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The spectre of sovereign default returns to rich world

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The sustainability of sovereign debt hangs heavily over bond markets, and the prospects for economic and financial stability.

Since 2007, OECD government deficits have risen by 7 per cent of GDP to just over 8 per cent, and debt, excluding contingent liabilities, has risen by about 25 per cent of GDP to just over 100 per cent.

The biggest increases have occurred in Iceland, Ireland, the US, Japan, the UK, and Spain. There is no peacetime precedent for the current speed and scale of public debt accumulation and it is difficult to assess the social tolerance for high debt levels, and for the pain of protracted fiscal restraint. In several EU member states, the threshold has already been breached. The spectre of sovereign default, therefore, has returned to the rich world.

Default does not have to mean outright debt repudiation. It can mean some type of moratorium on interest payments, and the restructuring of loan terms. Richer nations are assumed to be above such measures, but not in extreme circumstances. The US abrogated the gold clause in government and private contracts in 1934, and in 1971, it abandoned the gold standard altogether.

Default can also occur via inflation, currency debasement, the imposition of capital controls, and the imposition of special taxes that break private contracts. Seen in this light, a few countries in eastern and western Europe may already be technically at risk of default.

At the moment, higher spreads on sovereign bonds and credit default swap rates do not provide convincing evidence of an imminent default crisis, per se. Japan’s public debt has already risen above 200 per cent of GDP, but the government can borrow for 10 years at 1.4 per cent, while Australia’s government debt is about 25 per cent of GDP, but it pays over 5.5 per cent. Other rich countries with varying debt ratios all pay roughly 3.5-4 per cent. However, the status quo is not sustainable.

Concerted fiscal restraint could trigger another recession, but the lack of it could end up in bigger default risks. Even Japan, now into its third ageing decade, may be vulnerable, while some eurozone countries, though sheltered from currency turbulence, may yet falter in their deflation commitments and compromise the integrity of the single currency as we know it.

The UK still lacks a credible debt management strategy, and the US cannot take investor goodwill for granted. There are five reasons why public sector de-leveraging may be particularly difficult in the next few years, and why, therefore, default risks loom large.

First, sovereign debt service costs are set to soar, overshadowing those for programmes, such as environmental protection and some social services, and, unlike past successful fiscal adjustments, no country can lower interest rates as a palliative. Perversely, the contrary may be the case.

Second, OECD governments have experienced a threefold increase in their structural deficits, about a quarter of which is attributable to the drop in tax revenues, some of which may be permanent, for example, where they are related to financial services and housing.

Third, a weak economic growth environment augurs poorly for effective fiscal adjustment, as will be evident as the bungee jump nature of economic recovery becomes clearer.

Fourth, the financial crisis and the recession are the immediate cyclical reasons for the disarray in public finance, but these pale next to the structural costs of age-related public spending, which are starting to rise relentlessly.

Fifth, high levels of capital mobility complicate debt management. Credit rating agencies have been quick to downgrade and opine about several sovereigns. The significance of their actions lies in the fact that most central banks, and some sovereign wealth funds, cannot hold securities rated below AA. Most 'long-only' asset managers have such restrictions too.

Governments have to commit to credible details for fiscal stabilisation, and to structural reforms that address demographic issues, and the need for new growth drivers. The war on waste, raid on the rich, and other slogans will no longer do. They should raise the pensionable age, tackle public sector pension arrangements, and blaze a trail towards higher labour force participation and phased retirement patterns. They should end post-1945 middle class, homeowner, and corporate tax privileges, to finance jobs- and growth-oriented programmes that support the green economy, infrastructure, innovation, and education. Effective political leadership and imagination are essential if default risks are to remain at arm's length. Otherwise, a spike in bond yields somewhere is all but assured and it may be impossible to prevent both contagion, and in the end, recourse to capital controls.

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