The disturbing deterioration of developed economies

When talking about whether the emerging markets are converging with the industrialised countries, most market analysts mistakenly focus on improving emerging market fundamentals. In so doing, they miss the bigger picture. The main reason for emerging market convergence is that there are a number of developed countries whose economic fundamentals are deteriorating at a 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 the next emerging market debt crisis would take place. Without missing a beat, he replied that it would occur in Germany or Italy or Portugal. On examining each of these three countries, he found that their public debt levels and public debt dynamics were approximately converging those of large emerging market economies such as Brazil, Russia, India and China.

Over the past few years, a number of big emerging-market economies have made great strides in improving their fundamentals. Perhaps the most striking example of such an improvement is offered by Brazil, which in October 2012 was considered to be on the verge of default. In marked contrast to its past record of public sector profligacy, Brazil’s government in each of the past four years has achieved a primary budget surplus in excess of 1 per cent of gross domestic product. This feat has allowed Brazil to gradually reduce its public debt to GDP ratio and improve the structure of that debt. At the same time, the Brazilian central bank has been granted monetary policy independence, which has helped to make the country’s disinflationary path seem like a distant and distant dream. Brazil’s external sector has also strengthened, thereby reducing vulnerability to external shocks.

It is not the only emerging market economy to have moved towards a convergence path over the past few years. China and India have been experiencing very rapid non-inflationary and export-led growth that is reminiscent of the way Germany and Japan changed the global economic landscape in the 1960s and 1970s. The same might be said, though to a lesser degree, of other Asian and European countries such as the Czech Republic, Indonesia, South Korea and Poland.

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Even in Spanish-speaking Latin America, single-digit inflation and low budget deficits have now become the norm. This stands in stark contrast to those countries’ many past painful experiences with hyperinflation. In contrast to the improving economic fundamentals in some of the big emerging market economies, too many of the developed economies have allowed their fundamentals to deteriorate in a disturbing manner. This is certainly true of the US, which has a “fiscal deficit” problem and is now the world’s largest debtor nation, with an insatiable appetite for new external financing.

More worrying still is the steady erosion of economic fundamentals in parts of southern Europe (Greece, Italy and Portugal), which has allowed public finances to drift. These countries now have budget deficits and public debt problems that make many emerging market economies look like paragons of fiscal rectitude.

The current sorry state of affairs in Italy is a good illustration of how the distinction between large emerging market economies and developed market economies is becoming more blurred. Since abandoning the lira in favour of the euro in 1999, Italy’s public deficit has consistently exceeded the 3 per cent of GDP Maastricht treaty criterion. It has done so in spite of the fact that Italy’s adoption of the euro has permitted its government to borrow at rates not materially different from the French and German governments. As a result, Italy’s public debt to GDP ratio has now risen to 125 per cent of GDP, approximately double that in Greece and Turkey. Even more troubling is the fact that this debt shows every sign of rising further as the Italian economy’s loss of international competitiveness negates its viability.

The upshot is that talk of default in large emerging market economies such as Brazil and Russia recedes, questions about the sustainability of the public debt situations in places 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 keeps rising. At that point, one will have to wonder how relevant the distinction really is between the large emerging market economies and the misguided but troubled developed economies.

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