Box 1

RECENT TRENDS IN SOVEREIGN SPREADS AND ECONOMIC FUNDAMENTALS IN EMERGING MARKETS

In recent years, the emerging economies of Asia and Latin America have experienced robust expansion in economic activity. Reflecting this, the spreads between the yields on sovereign bonds issued by governments in these two regions and yields on US government bonds (sovereign spreads) have declined to their lowest levels since data first became available for these series. Indeed, at around 300 basis points, emerging market bond spreads are now considerably below the levels registered during the Asian crisis of 1997-99, when they reached 1,400 basis points, or during the Argentinean crisis at the end of 2001, when they reached about 1,000 basis points (see the chart). This combination of robust growth and low spreads is strikingly similar to developments prior to the Asian crisis. This box takes a look at the domestic fundamentals underlying the low level of spreads and compares them with the situation prior to the Asian crisis. It thus provides some insights into whether these countries are now in a better position to deal with external shocks than they were in the mid-1990s.

Non-Japan Asia

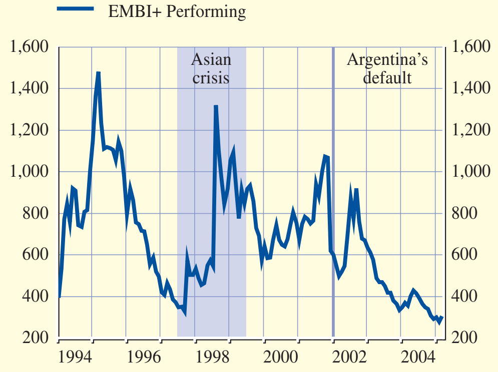
Non-Japan Asia is currently experiencing robust economic expansion and benign price developments, just as it did prior to the Asian crisis. At the time of that crisis, the economic effects on individual countries differed greatly: while China and Taiwan were relatively unaffected, Korea and Thailand were among the worst hit economies, with severe currency depreciation, high inflation and a significant decline in economic activity (see the table).

Differences in some economic fundamentals can help to explain the variations in the intensity of the crisis in different countries. For example, Korea and Thailand exhibited current account deficits prior to the crisis, whereas China and Taiwan had current account surpluses. The situation has changed quite considerably since then. In 2003 and 2004, all of these countries recorded current account surpluses. Fiscal balances were in deficit in two of these countries, but debt-to-GDP ratios remained low.

In addition to the improvement in macroeconomic fundamentals, these economies, particularly Korea and Thailand, have made progress in the areas of structural and institutional reforms. In Korea and Thailand the banking sectors have been thoroughly restructured. Regarding the policy framework, these two economies have moved to more flexible exchange rate arrangements, while keeping control of inflation. Against this background, it appears that most non-Japan Asia economies are now better placed in

Emerging markets sovereign spreads

(basis points)



Sources: JP Morgan.
Note: The Emerging Markets Bond Index Plus (EMBI+) Performing is a market capitalisation-weighted index comprised of performing USD-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign entities in emerging markets.

terms of economic fundamentals than prior to the Asian crisis.

Latin America

Similarly, in Latin America, economic conditions generally appear to be better now than in the mid-1990s. The region is going through a period of strong output expansion, while inflation rates remain relatively low (see the table). In addition, in the three largest economies – Argentina, Brazil and Mexico – current account balances have improved. However, while fiscal balances have also improved overall, they still remain an issue, particularly in Brazil and Argentina.

In Latin America, as in non-Japan Asia, these better economic fundamentals have been accompanied by progress in the areas of structural and institutional reforms, making the countries in the region more resilient to shocks. A move to more flexible exchange rate arrangements has also allowed some of the region's largest economies to limit inflationary pressures amid robust expansion.

Overall assessment

The economic situation in these emerging economies appears to be better overall than on the eve of the Asian crisis, although Latin America is – of the two regions considered here – relatively more exposed to downside risks due to higher levels of public debt. Although sovereign spreads are currently at about the same low levels as prior to the Asian crisis, the assessment of the financial markets appears now to be matched by sounder economic conditions. As a result, although some fragility persists, the improvement in economic fundamentals coupled with progress in structural and macroeconomic policies should provide buffers to external shocks.

Macroeconomic indicators in selected emerging economies

(annual averages)

A) Asia

	China	South Korea	Taiwan	Thailand
Real GDP growth (in percentages)				
1994-1996	10.9	8.5	6.5	8.0
1997-1999	7.9	2.4	5.3	-2.5
2003-2004	9.1	3.9	4.5	6.5
CPI inflation (in percentages)				
1994-1996	16.4	5.2	3.6	5.6
1997-1999	0.2	4.3	0.9	4.7
2003-2004	2.5	3.6	0.6	2.3
Current account balance (as a percentage of GDP)				
1994-1996	0.8	-2.3	2.9	-7.3
1997-1999	3.2	5.2	2.2	7.4
2003-2004	3.2	3.0	8.2	5.0
Fiscal balance (as a percentage of GDP)				
1994-1996	-1.7	0.3	-0.5	2.3
1997-1999	-1.8	-1.8	0.8	-2.1
2003-2004 1)	-2.5	-0.9	-3.1	0.4

B) Latin America

	Argentina	Brazil	Mexico
Real GDP growth (in percentages)			
1994-1996	2.8	4.2	1.1
1997-1999	2.9	1.4	5.2
2003-2004	8.9	2.9	2.9
CPI inflation (in percentages)			
1994-1996	2.6	732.0	25.4
1997-1999	0.1	4.9	17.7
2003-2004	8.9	11.6	4.6
Current account balance (as a percentage of GDP)			
1994-1996	-2.9	-2.0	-2.8
1997-1999	-4.4	-4.2	-2.9
2003-2004 2)	5.8	1.4	-1.3
Fiscal balance (as a percentage of GDP)			
1994-1996	-1.1	-6.4	-0.5
1997-1999	-1.9	-7.1	-1.6
2003-2004 1)	0.1	-4.0	-1.5

Sources: Global Insight and Banco Central do Brasil.
1) Data only for 2003 with the exception of South Korea and Brazil.
2) Data only for 2003 in the case of Argentina.