Alarm signals

America the risky?
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The results from an economic early-warning system

WITH an eye to the crises that have erupted in emerging markets in recent years, the clever economists at Lehman Brothers have produced a model to help prevent investors losing their shirts again. The model, called Damocles (as in “sword of”), is an early-warning signal. It puts together ten indicators—from external debt as a percentage of GDP to foreign reserves as a percentage of short-term debt—to assess the overall riskiness of a country, which is expressed as an index.

The bank picks a number for each of the factors; a rise above that number is reflected in the index. The choice of the factors, says the bank, involves theory and experience in equal measure; their weights are derived by looking at their contribution to crises in 15 emerging-market economies since 1995. A reading above 75 indicates that a country has a one-in-three chance of a crisis in the next 12 months; a figure above 100 implies a 50-50 chance.

As is generally the way with such models, Damocles has worked well when tested on past crises: it would have predicted the Asian crisis of 1997, for example. In recent years, the index has fallen for just about every emerging market except South Africa. There is, however, a bigger exception, a country that is not normally bracketed in such company: America.

When Lehman ran America's economic numbers through Damocles, the outcome was striking. With its rapidly climbing current-account deficit and foreign debt, among other worries, America's Damocles index is just shy of 75. There are, points out Russell Jones, the bank's international economist, problems applying Damocles to America, which enjoys the luxury of having the world’s reserve currency. Granted. Poorer countries tend to owe dollars, and therefore suffer when their currencies fall. Lucky America, of course, owes its own currency.

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