The Debt of Nations: Prospects for Debt Restructuring by Sovereigns and Banks in Advanced Economies

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Abstract

For the first time since World War II, sovereign debt sustainability is affecting advanced economies rather than emerging markets and developing countries. It will remain an important market driver in Europe for 2011 and the following few years, as well as become a key market driver in Japan and the United States around 2013 or later.

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Topics

- Economics
  - Economic Growth and Development
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- Fixed Income
  - Fixed-Income Markets: Characteristics, Institutions, and Benchmarks
    - Debt Market Structure
    - Sovereign Debt

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For the first time since World War II, sovereign debt sustainability is affecting advanced economies rather than emerging markets and developing countries. It will remain an important market driver in Europe for 2011 and the following few years, as well as become a key market driver in Japan and the United States around 2013 or later.

In Europe, the sovereign debt crises in the periphery of the euro area are inextricably intertwined with a "zombie bank" problem and an undercapitalized bank problem. Zombie banks are banks that would be considered insolvent if their existing losses were recognized; but they are kept alive by regulatory forbearance and by posting collateral with, in the case of the eurozone, the European Central Bank (ECB). Undercapitalized banks are banks that would not be insolvent if existing losses were recognized but could be brought to a seriously undercapitalized, insolvent state if a sovereign debt restructuring of any magnitude were to occur in the euro area.

A key in understanding public sector finance and the prospects for a sovereign is looking at public sector balances. The future possibility of assets and liabilities migrating from the private to the public sector, or vice versa, has to be considered. The boundaries are fluid between the state and the sovereign and between the sovereign and the private sector. The socialization of losses in private entities that are either too systemically important to fail or deemed too politically connected to fail has become a well-established feature of the current reality.

The global financial world is adjusting to a world without AAA rated sovereigns. In Europe, Germany may be the last large country whose sovereign debt has a bona fide AAA rating, but even that is a stretch. If Germany had tried to join the eurozone in 2010 or earlier, it would not have been able to do so because it did not meet the perfect debt or deficit criteria. The United States no longer has, and has not had for some time, a bona fide AAA rating. Unless the U.S. government can reach an agreement on a sustainable tightening of fiscal policy by at least 8 percent of GDP, or more than $1 trillion a year on a permanent basis, the negative outlook of Standard & Poor's (S&P) is likely to be followed by a negative credit watch and ultimately by a sovereign downgrade early in 2013.

In the United Kingdom, which is in bad shape in terms of debt and deficits, the government is implementing fiscal tightening of 8.5 percent of GDP, which includes 6 percent in spending cuts and 2 percent in tax increases. As long as the ruling coalition government survives and a program of this severity is adhered to, the market should accept it. If the coalition falls, then the United Kingdom could face the same difficulties as Spain did in 2010.

Sovereign Vulnerability

I anticipate that the eurozone will experience at least three sovereign debt restructurings because of a mixture of large unexpected deficits and fiscal austerity as well as fiscal adjustment fatigue in those countries that are suffering the effects. Another consequence of these factors is bailout fatigue in the northern eurozone countries that are having to support the Mediterranean states.

Table 1 shows the general government debt and deficit of some advanced economies. Greece stands out with net debt of 97 percent of GDP at the end of 2010, as does the United States with net debt of 68 percent of GDP. On a gross basis, if the Fannie Mae and Freddie Mac debt is included, then U.S. debt is around 130 percent of GDP, which is similar to Greece's gross government debt.

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