Reflections on the Sovereign Debt Crisis

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The Global Financial Crisis has taken a heavy toll on the public purse. In the developed world, government indebtedness has soared to levels not seen since the end of the Second World War. Economists point out that high levels of public debt are associated with poor economic growth and higher rates of inflation. There’s also the danger that bondholders might take fright if fiscal deficits in several countries were to continue unchecked. According to this scenario, Greece is the harbinger of a sovereign debt crisis that threatens to engulf several leading economies.

This paper seeks to answer several questions: Why in the past have governments defaulted on their debts? When have deeply indebted countries kept faith with their creditors? Under what conditions do governments opt for inflation rather than default? And, in the light of our historical findings, is Greece really the crest of a wave of sovereign debt crises about to crash down upon the developed world?

The problems of prediction

It’s true enough that the “history of government loans is really a history of government defaults.” But there is also a long history of false alarms about fiscal solvency. Surveying the large national debt of mid-eighteenth century England, the philosopher David Hume opined that “when a government has mortgaged all its revenues... it necessarily sinks into a state of languor, inactivity, and impotence.” Public credit threatened to destroy the nation, wrote Hume, who predicted an eventual state bankruptcy. Hume’s friend and fellow Scot, Adam Smith, was similarly downbeat about England’s national debt. “The “practice of funding [i.e., issuing long-dated government debt],” wrote Smith in The Wealth of Nations, “has gradually enfeebled every state that has adopted it... When national debts have once accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid.”

Hume and Smith were plain wrong. Their gloomy predictions were penned during the early days of the industrial revolution, which was to turn the British economy into the wonder of the world. English public credit didn’t collapse. Later in the next century, the Victorian historian Lord Macaulay scoffed at those who had doubted England’s capacity to bear her national debt. “At every stage in the growth of that debt,” wrote Macaulay, “the nation has set up the same cry of anguish and despair. At every stage in the growth of that debt it has been seriously asserted by wise men that bankruptcy and ruin were at hand. Yet still the debt kept on growing; and still bankruptcy and ruin were as remote as ever.”

In recent decades, alarms have been raised about the solvency of other nations. A respected City economist in 1988 warned about crippling high US interest rates and predicted that large budget deficits would hurt growth. As it turned out, interest rates on US Treasuries kept on falling. By the end of the century, Washington even produced a rare surplus – at which point, it was predicted that the US national debt would be paid off within a decade. For twelve years or more, the ratings agencies and others have fretted about the inexorable rise in Japanese public debt. That debt (on a gross basis) is now

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1Max Winkler, Foreign Bonds: An Autopsy, 1933.
2David Hume, Of Public Credit, 1752.
approaching 230% of GDP. Yet the interest rate paid on long-dated Japanese government bonds (JGBs) is lower today than when the country’s debt was first downgraded back in 1998.

It’s tough to make predictions, especially about future government defaults. There are no reliable leading indicators of public insolvency. As Professors Carmen Reinhart and Ken Rogoff observe in their history of financial crises, countries have often defaulted at levels far below the maximum 60% debt to GDP ratio prescribed by the Maastricht Treaty. Russia, for instance, defaulted in 1998 when government debt was a mere 12.5% of GDP. Other countries with far greater debt burdens have continued servicing their loans. Nor are the ratios of public debt to government revenue or external debt to exports much more reliable indicators of national solvency.⁷

**When do governments default?**

Statistics may be of little help in predicting a sovereign debt crisis. Nevertheless, past instances of default have tended to occur under some or all of the following circumstances:

1. **A reversal of global capital flows:** Since 1800, there has been an irregular ebb and flow of sovereign lending. The cycle goes something like this. During booms, money is disbursed from the financial centers to countries at the periphery, which promise higher rates of return. The good times don’t last. A panic in London or New York, often caused by a bank failure, stanches the flow of international credit. Trade is interrupted. Commodity prices fall, reducing the export earnings of peripheral economies. The world economy turns down. Foreign borrowers find themselves unable to either service their debts or refinance them. They default.

Reinhart and Rogoff find that sovereign defaults tend to pick up after banking crises and peaks in the capital flow cycle. This pattern of boom and bust in government lending was first evident in the 1820s, when newly independent Latin American republics raised funds in the London money market. A severe financial panic in the City of London at the end of 1825 brought this lending spree to an end. All of the Latin American loans raised in this period defaulted.

This cycle of the rise and fall of international lending, followed by sovereign default, was repeated in the 1870s, 1930s, and 1980s. For instance, the collapse of Austria’s Creditanstalt bank in the summer of 1931 was followed by bank failures and ultimately sovereign debt crises across central Europe.

2. **Unwise lending:** the cycle of sovereign lending is similar to that of private lending. In times of prosperity and low prevailing interest rates, investors grab for yield. They rush to acquire the higher yielding bonds of countries with poor credit records. Issuing banks encourage this jamboree as there are large fees to be earned. Competition among banks leads to a further deterioration of lending standards. Loans are floated with no realistic prospect of being repaid. Those who question the wisdom of foreign lending and point to past errors are told, “This time is different.” But when the cycle turns and the supply of fresh credit is cut off, the inevitable defaults appear. The Victorian economist Walter Bagehot bemoaned the poor quality of foreign lending: “We lend to countries whose condition we do not know, and whose want of civilisation we do not consider, and therefore, we lose our money.”⁸ Back in the 1820s, a loan was even raised in the City of London by a Scottish adventurer, Gregor MacGregor, who posed as the ruler of a fictitious Latin American country.

Foreign loans were the subprime securities of the 1920s. A heap of foreign bonds were sold by Wall Street on behalf of several Latin American and Central European states, cities, and provinces. The poor financial condition of many of these borrowers was deliberately glossed over by the issuing banks. Nearly 90% of the foreign bonds sold in United States in 1929 subsequently defaulted.⁹ “There is no question but that the major cause of [sovereign] default is the lending of money to unstable, unendurable borrowers,” wrote Max Winkler in his 1933 book *Foreign Bonds: An Autopsy.*

3. **Excessive foreign debts:** The servicing of a foreign loan requires the transfer of resources abroad. This involves some genuine sacrifice on behalf of the nation. The distrust of foreign loans is longstanding. “As foreigners possess a great share of our national

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⁸Walter Bagehot, *The Danger of Lending to Semi-civilised Countries*, 1867.
funds,” warned Hume in 1752, “they render the public, in a manner tributary to them, and may in time occasion the transport of our people and industry.” A dependence on foreign borrowing is often a sign that domestic savings are low. This may call into question the country’s ability to service or repay its loans. According to historian James Macdonald, “states that require foreign capital are invariably less creditworthy because of their relative paucity of resources, but also because of a latent hostility toward their foreign lenders which could bubble up from below in times of crisis.”

The problem of external debt is made more acute when loans are denominated in a foreign currency. During the boom period, countries with fixed exchange rates often experience a loss of international competitiveness, owing to relatively high inflation or low productivity. This makes it difficult for them to generate the exports and foreign earnings required to service their debt. Yet if the borrowers’ currency collapses, the real value of the external debt increases.

Finally, it should be noted that foreign bondholders are in a weak position when it comes to enforcing the repayment of their loans as they have little or no political sway over their debtor. The effect of all this has been to make the repudiation of external debts far more common than domestic default. Reinhart and Rogoff record some 250 cases of default on external debts compared with 68 defaults on domestic debts since 1800.

4. Poor credit history: A country’s default history tends to be the best predictor of future defaults. The habit of persistent default is generally due to weak political institutions, poor economic growth, and cultures of public corruption. Size and the state of economic development also matter. Reinhart and Rogoff find that advanced industrial economies, with longer traditions of public borrowing and deeper financial markets, have a higher degree of “debt tolerance” than developing countries.

Britain, for instance, hasn’t defaulted on its national debt since the Stop of the Exchequer in 1672. The United States has an equally good credit record. The record of various Scandinavian countries is likewise free of blemishes. Latin American countries have defaulted on numerous occasions since the 1820s. The Argentine default of late 2001 is generally recognized as the largest sovereign default in history.

Various Mediterranean borrowers also have poor sovereign credit histories. A nineteenth century writer, Dudley Baxter, complained that governments in southern Europe were “too often reckless and spendthrift, prone to overspend their income in times of peace… and sometimes unable to pay interest.” Greece may be a cradle of civilization. But it is also the birthplace of sovereign default. The country has been in default for roughly half the years since achieving independence from Turkey in 1822. Since 1800, Spain and Portugal have defaulted, respectively, on thirteen and five occasions.

5. Unproductive lending: Debts are more likely to be repaid if the money has been spent wisely. The doctrine of “odious debt” was developed to question the validity of unproductive loans frittered away by despotic governments in poor countries. The latest example of this is Ecuador’s recent repudiation of debt issued by a previous administration and deemed “immoral.” Politics are also important. Revolutions have often resulted in the repudiation of public debts. In 1918, Lenin reneged on all of the Czarist debt. The superior credit history of the Anglo-Saxon and Scandinavian nations owes much to their political stability.

6. Rollover risk: National debts are scarcely ever repaid. They are rolled over. As long as the capital markets remain open and a government’s credit holds good, there’s no problem. However, when the debt is largely short term, there’s an increased market risk. This problem was particularly acute before the development of modern bond markets in the seventeenth century. Habsburg Spain was continually caught short by an excessive dependence on short-term financing. The Emperor Philip II’s default in 1557, which sparked the first international credit crisis, occurred at a time when short-dated debt was 3.5 times the imperial net revenues.

7. Weak revenues: Reinhart and Rogoff estimate that, on average, public debt grows by around two-thirds in the years immediately following a banking crisis.

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10 Ibid.

They also find that the aftermath of banking crises is generally followed by prolonged periods of below average economic growth. As a result, tax receipts are lower than normal. An incipient fiscal crisis can be solved if the government takes action to either reduce its spending or raise revenues. However, there may be little public appetite to endure the austerity of public spending cuts and no consensus on tax increases. The collapse of Louis XVI’s government, which ushered in the French Revolution, was largely the result of a fiscal crisis that originated in the state’s inability to raise sufficient taxes to pay its debts.

8. Rising interest rates: One of the consequences of short-term debt is that creditors are able to raise rates rapidly in response to changing perceptions of credit risk or rising inflation. Rising risk premiums on government loans may lead directly to state bankruptcy. Philip II, for instance, was paying nearly 50% annual interest on his new loans prior to 1557. The French government in the late eighteenth century found itself borrowing at twice the cost of its great rival, England. Higher interest charges on floating rate bank loans were a major factor behind the Third World Debt Crisis of the 1980s.

In short, a sovereign default may be due to circumstances beyond the borrower’s control, such as the reversal of international capital flows, a loss of competitiveness due to a fixed exchange rate, a terms of trade shock, a severe economic downturn, rising interest rates, a foreign exchange collapse that renders the external debt unbearable, or the market’s refusal to roll over short-term debts. Alternately, the default may be more political in nature, resulting from an unwillingness to raise taxes or cut spending, a reluctance to repay foreigners, or a sense that the debt is “odious” in some other way. Most sovereign defaults appear to involve some combination of “Can’t Pay! Won’t Pay!”

Defaults avoided

Imagine a country whose public debt has rapidly climbed to around twice the national income and whose currency has fallen by half on the foreign exchanges. Against the advice of the nation’s most celebrated economist, the government decides to embark on a policy of extreme deflation. This results in a 45% overall decline in the general price level. There is a severe depression. Unemployment soars, accompanied by labor unrest and bloody riots. By the time the deflation is over, the real value of the national debt has climbed to more than 250% of GDP. What happens next? A default on the government debt? A bond market crash as investors shun this junk sovereign credit? A burst of inflation? The prolonged stagnation of an economy crippled with excessive debt? Political collapse?

The answer is none of the above. The country in question is Britain in the aftermath of the Napoleonic Wars. An enormous debt had been incurred fighting the Corsican upstart. During the war, Sterling convertibility was suspended. Once hostilities ended, the government planned a return to gold, against the recommendation of the great economist and MP, David Ricardo. The subsequent depression prompted widespread workers’ protests, resulting in the Peterloo Massacre (August 16, 1819) in which 15 people were killed and several hundred injured.

Exhibit 1

Gilts as Good as Gold

British net public debt (as % of GDP)

Note: Shaded areas represent Napoleonic Wars (1793-1815), World War I (1914-1918), and World War II (1939-1945).

Source: Citigroup

By the early 1820s, the British national debt relative to the national income was far larger than any country had ever experienced. Yet there was no default and no attempt to inflate away the debt. The economy didn’t suffer much from the large public debt and was booming by the middle of the decade. Sterling remained on the gold standard and the price level remained stable. The real purchasing power of British government bonds quadrupled between 1815 and the end of the century. By the advent of the First World War, the national debt had shrunk to below 40% of GDP.
There are several reasons why Britain didn’t default. First, the debt was mainly financed domestically. Second, bondholders were well represented in Parliament at a time when the franchise was limited. The ruling rentier class didn’t flinch from inflicting a deflationary purge on the economy, regardless of the social costs. It was also prepared to direct up to 10% of the country’s national income to service the debt. A high level of domestic savings produced the necessary surplus. Third, aside from the odd cyclical downturn, the British economy continued growing throughout the nineteenth century. The decline in the ratio of public debt to GDP was largely the result of a century of sustained economic growth.

Furthermore, Britain’s large debt wasn’t due to structural fiscal deficits. Rather, it resulted from abnormal military expenditures that were easy to cut once hostilities had ceased. The government played a limited role in the economy and wasn’t burdened with welfare obligations. During the nineteenth century, fiscal surpluses on the primary balance (i.e., the government’s financial position before interest charges on the national debt) were the rule and there were few large-scale military engagements. Finally, the national credit remained a matter of national pride and a sign of strength rather than weakness. The British were prepared to pay the taxes to service this debt. In a world free of inflation, gilts remained the ultimate risk-free investment.

Post-Napoleonic Britain is the most extreme case of a highly indebted country successfully reducing its national debt without resorting to either default or inflation. In the early 1990s, several countries – including Sweden, Finland, and Canada – also succeeded in reducing their national debt from relatively elevated levels. For instance, in 1993, during the aftermath of the Scandinavian banking crisis, Sweden found itself with a fiscal deficit of 11% of GDP. Three years later, Swedish gross government debt peaked at 84% of GDP. This debt has since shrunk to below 45% of Swedish GDP.

Fiscal deleveraging in Sweden and elsewhere was achieved through a combination of tax hikes and tight control of government spending. Government receipts were boosted by economic growth, helped by a strong global economy and currency depreciations, which encouraged exports. Falling inflation lowered the interest charges on their debts. Like Britain in the early nineteenth century, the public debt of these countries was largely held domestically and wasn’t denominated in a foreign currency. Perhaps it’s no coincidence that all of these countries boasted excellent sovereign credit histories and stable political regimes.

When does a heavily indebted government prefer inflation to default?

The story doesn’t always end so happily. Reinhart and Rogoff find banking crises are followed by a wave of sovereign debt defaults and rising inflation. On countless occasions, governments have turned to inflation when faced with acute fiscal problems. At the turn of the fourth century BC, the tyrant Dionysius of Syracuse became the first ruler to debase the coinage in order to reduce his debts. Roman emperors followed this example in the third century AD. Debasement of the coinage was commonplace in Europe in the Middle Ages.

The first hyperinflation of the modern era followed the unlimited issuance of a new paper currency, the assignats, used to finance large deficits during the French Revolution. After the First World War, the leading European combatants had accumulated vast public debts. Germany fell into the vortex of a disastrous hyperinflation, while the French debt was reduced by a more moderate inflation. Over the past century, surges in US fiscal deficits have been accompanied by a pick-up of inflation.\(^{13}\)

There are several reasons why governments generally

\(^{13}\) A link between inflation and large fiscal deficits is more common among emerging markets than developed countries. The US is an exception in this respect.
prefer inflation to default when faced with intractable fiscal problems.

- **Inflation is more convenient than default:** Inflation reduces the real value of the public debts. This represents a covert default without any formal breach of contract. Britain, for instance, may have avoided a headline-grabbing default. But in the aftermath of the Second World War, inflation played the largest role in reducing the country’s vast national debt. To achieve inflation, a government must either have control of the monetary printing press, which nowadays means the central bank, or be in a position to force the domestic banks to acquire its bonds. Under a fiat monetary system, inflation will always be preferred to default when domestic debts predominate.

- **Inflation resolves political conflicts:** As Keynes pointed out, servicing a large public debt involves transferring resources from the productive and poorer sections of society to the unproductive, wealthier rentier class. When this burden becomes politically unacceptable, reducing the value of the currency in which the debt is repaid becomes, according to Keynes, “the line of least resistance... it is, so to speak, nature’s remedy, which comes into silent operation when the body politic has shrunk from curing itself”. Inflation is often the last resort for resolving difficult distributional conflicts within a society.

- **When avoiding inflation is a low priority:** Accounts of the German hyperinflation of the early 1920s suggest that one of the main reasons the Reichsbank continued monetizing public deficits was because it feared unemployment, which threatened political unrest, and even revolution, far more than inflation. Likewise, the surge of inflation in the decades after World War II reflected the new priority of central banks to avoid repeating the deflation and unemployment of the 1930s.

- **Flameout:** Inflation may be the only option when public credit has evaporated. If there are no willing providers of public loans, the government may be forced to monetize the debt. Inflation may be exacerbated by a currency collapse as capital flees the country. This type of inflationary debt crisis has been relatively common in emerging markets (e.g., Indonesia in 1997 and Argentina in 2001). Research suggests there’s a positive correlation between “financial repression” — the fancy name given to the policy of stuffing domestic banks with public debt — and inflation.

### The sovereign debt crisis today

Events over the last couple of years have followed the sovereign debt crisis playbook, as described by Reinhart and Rogoff. International capital flows were disrupted after the collapse of Lehman. Governments around the world have run massive fiscal deficits. Sovereign default concerns have surfaced in crisis-ridden countries from Iceland to Dubai. Hungary was forced to rely on the largesse of the European Union and IMF. Lately, the sovereign debt crisis has spread to the periphery of the Eurozone.

### Exhibit 3

**The “Great Debt Swap”**

G7 debt soars after the global financial crisis

Fiscal problems aren’t just besetting smaller countries. Topping the list of debtor deadbeats in order of magnitude are Japan (with a current gross debt of 227% of GDP), Greece (133%), Italy (120%), Belgium (100%), US (93%), France (84%), Portugal (87%), UK (78%), and Ireland (78%). Fiscal deficits aren’t simply a result of the global financial crisis. In several countries, they appear to be structural in nature. According to the Bank

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14 John Maynard Keynes, *Collected Writings*, Vol XVIII.
17 Data from IMF/OECD.
for International Settlements, the largest structural deficits are to be found in the UK (10% of GDP), the US (9%), Ireland (9%), and Japan (7%).

**Exhibit 4**

**Deficits Are Structural Rather than Cyclical**

![Graph showing deficits as a percentage of GDP for various countries.](source)

*Source: BIS, Independent Strategy*

To make matters worse, many governments have huge contingent liabilities that don’t appear in the official statistics. Unfunded British pension liabilities have been estimated at some 78% of GDP. One estimate of US healthcare and pension liabilities runs to 7 times the country’s GDP. According to the OECD, unfunded government liabilities are some 330% of GDP in France, 190% in Germany, 150% in Japan, and 130% in Italy.

A recent paper from the BIS suggests without a substantial change in fiscal policy and age-related spending, the ratios of debt to GDP will soon exceed 300% in Japan, 200% in the UK, and 150% in Belgium, France, Ireland, Greece, Italy, and the United States. This is not all. During the panic of 2008, governments felt obliged to guarantee the liabilities of their stricken banking systems, which, in several cases, were larger than the national income of the host nation. Ireland guaranteed bank liabilities equivalent to a staggering 200% of GDP. UK financial guarantees amounted to more than 50% of GDP.

Sovereign credit is further weakened by the fact that several countries have large foreign liabilities. Iceland’s negative external assets ballooned to over 200% of GDP. The foreign liabilities of Hungary exceeded 100% of GDP. Even the US, the provider of the world’s reserve currency, has net foreign liabilities equivalent to a fifth of GDP. In this age of global finance, large swaths of government debt are owed to foreigners. Nearly half of outstanding US Treasuries are held abroad. The non-resident share of government debt is high in Portugal (equivalent to 70% of GDP), Ireland, Netherlands, Spain, and France (all at around 60% of GDP). Around a third of British giltts are also owned by foreigners.

**A historical perspective on the current sovereign debt concerns**

1. **This time is (really) different.** In the past, the sovereign default cycle has tended to involve developing rather than advanced economies. The current crisis is different. In contrast to earlier episodes, in the years leading up to the 2007 credit crunch, developing nations were not the main borrowers in the global capital markets. In fact, emerging markets in aggregate ran current account surpluses, which were recycled to borrowers in developed countries. Leaving aside problems in Dubai and Central Europe, the latest sovereign debt crisis is being played out in the developed world.

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20 Public Sector Pensions: The UK’s Second National Debt, Neil Record, Policy Exchange, June 2009. A number of public investment projects also don’t appear in the British public debt figures. The liabilities of the so-called Private Finance Initiative have been estimated at 15% of UK GDP.


22 Cited by Bob Mceke and David Roche, Sovereign DisCredit, 2010.


25 Figures from Credit Suisse.

26 Figures from Independent Strategy.
Earlier cases of excessive government debt levels among advanced economies aren’t much relevant today. The deleveraging of the Scandinavian countries and Canada in the early 1990s, for instance, occurred against a backdrop of strong external growth and local currency devaluation. Their economies were also relatively small. The recent banking crisis and subsequent explosion of government debt has affected a much larger share of the global economy. While a few countries may attempt to grow exports by devaluing their currencies, this is not a route that everyone can follow.

Some commentators argue that Japan’s experience over the last two decades since the collapse of its real estate bubble provides the best analog. According to this argument, there’s no limit to rising government debt levels. As the private sector pays down its debt, funds will become available for governments to borrow. In the age of deleveraging, inflation will also remain low despite zero interest rates and the expansion of central bank balance sheets.  

This argument deserves to be taken seriously. However, we shouldn’t overlook the profound differences between Japan’s condition in the 1990s and our current circumstances. Japan, for instance, enjoyed a very high savings rate compared to the low savings of the US and UK in recent years. The Japanese authorities were also slow to respond to their incipient banking crisis, whereas the authorities in the US and elsewhere turned quickly to innovative monetary solutions and huge fiscal bailouts. Japan’s financial crisis was local, our own is global.

Finally, we should note that our financial problems are more complex than ever before. The notional value of outstanding derivatives is several times greater than global GDP. Banking liabilities in several countries, including the UK and Switzerland, far exceed their respective national incomes. Private sector debts remain at unprecedented levels (more than twice GDP in the US, UK, and Australia). This time really feels different.

2. We are not all Greek. Some commentators have suggested that Greece is the canary in the coal mine—a Bear Stearns in an unfolding sovereign debt crisis with the larger sovereign defaults to come. This view is understandable. On certain measures, Greece doesn’t appear to have the worst fiscal problems. The UK and the US, for instance, have larger structural deficits. Japan’s gross government debt at some 230% of GDP dwarfs that of Greece. Nor is Greece overly dependent on short-term borrowing. The average maturity of Greek government bonds is around eight years, compared to just four years for the US.

**Exhibit 6**
**PIGS Caught in a Debt Trap**

<table>
<thead>
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<th>Country</th>
<th>Cyclically-Adjusted Primary Balance</th>
<th>Interest-Growth Differential</th>
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</thead>
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<td>2</td>
</tr>
<tr>
<td>New Zealand</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Italy</td>
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<td>0</td>
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<tr>
<td>Portugal</td>
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<td>0</td>
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<td>0</td>
</tr>
<tr>
<td>Australia</td>
<td>-4</td>
<td>0</td>
</tr>
<tr>
<td>France</td>
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<td>-10</td>
</tr>
<tr>
<td>US</td>
<td>-8</td>
<td>-10</td>
</tr>
</tbody>
</table>

*The rate on 10-year government bonds less forecast 2010 nominal economic growth

Source: IMF, Bloomberg (6/24/10)

Nevertheless, the problems facing Greece and other members of the Eurozone periphery, such as Portugal, Ireland, and Spain, (which together comprise the so-called “PIGS”) shouldn’t be extrapolated blindly to other sovereign credit markets. For a start, as we have seen, Greece, Spain, and Portugal all have abysmal credit records. Greece also scores badly in the international indexes of corruption (compiled by Transparency International and The Better Business Bureau). Greece and Portugal have the lowest savings rates in the developed world. During the boom years, blind capital flowed into these countries. Lenders didn’t care that the proceeds of their loans were spent unproductively and didn’t notice that, in the case of Greece, the national accounts were fudged. When they realized their mistake, the flow of foreign lending dried up. By this date, foreigners found themselves holding Greek bonds with a face value approaching 100% of the country’s GDP.

The debts of Greece and the other Eurozone members aren’t denominated in their own currency. By joining the European Monetary Union, the PIGS gave up

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control over monetary policy. As a result, they can’t devalue or inflate their way out of this crisis. Furthermore, they have all experienced a loss of competitiveness relative to Germany in recent years. Bound by euro shackles, their economies face the prospect of low growth and prolonged deflation, while burdened with an excessive debt, denominated in a foreign currency and largely owed to foreigners.

To make matters worse, Ireland and Spain are struggling with the after-effects of extreme real estate and credit bubbles. Private sector credit ballooned during the boom years. Their governments felt obliged to guarantee their bloated banking sector liabilities just as banks’ assets (secured on real estate) were souring. Sovereign credit concerns in these countries are likely to persist until Germany accepts either a fuller political and fiscal union (i.e., underwrites their debts) or the ECB embraces an inflation to wash away the excessive debt burden of the smaller Eurozone partners. An alternative option would be for Germany to accept that the monetary union was misbegotten from the start and to jettison the euro.

3. The US isn’t on the verge of default. As we have seen, there’s a long history of commentators fretting about an impending public debt implosion that never arrives. It’s true that several countries, including the US and UK, have large structural fiscal deficits and huge unfunded contingent liabilities. But it’s a mistake to extrapolate current fiscal deficits indefinitely into the future and point to “inevitable” bankruptcy. In time, welfare and pension obligations will be reduced and taxes will rise. We are already witnessing the first round of fiscal tightening in the UK and elsewhere. As long as inflation remains quiescent and bond yields are low, the share of GDP consumed in servicing the government debt remains manageable.

Furthermore, large industrial economies, such as the US and UK, have in the past carried large public debt burdens without defaulting. They have deep financial markets and domestic banking systems that are capable of absorbing vast amounts of government debt. Most importantly, unlike Greece and the other stricken Eurozone members, public debt is issued in their own currency and they maintain control over their central banks and foreign exchanges. Given these institutional characteristics, default is extremely unlikely.

4. Inflation is more likely than default. Just because default is not in the cards, this doesn’t mean that US Treasuries, British Gilts, and Japanese JGBs are as safe as Victorian gilts. There are several reasons why inflation is the most likely outcome to excessive public debt burdens. For a start, it is more attractive from a political perspective. Inflation redistributes wealth from creditors to borrowers in a relatively painless fashion. In the US and UK, it would reduce both government and private sector liabilities, and diminish these countries’ foreign liabilities.

The maintenance of a stable price level is no longer the main priority of policymakers. Contemporary central bankers, most notably “Helicopter Ben” Bernanke at the Federal Reserve and Mervyn King at the Bank of England, have gone to extreme lengths to avoid deflation. The policy of quantitative easing, as practiced by the Federal Reserve and other central banks, is a monetary experiment fraught with danger. Last year, the Bank of England “printed money” to acquire bonds with a value equivalent to 15% of Britain’s GDP. History records that all great inflations have originated with the monetization of debt. It’s true that the aftermath of the current financial crisis has been marked by private sector deleveraging and deflationary pressures. However, at some stage – and no one knows exactly when – central banks will have to reverse their crisis policies. If they don’t take away the punch bowl in time, inflation will return.

5. Tipping points. Public finance is a Ponzi scheme. As long as new creditors can be found to roll over existing loans and provide fresh funds, the debt juggernaut can continue. Reinhart and Rogoff point to multiple equilibria for government debt. In their view, it’s inherently unpredictable whether a government defaults or not. There’s a fallacy of composition involved. It may be rational for an individual to refuse to roll over a risky loan, but irrational for all lenders to refuse as their actions may trigger a crisis.

At some moment, however, a tipping point is reached. That moment came to Greece late last year when it emerged that the previous government had misled the markets about the size of the fiscal deficit. Once the risk premium on Greek bonds started spiraling upward, the game was over.

28 Carmen Reinhart and Ken Rogoff, This Time Is Different, 2009.
Tipping points also may exist for other sovereign credits outside of the Eurozone. Take the case of Japan, for example. As we have seen, over the past couple of decades this country has accumulated a vast public debt without spooking the debt markets. As a borrower, Japan has enjoyed huge advantages over Greece: its debt is issued in its own currency and it has its own central bank; the debt is almost entirely domestically held; Japan has had very high savings; the world’s second largest economy has more debt “capacity” and its domestic financial system – including public pension funds – was large enough to absorb a vast quantity of government bonds.

Furthermore, Japanese debt is relatively short term. The face value of bonds that have to be rolled over this year is equivalent to nearly half of Japan’s GDP. Unless Japan changes direction, its public credit will come under threat.

The province of uncertainty

As a result of the financial crisis, the world’s leading sovereign credit markets have left the world of risk, where probabilities of gains and losses can be measured, and entered the darker province of uncertainty. The future performance of sovereign credits depends on future events and decisions that are unknowable.

Will the global economic recovery be sustained? Or will economic growth and tax revenues remain weak for a prolonged period? Will policymakers in leading countries find the political strength to restore their government finances to order? Or will, as some fear, the attempt to cut deficits actually increase them (by hurting the economy and reducing tax revenues)? Will central banks engage in further bouts of quantitative easing until they reach the point of no return? Or will they err on the side of caution and tighten too early? Will the current deflationary policies within the Eurozone persist? Or will the ECB turn toward the monetization of excessive debt levels? Will interest rates on long-term government debt remain low? Or will bond vigilantes take fright and demand higher rates as compensation for all this uncertainty and risk?

These are interesting but intractable questions. Nobody knows their answers. Current yields on government bonds in most advanced economies (PIGS excepted) are at very low levels. Under only one condition – that the world follows Japan’s experience of prolonged deflation – do they offer any chance of a reasonable return. But this is not the only possible future. For other outcomes, long-dated government bonds offer a limited upside with a potentially uncapped downside. As investors, such asymmetric pay-off profiles don’t appeal to us. Caveat (sovereign) creditor!

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