majority-action clauses that make it more difficult for rogue bondholders to block restructurings. But it is hard to see how such incremental legal changes are going to solve a 500-year-old problem. We can strengthen the IMF's role as global lender of last resort by sharply raising its resources. One problem, though, is that IMF decisions are sometimes highly politicised, especially in the case of large bail-outs. Politicisation translates into lack of predictability and transparency. Building up IMF bail-out resources also risks exacerbating the so-called moral hazard problem, encouraging countries that ought to be borrowing less, into borrowing more. And it encourages creditors to let them.

BREAKING THE CYCLE

In the meantime what, exactly, are potentially vulnerable middle-income debtor countries supposed to do? History shows two ways to escape from serial default. One way is simply to run prudent fiscal policy year-in and year-out, eventually working down debt ratios as Chile has, at least for public debt. Of course, a major debt restructuring is another fast but risky route to the same destination. Alternatively, a country can offer its citizens the prospect of membership of an exclusive club, as Spain, Portugal and Greece have done with the European Union, and as Turkey and many central European countries are trying to do.

Perhaps policymakers in the advanced countries can also try to think of ways to channel a greater percentage of developing country capital flows into assets with better risk-sharing properties than plain vanilla debt, including equity, direct foreign investment and, possibly, GDP-indexed bonds.

Fifteen years ago, I suggested that one could level the playing field for equity and FDI by making it more difficult for developing country governments to borrow under US or British law, a device that favours debt in environments where domestic institutional capacity to enforce contracts is limited. Proposals for an international bankruptcy court have been kicking around for at least 25 years. In practice, creditors would probably expect to see their rights weakened even further, and hold back from lending, which would lead to the same end.

Of course, there are always optimists who suggest that tough measures can be avoided through creative financial engineering, such as finding ways to help emerging markets borrow more money in their local currency. They seem to think that the problem with emerging markets is that they borrow too little, not too much. Unfortunately, borrowing too little has never really been the problem. Unless more countries take advantage of today's good times to bring down their debt levels, the current cycle, like so many past cycles, may end in tears.

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