



Investment Strategy Group

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Investment Strategy Bulletin

Why & When Sovereigns Default

Governments can, and have, run large budget deficits and experience sharply rising debt stock burdens without recourse to default or experiencing funding crises. At a time when excitement surrounds the risk of default in, amongst others, Greece, we think a calming look at the precise conditions that imply sovereign failure is warranted. A quick look at national accounting:

The external surplus / deficit for any country reflects the excess of spending over saving for the whole economy (in deficits), and represents the sum of the saving/spending balances across the government, household and business sectors. A government deficit that exceeds a private sector surplus implies an external deficit and the need to "fill the gap" with savings borrowed from foreigners (this is the case, for example, in the USA, the UK and Greece). A similar magnitude government deficit, but with a large and offsetting private surplus, implies an external surplus and a surfeit of savings (this is the case for example in Japan).

Large government deficits, as in Japan, and the associated debt burden, can be relatively predictably financed and maintained for a prolonged period since they can be financed by a steady stream of domestic savings. Problems arise, however, when foreign financing is required and a steadily declining exchange rate is often necessary to cheapen government bonds and encourage foreign buying. This has been the case in the UK and the USA.

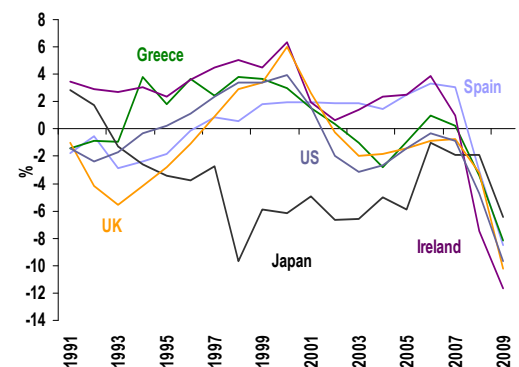
At what point do high debt ratios become unstable? The stable ratio of government debt to GDP is given by the following expression:

$$\text{Debt / GDP} = \frac{\text{(the non-interest, or primary, Budget balance / GDP)}}{\text{(the GDP growth rate less the interest rate on government debt)}}$$

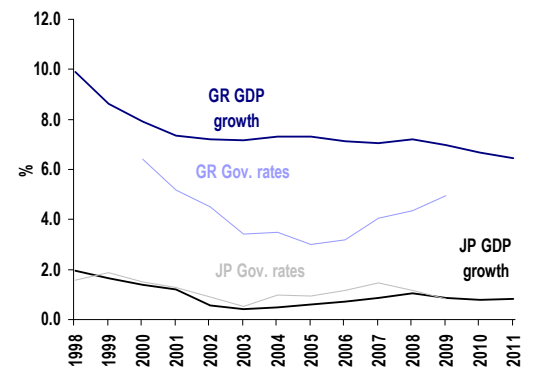
So long as the growth rate in nominal GDP exceeds the interest rate on government debt, the Debt/GDP ratio can be regarded as stable and sustainable. As the lower chart shows, Japan has not tipped, yet, into the zone of instability, having a surplus of domestic savings and rates close to nominal trend growth. Greece is, similarly, not in a default position on its STOCK of existing debt. In terms of the FLOW of new debt, sales of that rely upon the willingness of foreigners to buy and the contribution of Greece to the euro is such that a weaker euro cannot naturally be expected to cheapen Greek debt to encourage foreign buying. In that case, interest rates are forced higher. *The Greek sovereign crisis is more a reflection of the over-valuation of the euro than it is of the sustainability of the underlying Greek debt position. Why buy low yielding assets if you expect currency depreciation to wipe out the yield?*

A weaker euro and Greek spending cuts should restore order soon.

Primary Budget Balance
% of GDP



Greece & Japan 5yr annualized nominal gross rates (% of GDP, 2010/11 OECD projections) versus nominal Interest rate on government debt (5-7yr average duration)



Source: Datastream, OECD, LO calculation

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