The Costs and Risks of Excessive Government Debt

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The problem

- The age of the „Great Moderation” and “complacency regarding the exposure to fiscal challenges” in the industrial world is over
  – The crisis of 2007-2010 made also “Old Europe” acquainted with the problem of exposure to debt crises
- Major liquidity or solvency problems of new EU member countries such as Hungary, Latvia and Romania in 2008
- Italy, Spain, Ireland, Greece and Portugal (to a lesser extent also the UK and Belgium) added to the list of potential victims of debt crises in 2010

A broader definition of debt crises

- Government insolvency, *but* also when government bonds carry a risk premium over a critical level
- A debt crisis may be a lasting process with a rise of the costs of debt service and a corresponding shrinking of the economy’s growth potential
  - debt crisis is not simply „declared” – is e. g. GR in debt crisis or was the country rescued before it?

„Cry wolf…”

- Not only indicators matter, but communication too
  - the international investor community has become very sensitive to even mentioning the terms „debt crisis”, „default” or „bankruptcy”
  - the use of these terms for domestic political purposes should be ABSOLUTELY excluded!
  - Hungary’s example: difference between „subjective” and „objective” perceptions of risk of defaulting

Major risks of debt crises – an intuitive approach

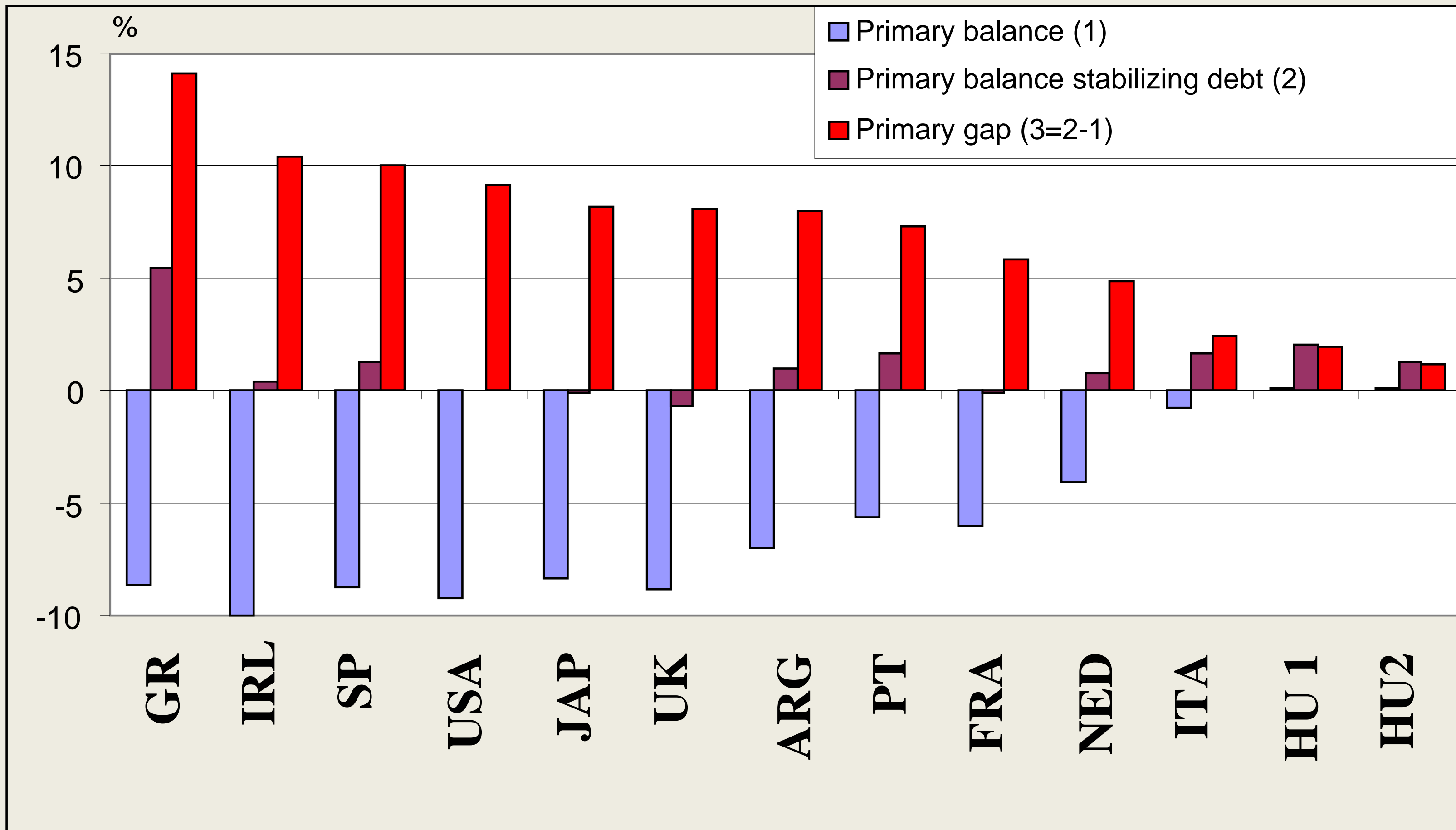
- 1. Domestic:
  - exhaustion of growth potential, capital costs may soar;
  - lasting destruction of credibility of and confidence in government policies;
  - possible outflow of human resources and capital due to increasing fears from domestic restrictions.
- 2. International:
  - global or regional investment climate may suffer;
  - increased risk of „contagion” due to investors’ changing perceptions of factors and sizes of country risk;
  - the creation of „black holes” in international finance (countries with persisting huge debt problems).

Fiscal sustainability after 2010

- 2010 : longer term fiscal sustainability becomes questionable in countries with more than 80 per cent government debt per GDP
- Most OECD countries may have debt levels higher than 60% of GDP in 2015
- „Early warning systems" of debt crises urgently needed
  - Is credit expansion a good predictor?
  - Drops in central bank reserves or significant currency appreciation also bad signs

Are indicators coherent? I

1. „Implicit gap":



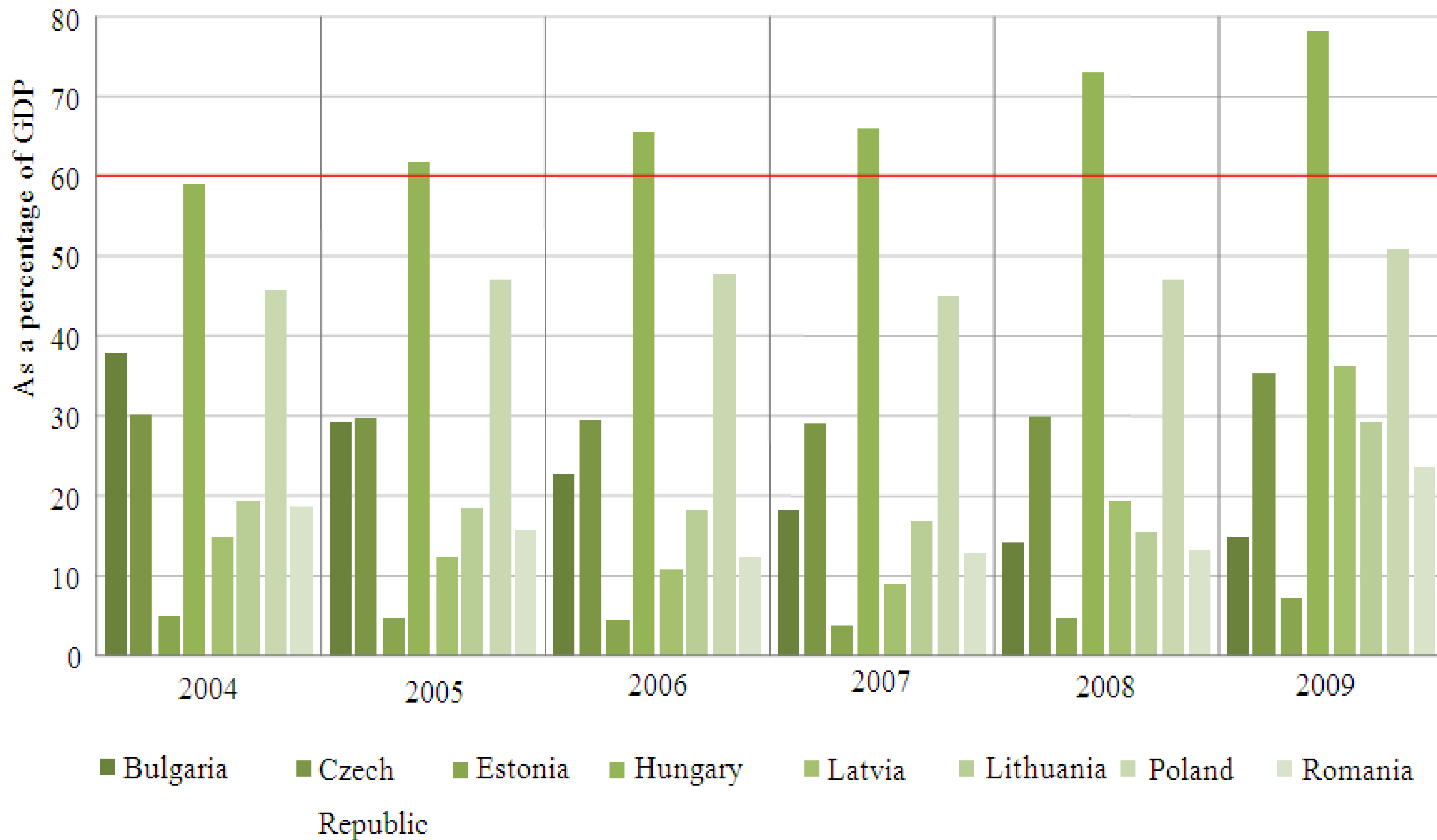
Calculations by Gábor Oblath, based on IMF data

„Implicit gap” – a measure of sustainability

- Based on conservative assumptions on interest levels and GDP growth perspectives, the difference between the *actual* primary balance and the primary balance *stabilizing* debt
- The long-term sustainability of government debt seems quite critical in most PIIGS (with a partial exception of Italy) and also in the United States
  - However, Hungary’s situation looks like more favourable
  - Do the markets recognize this?

Are indicators coherent? II

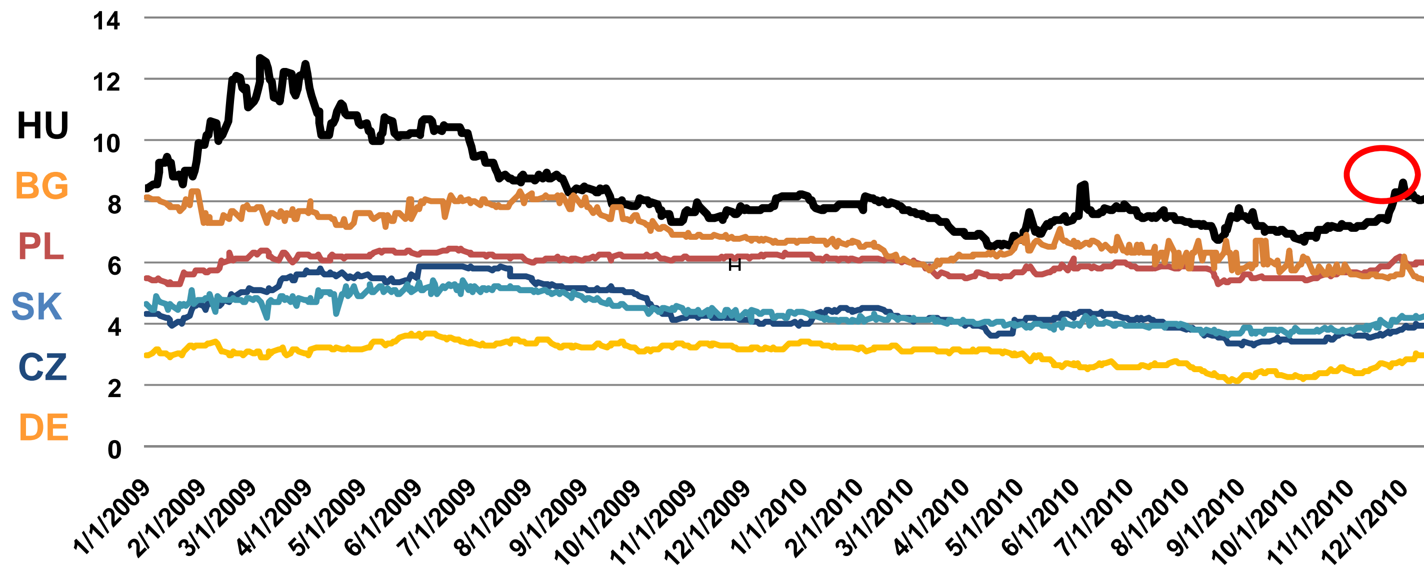
2. Sovereign debt/GDP in the CEE region, 2004-2009



Sovereign debt and political cycles

- Recent debt developments in the CEE region speak of a strong influence of the political (electoral) cycle on fiscal policy, most notably in Hungary
  - „Fiscal alcoholism” (copyright G. Kopits) – a qualitative predictor of debt crises?
- How could this „cycle sensitivity” of fiscal policy be broken?
  - A „dynamic inconsistency” problem - independent institutional actors should be introduced

Are indicators coherent? III



A proxy of the „cost” of higher debt

- Higher bond yields mean increasingly higher costs of servicing debt, and they therefore deteriorate sustainability by themselves
  - Growth perspectives also worse, „crowding out” more considerable
- Bond yields reflect debt levels, debt structures (e. g. maturity) *and* subjective perceptions of debt perspectives by market players
  - Perceptions are largely influenced by transparency!
  - Lower transparency may be interpreted as a deterioration of sustainability even if this is not necessarily true
- Objectively seen, Hungary’s debt situation did not worsen between May 2010 and January 2011 (unlike that of GR or PT), but:
  - the perceptions of markets are different

The CDS picture: a mirror of perceptions

Cf. favourable implicit gap!

The top ten most risky sovereigns

Position Q4	Country	5 Year CPD (%)	CMA Implied Rating	5 Year CDS Mid (bps)	Previous Ranking
1	Greece	58.8	CMA_ccc-	1026.5	2 (Down 1)
2	Venezuela	51.4	CMA_ccc+	1009.6 (18.9% U.F)	1 (Up 1)
3	Ireland	41.2	CMA_b	619.2	6 (Down 3)
4	Portugal	35.9	CMA_b	497.3	9 (Down 5)
5	Argentina	35.4	CMA_b	602.4 (4.3% U.F)	3 (Up 2)
6	Ukraine	30.6	CMA_b+	509.5	5 (Up 1)
7	Spain	26.7	CMA_bb-	347.7	New Entry
8	Dubai	25.5	CMA_bb-	417.6	7 (Up 1)
9	Hungary	23.6	CMA_bb-	378.0	New Entry
10	Iraq	23.1	CMA_bb-	366.1	8 (Up 2)

CMA Global Sovereign Debt Credit Risk Report, January 7, 2011

See PIIGS taking „top” positions!

How could the market's perceptions be changed?

- „Institutional anchor" of fiscal policy needed in any country where investors may doubt the government's full commitment towards fiscal sustainability and transparency
  - and thus towards the avoidance of debt crises
- Markets should be convinced that fiscal policy is fully independent from the political cycle
  - Governments are dependent on the political cycle, and the markets know this
  - Not only the bad record of governments, but also that of countries matters
    - therefore: a change of government by elections does not necessarily restore investor confidence

The tasks of the „institutional anchor” (Kornai) and their implications for crisis prevention

- 1. the analysis of effects of political decisions resulting in fiscal policy action;
  - only fully independent/impartial analysis is accepted by markets
- 2. checking for consistency in the government’s role in the economy, with an emphasis on fiscal policy of course, and with a marked stance against populist economic policies;
  - economic populism may be bought by the electorate - are there adequate short-term guarantees against it in democracies?
- 3. insistence on the transparency of fiscal policy decisions and actions
  - less transparency may mean a lower likelihood of sustainability

Thank you for your kind attention!