The Causes and Consequences of Sovereign Debt

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Abstract

Sovereign debt is the focus of an intense interest and concern in many countries and international financial institutions, not only because of its impact on the economies of both the lending and borrowing countries, but also due to its impact on the growingly integrated and inter-connected world economy. Measured as a percentage of the gross domestic product (GDP), sovereign debt has risen in many countries in recent years to levels in excess of 100 and even 200 percent of their GDPs; thus, affecting their economic growth and stability, and bringing some countries to economic stagnation and even to the border lines of economic collapse. Although high levels of such debt have traditionally been associated with wars and making poor public policy choices, sovereign debt has also risen and fallen with the business cycles and government financing and/or subsidizing of socially or politically desirable, but growingly unaffordable, programs whose costs usually accelerate with inflation and growing populations. Among the questions to be examined in this paper are: How do nations manage their debt portfolios? At what level of debt should a government realize that its debt obligations have escalated to unmanageable and dangerous levels? How do governments avoid or deal with the unintended negative consequences of frequently recommended solutions to sovereign debt problems? And are there universally-recognized and accepted mechanisms, processes, and procedures to solve sovereign debt problems?

Keywords: Public debt, debt stress, debt crisis, debt portfolio, debt sustainability framework, Pari Passu Clause.

Introduction

Sovereign debt, which is also referred to in this paper as public debt, is the amount of money governments borrow either domestically, or from other governments and international financial institutions. Throughout modern economic history, sovereign debt has risen and fallen, both in dollar terms and as a percentage of GDP, due to factors and reasons that are not always or completely within government control. However, sovereign debt has consistently been growing on a global scale, at least over the last two decades. Although high levels of such debt can significantly slow the rate of economic growth, and even bring it to a halt, care should be given to avoiding some of the extreme and severe corrective measures that can create new problems, and cause other negative and costly outcomes like severe recessions and economic distortions.

A question that is often asked: What are the developments and circumstances that cause governments to borrow extensively from domestic and/or external sources? Some observers like Azzimonti, Francisco, and Quadrini (2012) blame wars and the business cycles, stating that " historically, the dynamics of public debt have been closely connected to war financing and business cycle fluctuations" (p. 1). Others attribute some of the increase in sovereign debt to measures taken in reaction to economic shocks caused by unanticipated developments like major crop failures or a sudden price rise in an important imported commodity like corn or oil. Some of the rise in debt is also associated with excessive spending due to some governments' irresponsible or fiscally unsound policy choices, the need to increase government expenditures in order to stimulate the economy to get out of a major recession, the desire to finance or subsidize costly social programs, and the implementation of ambitious c development projects that have not been adequately funded from other sources. In other words, governments may borrow due to deficits, incurred because of expenditures on programs that are perceived to be national priorities, revenue shortfalls, or as a result of needs dictated by special circumstances at a certain point in time.

For example, in the United States' formative years as a sovereign nation, the government found it necessary to borrow in order to balance its budget without a significant tax increase. Imposing new taxes was then, as it is today, highly unpopular. After all, the American Revolution and War for Independence started in reaction to a British imposed tax rise. Thus, the new American government preferred to borrow internally as well as externally, mostly from European banks. As far back as 1790, the U.S. government had a debt to GDP ratio hovering around 30 percent. Phillips (2012) notes in the Atlantic (November 13, 2012) that "the US was born in debt…The nascent US government …raised cash by borrowing under all sorts of authorities…" (p. 2). By 1866, public debt in the United States reached $2.76 billion, surged to more than $25 billion (33 percent of GDP) by the end of World War I, and rose to 44 percent of GDP by the end of World War II. In 2011, US government debt stood at about 100 percent of GDP (Phillips, p. 8). Like the United States, other countries have historically borrowed both internally and externally, and continue to do so at the present time, sometimes excessively, as the debt crisis in a number of European Union (EU) members has reflected in 2010-2012. Describing the sequence of events at the beginning of this debt crisis, Lane (2013) indicates that "Greece was the first country to be shut out of the bond market in May 2010, with Ireland following in November 2010, and Portugal in April 2011" (p. 57). However, that crisis did not hit the countries concerned without several multi-year imbalances. For example, as Lane (2013) also indicates, both Greece (which was hit hard by this crisis) and Italy "had debt/GDP ratios above 90 percent since the 1990s… Furthermore,1999-2007 looks like a period in which good growth performance (in several EU countries) and a benign financial environment masked the accumulation of an array of macroeconomic, financial, and fiscal vulnerabilities" (p. 51).

Sovereign Debt in Rich and Poor Countries

Until recently, it was commonly assumed that sovereign debt crises were encountered only by small and low income countries, whose limited resources, poor fiscal management, as well as corrupt practices and overall economic mismanagement, may have resulted in accumulating significant amounts of debt that they could not service or eventually repay in accordance previously agreed terms and conditions. Some of those countries, when they found themselves in financial trouble, they sought partial or complete forgiveness of their externaldebt from their rich counter- parts and other lenders. They were perceived as the "bad boys" in the international financial community as far as the management of their fiscal affairs was concerned; yet, they expected to be bailed out and rescued, or saved from themselves, by their big lenders and international financial institutions like the World Bank and International Monetary Fund (IMF). Even when the bigger and more economically advanced countries borrowed heavily from external sources, their ability to manage their debt, without causing a lot of harm to themselves and other nations, was not questioned or disputed. Describing the old distinction between rich and poor countries' debts, Reinhart and Rogoff (2013) write: "Until 2007-2008, the presumption was that (the advanced economies) were not nearly as vulnerable to financial crises…. The idea still persisted that if a financial crisis does occur, advanced countries are much better at managing the aftermath, thanks to their ability to vigorously apply countercyclical policy"(p. 3).

In recent years, however, the world has learned that the larger and more economically advanced economies are also vulnerable, and can suffer from debt stress due to over-borrowing. They can even encounter debt crises and possible bankruptcy as smaller and less affluent countries can. As already mentioned, this vulnerability to serious financial and economic consequences has been amply demonstrated by the debt crisis faced by members of the European Union (EU), some of whom like Greece and Spain have eventually been pressured to implement severe austerity measures that led to recession, political turmoil, riots in the streets, and higher rates of unemployment. Table I indicate the debt-to-GDP ratios in eighteen countries at different levels of development and located in different parts of the world, that have been arranged on the basis of per capital GDP. This table reflects the vulnerability of both rich and low income countries to debt crises due to excesses in accumulating sovereign debt relative to their GDP.

Table I: Per Capita GDP and Debt Ratios in Selected Countries (2012, 2013)

Country	Per Capita GDP (2013)	Sovereign Debt as a % of GDP (2012)
United States	$53,000	72.5
Ireland	48,608	188.0
France	44,099	89.0
United Kingdom	39,372	90.0
Japan	38,468	214.0
Italy	34,715	126.1
Spain	29,150	85.3
Cyprus	24,867	80.9
Malta	22,892	72.0
Greece	21,857	200.0
Portugal	20,995	129.0
Uruguay	16,421	57.2
Argentina	14,709	41.6
El-Salvador	3,835	57.4
Egypt	3,243	85.0
India	1,507	49.6
Pakistan	1,275	50.4
Zimbabwe	1,007	202.0

Sources: The IMF's World Economic Outlook Database, 2014; and the CIA's World Fact Book, 2013.

Sovereign Debt Planning and Management

Ideally increasing or decreasing sovereign debt should take place within the framework of a debt management strategy. History, however, does not tell us that sovereign debt had always been carefully coordinated in accordance with well-crafted and fiscally-sound strategies. Had this been the case, the world wouldnot have witnessed the debt crises experienced inthe last three decades by countries like Greece, Spain, Portugal, Ireland, Mexico, Argentina, Belie, Jamaica, St. Kitts and Nevis, Grenada, the Dominican Republic, Ecuador, Seychelles, and others.

For the management of sovereign debt, once a decision is made by the responsible government authority to borrow for a particular purpose or purposes, the next steps are to determine how much to borrow; what types of borrowing instrument(s) should best be used; and figure out the short, medium, and long range risks and consequences of the new debt in terms of its amount as well as the chosen instrument(s). Melecky (2007) writes about the importance of making such decisions and evaluations of debt within the framework and guidelines of a comprehensive debt management strategy in order to optimize the outcome and avoid making mistakes in terms of debt quantity and the ideal instruments to be used (p. 2). Having a well-crafted public debt management strategy, Melecky (2007) stresses, would, at least, ultimately help in having a debt portfolio that minimizes risks and the costs of servicing the debt. The advantages of a debt management strategy also include setting a ceiling on debt maturity within one year and the average time to maturity. (Melecky, p. 6,16).

Are There Safe Debt Ceiling Limits?

In 1962, the Maastricht Treaty, that led to the creation of the "Euro" as the European Union members' common currency of choice, also set a ceiling for sovereign debt at 60 percent of each country's GDP (Oxford Analytica, p. 1). This ceiling limit, however, was taken by many countries as a guide, not a mandate. As a result, and as indicated earlier, several countries in the Eurozone have exceeded such a ceiling, and let their debt reach critically dangerous levels.

Not all economists subscribe to the idea that there can, or should be, one universal safe debt ceiling that applies to all countries and in all circumstances. One can point to a number of factors that can impact what may be considered by some countries to be a safe debt limit.

These include: The current and projected rates of economic expansion, the sources of the debts in a country's portfolio (internal vs. external), the intended use(s) of the debt, the cost of the debt, the size of the economy, future inflation rates, the type of debt (concessionary vs. non-concessionary), the strings or conditions attached, and the prevailing attitudes toward sovereign debt among political leaders and the public at large. These factors reflect the complexity of debt management and the range of factors that impact the levels of debt that different economies can maintain without necessarily raising the red of flag at a particular point in time. For example, Windsor (2014) commented on Japan's high debt-to-GDP ratio stating that, "one reason Japan's sovereign debt hasn't toppled its economy has been that much of it is held by domestic investors. High domestic savings, coupled with a relatively strong tendency towards domestic investment…has cushioned Japan against risks from fluctuations in currency markets" (p. 1). Windsor (2014) still warns, however, a runaway national debt must eventually be dealt with because it would eventually destabilize the economy and endanger national security (p. 2).

Ways to Reduce Sovereign Debt

In a speech by Anne Krueger of the IMF, delivered at the National Economists Club in 2001, she referred to deficiencies in the international financial structure that make it difficult to get out of unsustainable sovereign debt in some orderly and consistent manner (Eichengreen, p. 75). Those who hold this view usually believe that unsustainable sovereign debt is not necessarily caused by irresponsible fiscal choices since such debt may be a result of factors beyond the control of the borrower, as previously indicated in this paper. Accordingly, the world should have the kind of financial support structure and the means necessary to manage and get out of sovereign debt. Disagreeing with having such mean to easily get out debt crises at least in the case of European Union countries in the Euro zone, Lane (2012) writes that "the ability of national governments to borrow in a common currency poses obvious free-rider problems if there are strong incentives to bail out a country that borrows excessively" (p. 49). A report by Brookings (October 2013) similarly expressed reservations about efforts to ease debt structuring stating that "there were fears that making debt easier to restructure would raise the costs and reduce the amounts of sovereign borrowing in many countries. This was perceived tobe against the interests of both the providers of (loans) and major borrowers" (p. 1).

Reinhart and Rogoff (2013) refer to five measures to deal with debt that has reached dangerous and unacceptable levels:

1. Accelerating the rate of GDP growth
2. Initiating a fiscal austerity program
3. Defaulting or debt re-structuring
4. Boosting inflationary tendencies
5. Applying financial repression by imposing caps on interest rates, restrictions on cross-country financial transactions, tighter regulations on banks; and borrowing from funds that are under government control such as public employee retirement funds and social security. Financial repression helps by discouraging financial excesses, but can lead to distortions like taxes do at times (p. 9).

To get out excessive debt obligations, Kaiser (2013) and Miller (2002)indicate that debt rescheduling and the swapping of debt instruments towards long maturities are often the strategies of choice to deal with debt stress (p. 3).Miller (2002) also indicates that lenders would change the payment schedules to give the borrowers more time before the payment's original due date. In some cases, the creditors agree to extend bridge loans to debtors so that they may be able to continue paying the interests on the loans although they may not able to meet their principal payment schedule. In addition to bridge loans, Miller (2002) brings attention todebt-equity swaps, according to which "smaller banks, holding less of the sovereign debt, rid themselves of a larger percentage of their exposure to sovereign debt without having to extend new loans to pay off the old loans …by transferring a loan to a third party in exchange for an equity investment in the debtor country" (p. 682).

For the benefit of low income debtor nations that are facing, or about to face, debt crises, some informal groupings like the Paris Club, which is composed to 19 of the world's largest economies and other creditors, emerged to help in re-negotiating some of those countries' external debt that was owed to official creditors, often on concessional terms for development purposes. Another group is the London Club that was set up to bring together creditor private banks to help in restructuring the debts of relevant sovereign debtors.

Another grouping of importance to resolving debt issues, is the Group of 7 (or 8 if Russia to be included) that is composed of some of the largest economies in the world that meet periodically to look at trends and issues in the world economy. This group started "the Heavily Indebted Poor Countries' Initiative (HIPC) in 1996 that helps in reducing some of the poor countries' bilateral and multilateral claims, provided that such countries agree to the implementation of structural adjustment programs under the auspices of the IMF(Kaiser, p.5-7). Describing the main features of an agreement reached between the Paris Club and Guinea, a World Bank report (2009) indicated that "on January 23, 2008, Paris Club creditors reached agreement with the government of Guinea to restructure its external public debt, following the IMFs approval …. The agreement resulted in the immediate cancellation of $180 million of debt, and the rescheduling of about $120 million….The agreement also deferred until after 2010 the repayment of arrears accumulated by Guinea" (p. 69).

The IMF Mandate

One of the IMF's main functions is to assist member countries that suffer from chronic balance of payments problems and unsustainable debt by extending conditional financing that may encourage other governments and financial institutions to do the same; thus, guiding those countries toward the path of economic and financial recovery. The conditions that are required to get IMF financial assistance aim at helping the countries involved to address their underlying problems and achieve medium-term external viability and restore investor confidence" (IMF, p. 9).

Due to the low-income countries' substantial need for external borrowing to reduce poverty in order to meet the Millennium Development goals (MDGs), the IMF and the World Bank jointly instituted the Debt Sustainability Framework (DSF) in 2005. DSF mainly involves the use of analytic tools that make it possible for the borrowing government to weigh external financing needs with the country's prospective repayment ability. This analysis can be an important input in the decisions to borrow or not to borrow. The purpose of DSF is to minimize the risk of debt distress and the subsequent repayment difficulties. Based on this initiative, "creditors are also encouraged to take into account the results of the debt sustainability assessment in their lending decisions" (IMF, 2014, p. 1). Since participation in this initiative is not mandatory, not all borrowing governments use it in their debt management decisions. Thus, an IMF study of the sustainability of 76 low-income countries conduced in 2013 revealed that 17 of those countries were either in debt stress or at a high risk state. The rest were found to be at a moderate or low risk levels. (Kaiser, p. 6)

The Equal Treatment (Pari Passu) Clause

Out of concern for possible unequal treatment of debtors in the restructuring and repayment of sovereign debt, the equal treatment or "Pari Passu" clause is usually added to cross-border lending agreements to ensure that borrowers would not discriminate or give preference to one or more creditors over the rest. When added to a debt agreement, the Pari Passu clause signifies that the debt instrument in question stands at the same level with the rest. In fact the term Pari Passu is a Latin term that simply means equally or in equal step. The hoped for implication of Pari Passu is to ensure that if there is not enough money to repay all debtors in full, "all equally-ranking debt must receive a ratable share" (Buchheit and Pam, p. 879).

Conclusion

Sovereign debt has grown steadily with the growth in governmental functions and responsibilities and the increasing demands and expectations of the average citizen. Only countries with consistently balanced budgets and payment balances have historically avoided incurring significant amounts of sovereign debt. While such debt may help in maintaining economic stability and financing some development projects, excessive amounts of sovereign debt have many negative consequences, including the slowing of the rate of GDP growth, a rise in unemployment, and possible insolvency and default. Furthermore, the higher the debt, the higher the likelihood of a rise in the cost of future loans, and the more likely that taxes would have to be increased to compensate for the rise in the cost of servicing the debt. When international organizations and other governments offer assistance to deal with a debt crisis, such assistance usually comes with strings attached and harsh conditions that may cause other problems and unintended consequences. As Lane (2012) points out, however, if facing a debt crisis had any benefit, it may be forcing the heavily indebted nation to implement much needed economic reforms due to pressure from lending countries and institutions (p. 65).

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