SOVEREIGN DEBT

From Safety to Default

Robert W. Kolb, Editor

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Essential Perspectives

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Introduction

Sovereign debt—borrowing by governments—has been a feature of world finance since antiquity. By its very nature, governmental borrowing is somewhat arcane and usually takes place beyond the purview of the typical citizen's personal interest. However, at all times, sovereign borrowing affects everyone in society—after all, when a government borrows it hands a piece of the obligation to every taxpayer. Normally obscure, sovereign debt sometimes suddenly seizes headlines and becomes spectacularly important for everyone in a society under stress. This volume offers the reader a comprehensive understanding of how sovereign debt works and how it affects the world today. Problems with sovereign debt shape the course of wars and help to determine national boundaries. In times of crisis, the management of sovereign debt even has an impact on the type and amount of food that people consume.

Today, issues of sovereign debt are more important than ever, and these concerns promise to reach into the lives of all of us to an unprecedented degree in the future. The last 15 years have witnessed rather spectacular events related to sovereign debt, debt crises, and default. In 1997, the Asian financial crisis swept across East Asia with devastating effects on economic growth and consumption in Thailand, South Korea, and Indonesia, and also afflicted Hong Kong, Malaysia, Laos, and the Philippines. Consumption plummeted in Thailand, and economic growth in the Philippines fell to nearly zero. At the same time, events forced Indonesia to devalue the rupiah. Widespread rioting followed, and Indonesia's government fell after decades of rule.

The Asian financial crisis led swiftly to a default by Russia, leading the International Monetary Fund and the World Bank to respond with a $23 billion bailout. Russia's nearby trading partners, many former Soviet republics, suffered considerably as well. Belarus and Ukraine sharply devalued their currencies, and in Uzbekistan the government placed restrictions on the sale of food to avoid panic. For their part, the Baltic states of Estonia, Latvia, and Lithuania fell into recession.

Having swept from Asia to Russia in a short period, financial distress came quickly to the United States with a dramatic effect on the hedge fund Long-Term Capital Management (LTCM), which was heavily invested in the Russian ruble. Events quickly proved that LTCM was pivotal in the global financial system, revealing a degree of interconnectedness that had previously been unthinkable. Policy makers soon realized that the collapse of LTCM threatened the entire financial system, and the Federal Reserve Bank of New York organized a bailout financed by $3.5 billion from the largest financial firms on Wall Street. The proud LTCM, which featured principals who had won the Nobel prize in economics, completely collapsed.[1] The aftermath of these crises revealed to all attentive observers a new world financial structure that now possessed an astounding degree of interconnectedness—a world in which financial distress could fly as quickly as rumor.[2]

Against the background of the late 1990s, it was easier during the time from 2007 to 2009 to comprehend the speed with which financial distress could travel from market to market and from firm to firm, even if the magnitude of that distress shocked virtually everyone, from Wall Street titan to the small-holding pensioner. These events have set a new stage for sovereign debt in a globalized financial world—a world in which a financial hiccup in one region, market, country, or company can cause convulsions in an economy previously thought to have been quite remote from the original point of distress.

SOVEREIGN DEBT: A PIVOTAL FACTOR IN WORLD AFFAIRS

With the breakup of the Soviet Union in the early 1990s, some observers saw an ultimate and permanent triumph of liberal democracies with an "end of history" that initiated a stable future. This view was short-lived, and now others see an enduring "clash of civilizations," or at least a "return of history and the end of dreams."[3] The attacks of September 11, 2001, certainly provide a general awakening to conflict at the level of civilizations, while the collapse of the dot-com bubble and the financial crisis of 2007–2009 has made us all aware that we now live in a new world of finance.

But we also live in a world being radically transformed by the rise of new economic, political, and military powers. At least one leading economist foresees China as quickly becoming the country with the world's largest GDP and succeeding in establishing an economic hegemony over the rest of the world.[4] With a military that is still little threat to that of the United States, China has just passed the United States in total number of warships. While some concede that the United States and the Western democracies generally face a slowly developing eclipse, others speculate that complex societies may be faced with sudden collapse and specifically suggest that such rapid dissolution of world standing might be a near-term fate for the United States.[5]

While any reasoned reading of geopolitical tea leaves suggests that the West faces huge challenges ranging from an aging population to a loss of economic and military primacy, it should be clear to all that much of the West's ability to navigate the next decades will depend to a considerable degree on its financial strength. In the United States, the collapse of home prices, the dislocations of the ensuing Great Recession, the fiscal plight of many state governments, and the growing furor over economic management at the federal level all make the financial challenges we face evident to almost everyone.

These challenges face the Western democracies generally. Exhibit I.1 shows the level of total societal debt—the sum of the debt of governments, households, financial institutions, and nonfinancial businesses—for the leading economic nations of the world. By this measure, the United Kingdom and Japan are far and away the most heavily indebted societies, with total debt exceeding more than four years

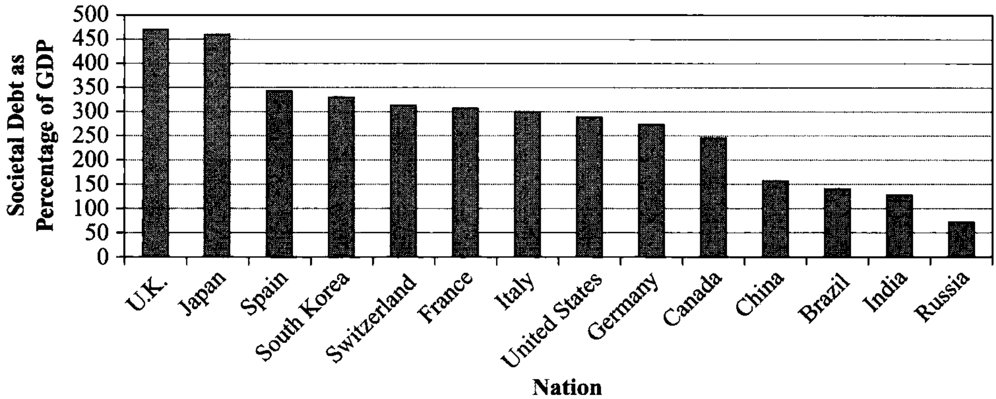

Exhibit I.1 Total Societal Debt as a Percentage of GDP
Source: McKinsey & Company, "Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences," January 2010, 20.

of the entire gross domestic product of these nations. The United States is only in the middle rank of these nations with slightly less than 300 percent of GDP as the burden of its societal debt. Notably, the large developing nations—the BRIC countries of Brazil, Russia, India, and China—carry the lowest debt burdens.[6]

For this same collection of nations, the rank ordering of sovereign debt as a percentage of GDP differs substantially from the ranking for total societal debt, as Exhibit I.2 shows. Japan's sovereign debt burden is almost twice as large relative to GDP as Italy's, which is second. Again, the United States falls in the middle rank of these countries. The BRIC nations, with uniformly lower levels of total societal debt, are diverse with respect to their sovereign debt levels. Most notably, Russia has very little sovereign debt, no doubt due to its sovereign default in 1998 and its subsequent exclusion from sovereign borrowing.

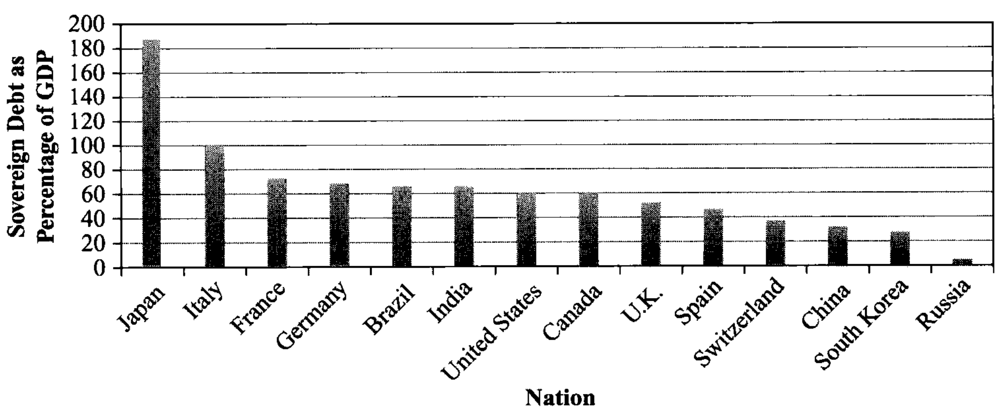

Exhibit I.2 Sovereign Debt as a Percentage of GDP
Source: McKinsey & Company, "Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences," January 2010, 20.

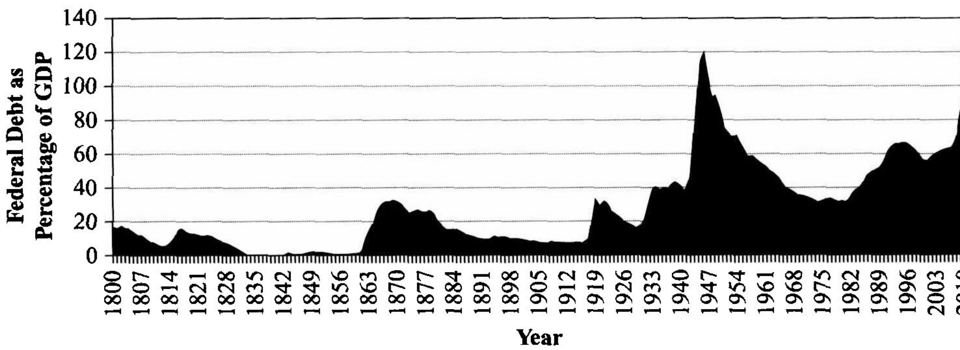

Exhibit I.3 U.S. Federal Debt as a Percentage of GDP
Source: www.usgovernmentspending.com/federal_debt_chart.html. Accessed September 1, 2010.

In the United States, the level of sovereign debt has varied dramatically over the years, showing a marked tendency to rise during times of war and to fall during times of peace. Exhibit I.3 shows the fluctuating level of sovereign debt for the United States from 1800 to 2010. The graph shows a clear pattern of debt that rose during periods of war: the Civil War, World War I, and during and immediately following World War II. The current debt level is second only to the level that resulted from World War II. In the United States, this unprecedentedly high level of sovereign debt in a period of relative peace, coupled with high levels of personal debt are two principal sources of the economic concern that resulted in the political realignments of the mid-term elections of 2010 and continue to threaten (or promise) continuing substantial political repercussions.

Concerns about sovereign debt are now widespread and intense. As a survey of sovereign debt conditions shows, the United States remains in a strong position as a borrower, despite having suffered a large worsening of fiscal conditions in a time of relative peace. Compare, for instance, the list of the world's riskiest sovereign borrowers, topped by Venezuela, as Exhibit I.4 shows. There is little doubt that Venezuela is capable of repaying its debts, given its substantial oil wealth. However, political posturing by an unreliable and perhaps unstable dictator there makes the honoring of Venezuela's debts a less-than-safe proposition. For Greece, the second riskiest sovereign borrower, the problem is quite otherwise. Greece worked itself into a bad situation through years of unsustainably generous social payments, a succession of governments that permitted themselves to be hostage to powerful unions, and a society committed to tax avoidance under the aegis of a government with poor tax-collection abilities. In late 2010, Credit Market Analysts, Ltd., the source of these rankings, gave both Venezuela and Greece a higher than 50 percent chance of default sometime during the next five years. Exhibit I.5 shows the most reliable borrowers, with Norway being the most likely to repay in full, due in no small part to its vast oil revenues, combined with its very substantial sovereign wealth fund. Despite the excited headlines, the United States remains a very reliable credit risk, ranked third for reliability by Credit Market Analysts, Ltd.

In late 2010, we appear to have reached the aftermath of the financial crisis of 2007–2009 as the Great Recession seems to recede or at least to moderate in its

Exhibit I.4 The World's Riskiest Sovereign Borrowers (Ranked from Riskiest to Less Risky)

1	Venezuela
2	Greece
3	Argentina
4	Pakistan
5	Ukraine
6	Dubai
7	Iraq
8	Romania
9	Latvia
10	Bulgaria

Source: Credit Market Analysts, Ltd., "Global Sovereign Credit Risk Report," Second Quarter, 2010, 4.

intensity. Nonetheless, the financial crisis and recession have left a very serious situation. This has been exposed by the crisis that rocked the European Union nations in 2010 as concern mounted over the economic viability of entire nations, the so-called PIIGS—Portugal, Ireland, Italy, Greece, and Spain—with Greece being the focal point of most intense concern. At one point in 2010, insuring Greek sovereign bonds against default for a single year exceeded 11 percent of the promised payment amount. The parlous state of world finance led the Bank for International Settlements to judge: "Fears of sovereign risk threaten to derail financial recovery."[7] However, comparison of sovereign debt levels with previous periods show them only as being high, not necessarily as being disastrous.

The elevated, but not necessarily dramatic, level of sovereign debt fails to disclose the whole picture, however. Some countries with the largest economies that have occupied positions of world leadership for decades are saddled not only with large levels of sovereign debt, but large levels of total societal debt, plus

Exhibit I.5 The World's Most Reliable Sovereign Borrowers (Ranked from Most Reliable to Least Reliable)

1	Norway
2	Finland
3	USA
4	Denmark
5	Sweden
6	Germany
7	Switzerland
8	Netherlands
9	Hong Kong
10	Australia

Source: Credit Market Analysts, Ltd., "Global Sovereign Credit Risk Report," Second Quarter, 2010, 5.

structural budget deficits they seem unwilling to correct. Exhibit I.1 has already shown the high levels of societal debt for Japan, the United Kingdom, some other leading EU countries and the United States. However, these countries also have chronic national budget deficits. These countries have been characterized as having fallen into a "ring of fire"—a situation of high sovereign debt coupled with high governmental deficits. Unenviable membership in the ring of fire means that a country has ". . . the potential for public debt to exceed 90 percent of GDP within a few years' time, which would slow GDP [growth] by one percent or more."[8] As Exhibit I.6 indicates, these unfortunate countries in the ring of fire include the United States, the United Kingdom, Japan, France, and most of the PIIGS—Spain, Ireland, Italy, and Greece. By contrast, Norway, Sweden, Germany, Canada, and the Netherlands are in fairly good condition, with Finland, Denmark, and Australia holding the strongest positions on this measure.

Thus, the issue of sovereign debt must be considered against this two-fold background. First, sovereign debt is a key part of the picture of financial irresponsibility on the part of many of the presumably richest and most powerful nations of the West. Resolving the consequences of this longstanding irresponsibility will take a major societal effort over a long period in each of these countries. Second, this malaise affects the countries that have led the world toward the West's cherished values of individual freedom and democracy, and their economic weakness has come to a crisis point just as the rise of countries such as the BRICs

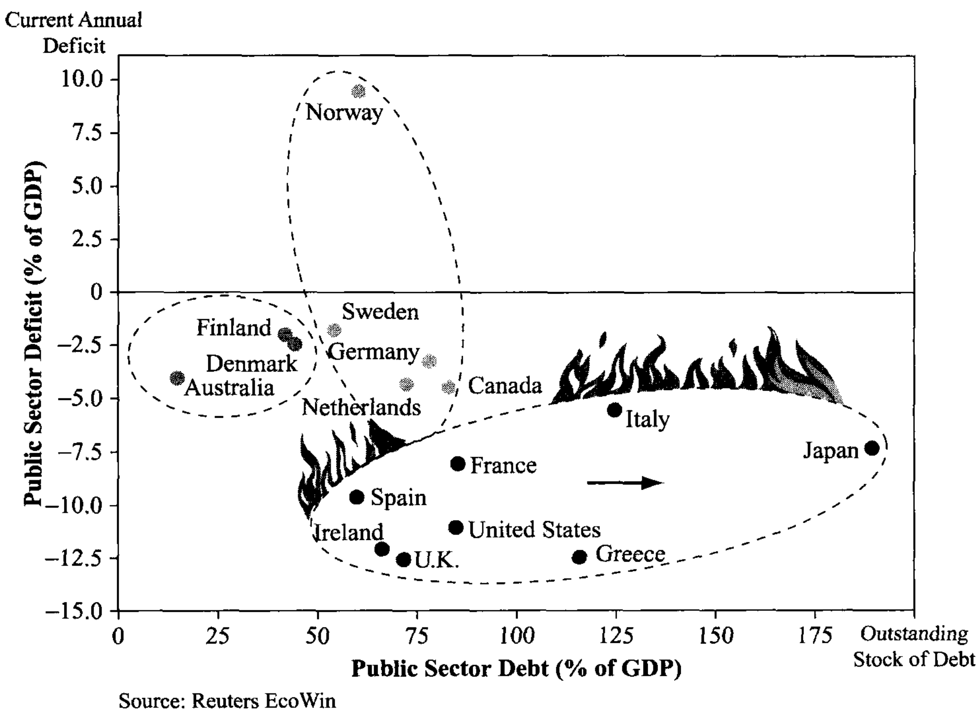

Exhibit I.6 The Ring of Fire

Source: Bill Gross, "The Ring of Fire," *PIMCO Investment Outlook*, February 2010, 4.

presents a serious challenge to the economic primacy of liberal democracies. Also, a resurgence of Islam may presage a serious global confrontation with the West's values of personal freedom and representative government.

These factors combine to make sovereign debt a critical piece of the economic and social challenge that the Western nations must face. Not too long ago, sovereign debt was a concern primarily, or even only, for developing and impoverished countries. A mere decade ago, one of the largest issues in sovereign debt was debt relief for the poorest countries. Today, it is the rich (or formerly rich) countries that face their own problems with sovereign debt, and there is no one to forgive these debtors. These themes are the issue that stimulated the development of this book.

ABOUT THE TEXT

All of the chapters in this volume represent the cutting edge of thinking about sovereign debt. The contributions stem from the authors' deep expertise in the subject matter. Almost all of the contributions are based on formal academic research conducted in the last two years. Accordingly, this book spreads before the reader the best thinking on sovereign debt by specialists drawn from top universities and key international financial institutions, including central banks, the International Monetary Fund, and the World Bank. All of the contributions in this volume have been especially written for the intended reader—a nonfinance specialist interested in understanding the vital importance of sovereign debt for the world's economic future. The book is divided into seven sections, and each is preceded by a brief essay describing the chapters in that section:

I. The Political Economy of Sovereign Debt
II. Making Sovereign Debt Work
III. Sovereign Defaults, Restructurings, and the Resumption of Borrowing
IV. Legal and Contractual Dimensions of Restructurings and Defaults
V. Historical Perspectives
VI. Sovereign Debt in Emerging Markets
VII. Sovereign Debt and Financial Crises

NOTES

1. For a riveting account of the rise and fall of Long-Term Capital Management, see Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, New York: Random House, 2000.
2. This financial interconnectedness offers considerable benefits in normal times, but it also means that financial markets under stress can be subject to financial contagion—the propagation of financial distress in one firm, market, or economy to others. See Robert W. Kolb (ed.), *Financial Contagion: The Viral Threat to the Wealth of Nations* (Hoboken, NJ: John Wiley & Sons, 2011).
3. See Francis Fukuyama, "The End of History?" *The National Interest*, Summer 1989, and *The End of History and the Last Man* (New York: Free Press, 1992). Samuel P. Huntington advanced the clash of civilizations point of view: "The Clash of Civilizations," *Foreign*

Affairs (Summer 1993, 22–49), and *The Clash of Civilizations and the Remaking of the World Order* (New York: Simon & Schuster, 1996). See also Robert Kagan, *The Return of History and the End of Dreams* (New York: Knopf, 2008).

4. Robert Fogel, "$123,000,000,000,000," *Foreign Policy*, January/February 2010. By contrast, other well-placed observers see a more modest rise in Chinese economic power: Robert D. Kaplan, "The Geography of Chinese Power," *Foreign Affairs* (May/June 2010), 22–41.
5. For a gradualist perspective, see Fareed Zakaria, *The Post-American World* (New York: W.W. Norton, 2008). Zakaria sees the fall of the United States as resulting more from the "rise of the rest," rather than from an actual fall. Niall Ferguson represents the view that sees sudden collapse as possible: "Complexity and Collapse," *Foreign Affairs*, March/April 2010.
6. For the idea that the BRIC countries hold the key to world economic development, see Dominic Wilson and Roop Purushothaman, "Dreaming with BRICs: The Path to 2050," Goldman Sachs Global Economics Paper No. 99, October 1, 2003.
7. Bank for International Settlements, *80th Annual Report*, June 28, 2010, 23.
8. Bill Gross, "The Ring of Fire," *PIMCO Investment Outlook*, February 2010.

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ABOUT THE EDITOR

Robert W. Kolb received two PhDs from the University of North Carolina at Chapel Hill (philosophy, 1974; finance, 1978), and has been a finance professor at the University of Florida, Emory University, the University of Miami, and the University of Colorado at Boulder. He was assistant dean of Business and Society, and director of the Center for Business and Society at the University of Colorado at Boulder. Kolb was also department chair at the University of Miami. He is currently at

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Kolb has published more than 50 academic research articles and more than 20 books, most focusing on financial derivatives and their applications to risk management. In 1990, he founded Kolb Publishing Company to publish finance and economics university texts, built the company's list over the ensuing years, and sold the firm to Blackwell Publishers of Oxford, England in 1995. His recent writings include *Financial Derivatives 3e; Understanding Futures Markets 6e; Futures, Options, and Swaps 5e;* and *Financial Derivatives*, all co-authored with James A. Overdahl. Kolb also edited the monographs *The Ethics of Executive Compensation, The Ethics of Genetic Commerce, Corporate Retirement Security: Social and Ethical Issues*, and (with Don Schwartz) *Corporate Boards: Managers of Risk, Sources of Risk*. In addition, he was lead editor of the *Encyclopedia of Business Society and Ethics*, a five-volume work.

Two of Kolb's most recent books are *Lessons From the Financial Crisis: Causes, Consequences, and Our Economic Future*, an edited volume published by John Wiley & Sons, and *The Financial Crisis of Our Time*, published in 2011. In addition to the current volume, he also recently completed *Financial Contagion: The Viral Threat to the Wealth of Nations*.

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To these approximately 100 people I extend my sincere gratitude for making this book possible.

ROBERT W. KOLB
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