THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
2099 Pennsylvania Avenue, N.W.
Suite 950
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

Chasing Yield

How the emerging market debt trading community is playing a dangerous game.

BY DESMOND LACHMAN

A highly successful emerging market bond trader once told me that he owed his success to his mentor's maxim: whenever you trade Latin American bonds, you should keep at the front of your mind the fact that over the past one hundred years no major Latin American country has ever repaid a thirty-year bond. This trader became prosperous and seasoned on the basis of such advice, while all too many of his colleagues went bust by getting carried away by the periodic euphoria that has come to characterize the emerging markets.

As reflected by the impressive 300-basis-point tightening in emerging market debt spreads since October 2002, it would seem evident that the market is yet to internalize the advice given to our bond trader. In particular, the market seems to have forgotten that the last time emerging market debt traded at today's lofty levels was in March 1998, on the very eve of the infamous August 1998 Russian debt crisis. And, just as was the case in early 1998, today's emerging market debt rally is also being fueled by the ample global liquidity flowing from the world's major central banks. Indeed, interest rates in Europe, Japan, and the United States are all at around 45-year lows, which are inducing global investors to stretch for yield and to venture into more risky and less familiar waters.

Considering that the emerging market spread tightening has occurred despite Argentina having defaulted on around US$90 billion of its private sector debt as recently as in December 2001 (the largest sovereign debt default in his-

Desmond Lachman is a Resident Fellow at the American Enterprise Institute. Prior to joining the AEI, he was Chief Emerging Market Economic Strategist at Salomon Smith Barney and a senior official at the International Monetary Fund.

tory), one must wonder whether there is not something fundamentally flawed in the market for emerging market debt. In particular, one has to question the incentive system for trading emerging market debt that makes money managers pay all too little attention to the longer-run individual country economic fundamentals and all too much attention to figuring out where money might be flowing in these markets on a day-by-day basis.

The short-term horizon of today's emerging market money managers is to be explained in large measure by the footloose nature of mutual fund money, which means today's money managers are expected to show good performance on a month-by-month basis. Knowing that they will be judged at such frequent intervals, money managers have a much greater incentive to focus on investment flows rather on underlying country economic fundamentals in determining their investment decisions. Further contributing to emerging market volatility is the fact that non-dedicated emerging market money from pension funds and from the insurance companies—who have such limited knowledge of the emerging market economies—habitually gets drawn into these markets once they start heating up. This always occurs on the expectation that this time is really going to be different for the emerging market economies, unlike the previous legion of false starts.

For their part, ministers of finance in all too many emerging market countries tend to view rising emerging market debt prices as market validation of improved domestic economic fundamentals. They do so even when it should be patently clear that it is global liquidity rather than improved economic fundamentals that is simultaneously driving spread tightening across a whole swathe of emerging market economies. As a result, rather than take advantage of the breathing space that easier international borrowing conditions might afford them to strengthen their countries' shaky public finances or to introduce much-needed structural reforms, these ministers all too frequently allow complacency to creep into their policy thinking. This is unfortunate since it leaves these countries ill-prepared to cope with the eventual and seemingly inevitable turn in the global liquidity cycle.

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The way in which Argentine paper is presently trading is perhaps the clearest example of the disconnect between emerging market fundamentals and debt prices. From a fundamental point of view, the Argentine government's seemingly firm offer to reschedule its external debt is widely considered to be worth somewhere between 6 and 10 cents on the dollar. Moreover, Ar-

Does Any of This Make Sense?

Argentine and Brazilian debt are far from alone in presently trading at prices that are far out of line with fundamentals. How does one explain Turkish debt trading at only 350 basis points over U.S. Treasuries at a time when its reform efforts have all but stalled and it continues to saddle itself with ever-increasing amounts of official debt? How does one explain that Poland's external debt now trades at barely 50 basis points over U.S. Treasuries at a time when Poland's government budget deficit is blowing out and questions about public debt sustainability are resurfacing? Or how does one explain how the once-hapless South African rand, which traded not so long ago at over 13 rand to the U.S. dollar, now trades at around 6.5 rand to the U.S. dollar, when the South African Reserve Bank's depleted international reserve position still leaves the rand so painfully exposed to a change in market sentiment? Similar questions might be asked of Colombia, Ecuador, Uruguay, the Philippines, Venezuela, and countless other emerging market economies.

—D. Lachman

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gentina's commitment under its International Monetary Fund program to meet a primary budget surplus target of barely 3 percent of GDP in 2004 suggests that the government might be hard-pressed to make good on even that paltry offer. Yet this is not stopping Argentine debt from trading at over 25 cents on the dollar, or around three times the government's seemingly firm offer price.

For another patent example of emerging market debt mis-pricing, one only need look at Brazil. Since October 2002, spreads on Brazil's external debt have narrowed from a whopping 1,800 basis points over U.S. Treasuries, before President Lula came to power, to around 500 basis points at present. Whatever President Lula's policy accomplishments to date, can one really say that Brazil's external debt would be trading at today's tight spreads without the ample global liquidity situation? Without chasing for higher yield, would investors really be unconcerned by the absence of economic growth or by the apparent drying up of foreign direct investment in Brazil? Might they instead not be focusing on the still very high level and dubious sustainability of Brazil's public debt?

Argentine and Brazilian debt are far from alone in presently trading at prices that are way out of line with fundamentals. How does one explain Turkish debt trading at only 350 basis points over U.S. Treasuries at a time when its reform efforts have all but stalled and it continues to saddle itself with ever-increasing amounts of official debt? How does one explain that Poland's external debt now trades at barely 50 basis points over U.S. Treasuries at a time when Poland's government budget deficit is blowing out and questions about public debt sustainability are resurfacing? Or how does one explain how the once-hapless South African rand, which traded not so long ago at over 13 rand to the U.S. dollar, now trades at around 6.5 rand to the U.S. dollar, when the South African Reserve Bank's depleted international reserve position still leaves the rand so painfully exposed to a change in market sentiment? Similar questions might be asked of Colombia, Ecuador, Uruguay, the Philippines, Venezuela, and countless other emerging market economies.

In a free market system, there is probably little that can or will be done to change the short-term focus of emerging market investors. As a result, one must expect to experience the same type of periodic mis-pricing that has long come to characterize these markets. However, this should not be allowed to lull emerging market finance ministers into a false sense of security that makes them let up on their countries' much needed economic reform efforts. We would appear to be fortunate that the likely maintenance of favorable global liquidity conditions over the next several quarters will afford the emerging market economies with a window for the very much needed strengthening of their underlying macro-economic fundamentals. We can only hope that this time they seize this opportunity. ◆

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