REALITIES AND PERSPECTIVES CONCERNING SOVEREIGN DEBT

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Abstract

Last years were marked by extremely high levels of sovereign debt; these facts can be associated both to economies of developed and emerging states, with a particular emphasis on the first category. We can say without exaggeration that the sovereign debt is currently questioning the future economic evolutions; this new climate can be described as one of uncertainty, but the presence of risk does not necessarily mean that default is imminent, and there is a complete lack of sustainability. In our paper, we aim to highlight some recent governmental debt mutations, and to present some perspectives concerning the future of sovereign indebtedness.

Keywords*: sovereign debt, sustainable debt, default, ratings, economic policies*

JEL classification: *F3, F34, G01*

1. Introduction

Regardless of the level at which we decide to analyze debt, it is clear from the beginning that it is often necessary, for various reasons, and that the state of indebtedness is one of normality (required for the coverage of current needs, or growth targets). So, we won't say here that the debt itself is a negative element; what we must stress is the fact that the impact of debt on growth and not only can be extremely significant.

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Undoubtedly, when the debtor is the state itself, things seem, at first glance, much simpler. States have borrowed since their appearance, and continue to do so today. This practice is as normal as possible, but must be strictly controlled; the need of control concerning sovereign indebtedness was highlighted by prestigious economists over time – Adam Smith himself said it categorically.

For many decades, to be the creditor of the state, especially of a powerful one, meant not being exposed to any risk. But, lately, new evolutions have shown, however, that such an approach is incorrect, and that sovereign risk is present, more than ever, in the contemporary globalized world. Any country in the world, rich or poor, can be subject to a default situation.

2. Recent evolutions concerning sovereign debt

Securities issued by national states were, over time, considered as extremely safe. This traditional perception was contradicted by several episodes recorded by the economic history, in the past centuries. In recent years, sovereign risk made its presence felt – many investors who held sovereign debt, for example, had to give up a fraction of their claims. Such developments have affected even European countries, members of the Eurozone.

Sovereign indebtedness and especially over indebtedness is certainly a problem of the modern world. The developed countries of the world have reached, from this point of view, an average level of sovereign debt to GDP of over 90-100%.

For over six years, from the beginning of the global financial and economic crisis, we are witnessing some surprising developments, even a succession of crises, following the axis: financial turbulences – economic crisis – sovereign debt crisis. The 2008 events and the ones that followed have hindered the development of private indebtedness, and caused an unprecedented collapse in global demand. Such a situation imposed taking strong measures by governments; the reaction came, sooner or later, with more or less pro-cyclical effects. Among the measures that were taken, we can mention the support offered to banks and to economic activity in general, in the context of the severe decline in global demand. But policies that allow economic revival have also adverse effects, such as recording significant budget deficits. The manner in which various investors began to perceive the state as a borrower and debtor has changed dramatically in recent years. To this mutation has contributed significantly the attitude – sometimes pro-cyclical – of rating agencies, which operated several degradations of sovereign ratings, having as effect, obviously, an unprecedented rise in interest rates levels required by investors.

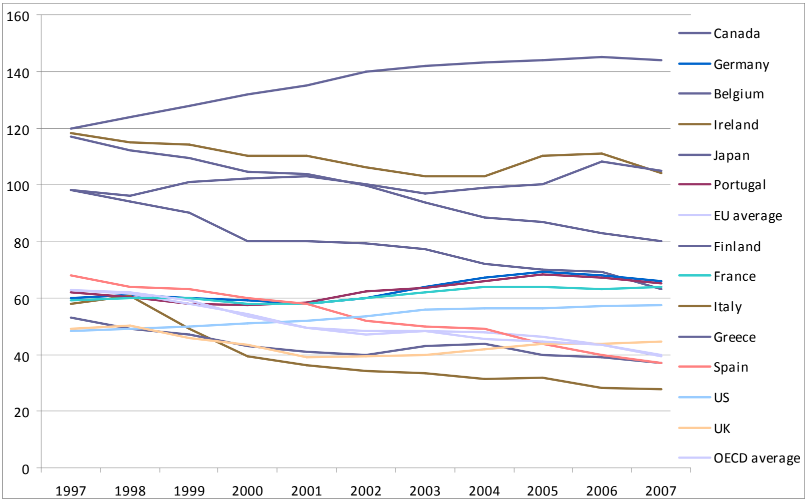
As we pointed out above, we will not say, however, that the current sovereign debt situation is a direct consequence of the global financial and economic crisis; the public debt increase occurred almost constantly for more than five decades, so the issue is not new at all. Of course, some explanations of the phenomenon can be identified – the public sector development in recent decades, the state maintaining an important role in the economy, the need for social policies, and many others.

Several studies (Banque de France, 2012, p. 5) emphasize that the effects of these phenomena have not been felt for some time, due to a still lower share of the deficit / debt to GDP ratio. In other words, the indicators degradation occurred in time, and was imperceptible for a while.

An overview of the performances of different states (EU and others) in recent decades reveals that roughly governments have not obtained "profit" for a long time (Garello, Spassova 2006, p. 7). Even in years when the sovereign debt / GDP ratio declined in comparison to the previous year, sovereign debt in absolute value continued to grow. In this context, many of the commitments made in the traditional way by states, such as those in the field of social protection, have become increasingly difficult to meet. In the early 2000s, during the period preceding the crisis, some countries have managed to reduce the sovereign debt to GDP ratio (Spain is a good example; the country managed to achieve an economic growth above the EU average), but in general the indicator exceeded 50-60% for most economies. The decreasing trend of the Debt to GDP ratio is clear, as shown in Figure 1.

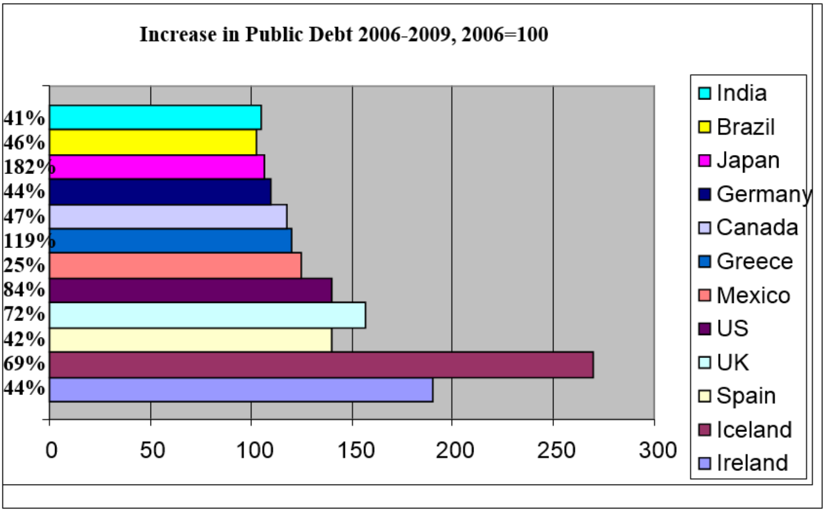
It is clear, therefore, that at the beginning of the global financial crisis the different countries of the world were largely indebted, the problem being one of a structural nature, and the various commitments (Stability and Growth Pact in the EU, the Maastricht Treaty, and others) had lost the initially established significance.

Figure 1: Sovereign debt trend before the economic and financial crisis (% of GDP) – selected states



Source: Author's calculations, using data from World Bank.

Figure 2: Public debt growth during the Crisis (selected states)



Source: Author's calculations, using data from IMF, *World Economic Outlook*, 2012, Reinhart & Rogoff (2010), World Bank.

After 2008, however, governments were placed in an even more difficult situation. The collapse of private indebtedness and demand led to a significant degradation of budget balances; already indebted, with uncertain growth prospects, many countries have become, as emphasized several authors (Brender, Pisani, Gagna, 2013, p. 3), unable to maintain a significant budget deficit without endanger the solvency.

The collapse of the private actors' appetite for debt was proportional to the propensity towards it before the crisis; in the EU, for example, it was significant in Ireland and less evident in Germany. Lending was quasi-stopped, private saving exploded and deflationary effects became imminent.

Of course, to eliminate borrowing in such a situation would have been harmful to the stimulation of economic activity; therefore, governments have borrowed even more. From this perspective, it becomes increasingly important to discuss about the sovereign debt sustainability.

In Europe, the situation is extremely is delicate, primarily due to the special architecture of the European Union – we are not dealing with a state or a federation, but with Member States that are sovereign and independent, but nevertheless transferring significant powers from the national to the supranational level. So, the problems of a member state (Greece, for example, although it is not the only European country in a delicate situation) seriously put in discussion the opportunity of solidarity (especially financial one) between union member states. In the same time, spillover effects have been there, and the sovereign debt crisis is a European one, first of all; the PIIGS episode can be also mentioned here. Some voices repeatedly highlighted the idea of a Euro currency crisis; however, we believe that it is not a crisis of the Euro currency, but one generated by the behavior of national governments. The European currency has proved – during its existence – to be viable, well received by the international markets, a stable currency, widely used internationally – in other words, all of the attributes of a successful currency.

After 2008, supporting demand involved extensive budgetary measures, in most countries of the world, as we outlined above. Even so, the recession could not be avoided, and the 2007 activity level was reached only in 2012-2013. These measures, however, significantly affected the budget deficits; we can talk here about the side effects of the economic recovery plans, the increased public spending (for social purposes, for example), the significant reduction of fiscal revenues, the lower GDP.

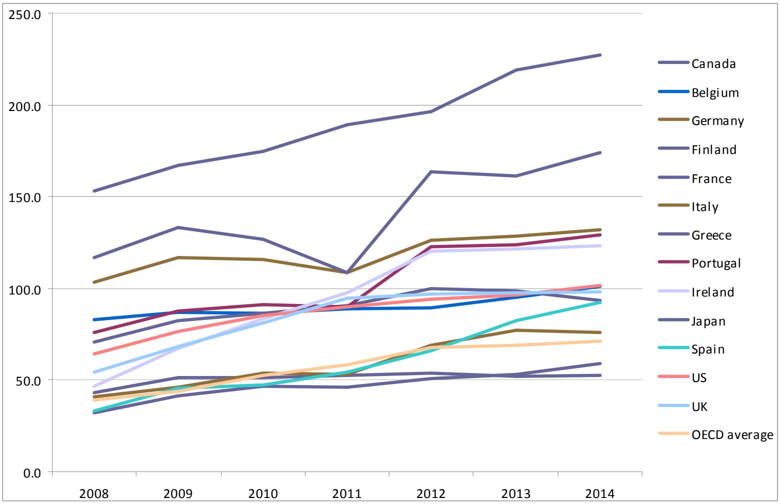
Undoubtedly, the economic recovery measures taken have had considerable effects, and succeeded in part to eliminate, at least in the short term, the negative effects of the recession. In the medium and long term, consequences are however difficult to predict. Some analysts talk about some contradictory effects (Banque de France, 2012, p. 12), for example in the case of households. If in a crisis situation households face a shortness of credit, and therefore are unable to modulate their consumption over time, they will tend to immediately consume the additional revenues provided by the budgetary re-launch, thereby enhancing their efficiency; at the same time, however, if a future tax increase is expected, in order to finance deficits, households will save a substantial part of the additional revenue generated by the re-launching policy, reducing the magnitude of the expected effects.

Another set of government interventions made in recent years aimed to assist the banking sector, through state guarantees, capital injections, and other actions.

All these developments have marked significant changes of sovereign risk indicators, which we will summarize in the table below. For OECD countries, the public debt problem turns out to be extremely serious; after the crisis, the true extent of the developed countries indebtedness was highlighted by a drastic decrease in budget revenues.

For some countries, this will be extremely difficult to manage politically and socially, as it requires important decisions concerning the reallocation of national income, subject already delicate due to the effects of the crisis; and, as we all know, the political element is strongly influenced by social reactions.

Figure 3: Sovereign Debt evolution after the Crisis, selected states (percentage of GDP)



Source: Author's calculations, using data from World Bank, www.tradingeconomics.com.

Table 1: Governmental Debt evolution, selected states (% of GDP)

	2008	2009	2010	2011	2012	2013	2014
Canada	43.0	51.3	51.5	52.5	53.5	51.9	52.3
Germany	41.0	46.0	53.7	53.3	69.0	77.0	76.0
Finland	31.9	41.2	47.0	45.9	51.0	53.2	59.0
France	70.9	82.6	86.4	90.6	100.1	99.0	93.6
Italy	103.4	117.1	115.9	108.9	126.2	128.5	132.1
Greece	116.8	133.2	127.0	108.7	163.5	161.0	174.0
Portugal	75.9	87.9	91.4	90.2	122.8	124.1	129.0
Ireland	46.8	67.0	83.7	97.8	120.5	121.7	123.3
Japan	153.0	166.8	174.7	189.5	196.0	218.8	227.0
Spain	33.5	45.5	47.1	54.6	66.0	82.4	92.1
US	64.0	76.3	85.5	90.2	94.3	96.2	101.5
UK	54.3	68.6	81.2	94.6	97.2	97.5	98.2
OECD average	39.4	44.1	52.6	58.2	67.9	69.0	71.3

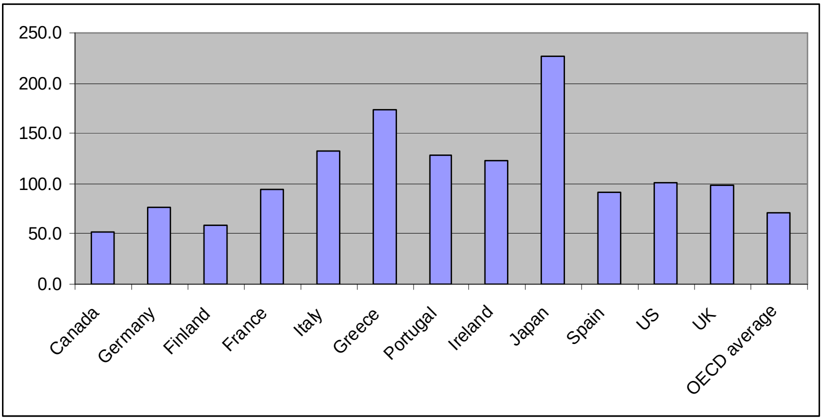
Source: Author's calculations, using data from World Bank, www.tradingeconomics.com.

As we pointed out above, budget deficits have increased significantly, especially in the case of developed countries, in the context of a large propensity of private agents to save.

The developed countries were already facing for quite a while high debt levels, unlike the emerging countries, where sovereign debt ratio to GDP was, before the crisis, somewhere below 50%.

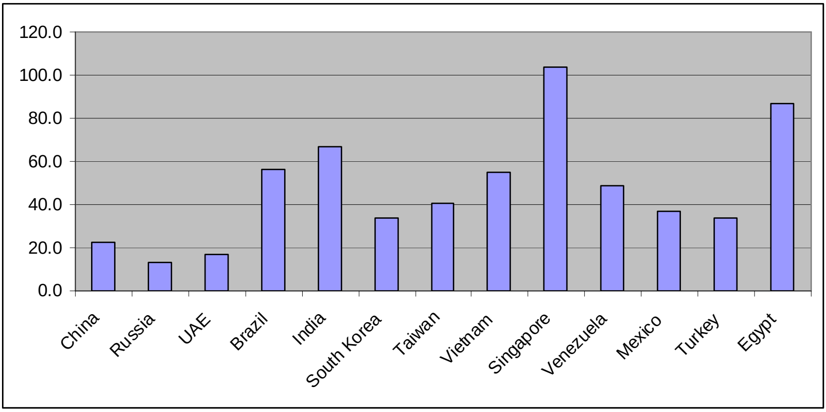
To all these realities we can add the fact that growth prospects of emerging areas are more favourable than those of the developed states; the latter have nowadays lower and lower advantages (even in terms of productivity), and social policy costs remain high.

Figure 4: Sovereign Debt to GDP (%) – 2014, developed states



Source: Author’s calculations, using data from World Bank, www.tradingeconomics.com.

Figure 5: Sovereign Debt to GDP (%) – 2014, emerging states



Source: Author's calculations, using data from World Bank, www.tradingeconomics.com.

3. Sovereign Debt – some important implications

The current economic context, of excessive debt, often puts sovereign debt in a very bad light. As a consequence, the concept is often considered to be extremely negative. In our opinion, such a view is superficial and does not reflect reality. Sovereign debt should exist, and its place and role are well established.

First of all, sovereign debt allows states funding, while a budgetary imbalance is often recorded. Of course, it is essential in this context that the funding can provide economic growth, so that the debt repayment can be achieved without major problems. Also, we emphasize here that the debt to GDP ratio should remain stable over time, a fact unfortunately often contradicted by practice. The upward trend has been a very significant one; of course, sometimes this evolution is fully justified, but many exceptions are recorded; as emphasized by some authors (Landau, 2012, p. 214), it is normal for future generations to pay for infrastructure or technology now requiring massive investment in research and development, but it is at least incorrect for descendants to pay for the current public consumption, for example.

Sovereign debt often takes the form of bonds issued by states. From this point of view, we are dealing with assets, often very appreciated by investors. For many decades, these assets were considered as risk free. Currently, however, sovereign risk can not be ignored, even if states maintain their ability to increase taxation or to issue currency (the limits are increasingly apparent in this context – for example, the situation of countries that are part of an economic and monetary union). A function of sovereign debt associated to sovereign bonds is storing value – we can speak about a sovereign debt market, with often surprising developments, with more or less liquid areas, depending on the characteristics of states, their economic performance, or even rating.

States must always take into account the preferences of private actors in this regard, the issues being related to public preferences for different maturities (Turner, 2011, p. 74).

One thing appears to be obvious, however, the lack of financial assets with high liquidity and low associated risk. And this, while the demand for such assets is increasing. But, sovereign debt really is a low risk asset, as seen for a long time? And most importantly, how it will be in the future? Developed countries are still characterized by a high solvency? What influence will have the budgetary discipline, so necessary today, on sovereign bonds issues? Here are some questions that will have to find clear answers in the near future.

The evolution of sovereign debt is obvious, its increase during last years is significant, both for developed and developing countries. Of course, the sovereign debt has evolved differently from country to country, from region to region, but the remark can be considered as a general one. But not the debt itself is that we consider the most concerning, but rather debt sustainability.

We can also notice that the developed countries took advantage of the low interest rates available for them, and this practice contributed to the accumulation of debt. Of course, we will not say here that indebtedness is synonymous with a total lack of government responsibility, but we believe that economic theory recommending state intervention in order to stimulate growth was not the only one behind these decisions. Several authors even talk about a political, electoral connotation of indebtedness (Garello, Spassova, 2011, p. 25).

Analysts talk more and more about the bankruptcy of a state nowadays, although technically this is relatively unlikely, given the *sovereign status* of the debtor. What really interests us is the risk of default; is debt sustainable or not, and will it be followed by default – or, in some cases, restructuring or moratorium.

As stressed by many economists, such as Jean-Pierre Landau (Landau, 2012, p. 16), most often the economic literature is search for a categorical answer to the question of sustainability – the debt is sustainable or not. In practice things are much more complicated, and even influenced by political factors – the states attitude towards markets (governments are "market friendly" or not / the "willingness to pay" matter).

Often, debt indicators (most notably the total external debt / GDP) are used to determine thresholds of indebtedness, thresholds above which default becomes imminent. This practice is extremely useful, and we made such exercises in other works, but we would like to point out here the limits of such an analysis. World states behave very differently, and a given level of debt can be perfectly sustainable in one state, and totally unsustainable in another. Economic history has recorded situations where states having a level of the sovereign debt / GDP ratio of more than 200% continued to repay their debt, while others went into default at 30-50% or even less.

Relative to the sustainability of sovereign debt and sovereign debt implications, we can make several remarks:

- If the debt level is extremely high, some psychological effects are emerging – the reaction of investors to rumors or bad news is disproportionate, and *modest shocks can generate a crisis* (Escolano, 2010, p.10);
- The point from which debt becomes unsustainable varies from borrower to borrower; indebtedness thresholds vary from country to country; however, we should remember the Reinhart and Rogoff idea: a Debt / GDP ratio of over 90% suggests signifiant negative effects on growth;
- There are also studies with surprising conclusions (Checherita, Rother, 2010), that identify an inverse relation between debt and growth, and a negative relation between public debt and private savings rate;
- Sustainability is favourably influenced by stability, in the sense that it is desirable that the debt-to-GDP ratio remains constant; if sovereign debt grows with the same rhythm as incomes, and the interest rate remains constant, the state can service its debt; a problem would arise when economic

growth falls and the interest rate does not decrease at the same rate;

- Sovereign debt sustainability is overwhelmingly influenced by the economic policies; we can give some examples in this context – a state that encourages exports and international trade in general will increase its chances to repay smoothly, especially if indebted in foreign currency; also, policies concerning the control public finances, in order to eliminate budgetary drifts and a clear expression of the desire for debt repayment will positively influence credibility and sovereign rating;
- Indebtedness can generate inflation, which often can result in a partial resolution of the problem;
- Growth prospects are essential when talking about sustainability – a state with significant economic growth has all the prerequisites for a refund without problems, but at the same time, indebtedness may affect growth, as evidenced by several recent studies that converge towards stating that the negative effects on economic growth increase when the sovereign debt is approaching 100% of GDP (Reinhart, Rogoff, 2010, p. 23); as shown in the table and graphs below, heavily indebted states and those that are generally recording lower rates of growth:

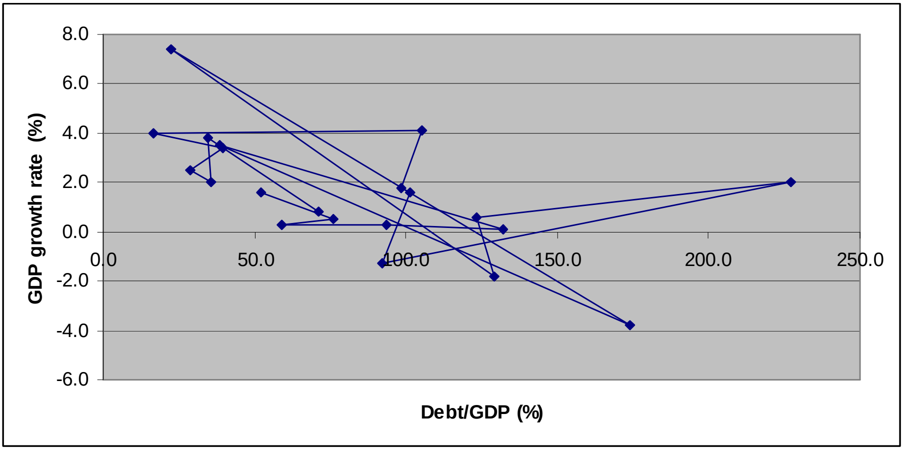
Table 2: Economic growth rate and Debt/GDP ratio (selected countries), 2014

	Sov. debt/GDP (%)	**Economic growth rate (%)**
Germany	76.0	0.5
Finland	59.0	0.3
France	93.6	0.3
Italy	132.1	0.1
Romania	38.4	3.5
Greece	174.0	-3.8
Canada	52.3	1.6
China	22.4	7.4
Portugal	129.0	-1.8
Ireland	123.3	0.6

Japan	227.0	2.0
Spain	92.1	-1.3
US	101.5	1.6
UK	98.2	1.8
Singapore	105.5	4.1
UAE	16.7	4.0
Lithuania	39.4	3.4
Australia	28.6	2.5
Switzerland	35.4	2.0
Turkey	34.8	3.8
OECD average	71.3	0.8

Source: Author's calculations, using data from Eurostat, World Bank, www.tradingeconomics.com.

Figure 6: Sovereign Debt and GDP Growth (2014), selected countries



Source: Author's calculations, using data from Eurostat, World Bank, www.tradingeconomics.com.

4. Sovereign debt and rating

Ratings aimed at assessing country risk are now becoming indispensable tools for the various actors in the financial markets. They are also one of the main forms of sovereign risk examination. Ratings are published by various bodies (rating agencies and not only – Standard and

Poor's, Fitch, Moody's, and many others), having the fundamental role of measuring insolvency risk related to sovereign bonds.

A specific attribute of ratings is synthesizing risk (Meunier, Sollogoub, 2005). Its importance is given mainly by the fact that operators on different markets feel the need to quickly assess risks using a global measure in order to take appropriate decisions, as soon as possible. The essence of the approach lies in bringing in only one dimension a relatively complex reality.

Of course, the discussion on the rating should be the subject of a separate paper. However, we emphasize here that the rating has some limitations, primarily because of the fact that it is too simplistic.

A cautious analyst will always be skeptical about the rating process conducted within the agencies, mainly due to lack of transparency, the fact that the processes are not explicit (Guessom, 2004). In the same time, the ratings convergence represents a problem in itself, and, from this point of view, a comparative analysis of the methodologies is always welcomed.

We can list here some limits of sovereign rating:

- The choice of criteria and weightings used may be subjective – their optimal character can always be questioned;

- The advantage of the synthetic character can become a weakness due to the too high degree of generality of the analysis;

- The static nature of the ratings and the factors used therein; hence the need to continuously adapt the criteria, to modify the criteria according to the evolution of society;

- The assessment of especially the macroeconomic and financial components of sovereign risk, the market specificities being thus neglected;

- The issue of trust and lack of regulation; however we believe that over-regulation in this context is not a solution, but rather the development of a critical thinking of the rating users; they must be able to adapt information provided by rating agencies to their own interests;

- Conflicts with policymakers (the Australian State case back in 1986, the sovereign debt crisis, and many other examples);

- The issues concerning the limited independence of the analysts working in the agencies;

- The lack of transparency and subjectivity of the scoring process;

- The problem of the moral responsibility towards the client who pays to be noted; agencies are paid by the issuers of securities, which can question their independence;

- No penalties for errors;
- The rating inertia – a crisis always reinforces the conviction of major faults in a system functioning (Bouchet, Clark, Groslambert, 2003);
- The high concentration in the rating market (quasi-duopoly Standard & Poor's – Moody's);
- The strong effects on markets evolution (pro-cyclicality of ratings) and the question of good faith.

5. Concluding remarks

Sovereign debt is undoubtedly a problem for most countries of the world. However, we should not confuse it with private debt; its character is special for several reasons. First, a state is sovereign; this means that, unlike private businesses, for example, which can not know if the investment that causes their indebtedness is appropriate, the state can estimate its future revenues. The state can also increase taxation (in this way it could even give up debt, at least in theory, but the electoral reasons cancel the justification for such a scenario), can print money, and perhaps even require some institutions to buy government bonds. Of course, we do not recommend these practices, each in turn having adverse consequences.

As highlighted in some recent books (Brender, Pisani, Gagna, 2013), studies (Minea, Parent, 2012) or papers (Reinhart, Rogoff, 2010), the level of debt from which onwards there is an imminent danger of default is difficult to identify and, on the other hand, impossible to generalize. More suitable is to set thresholds above which sovereign debt implies adverse consequences of economic life; from this point of view, most of the papers identify an alert threshold around 90-95% of GDP. Above this value, growth seems to be difficult, if not impossible, to achieve.

The current situation, the sovereign debt crisis, is not a disaster in itself. Rather, it is a warning, a lesson to be learned and well understood, than can definitely serve to improve governance. Surprisingly, the excess of debt seems to affect more developed countries. Governance is, in this context – today more than ever – put under scrutiny. Sovereign debt sustainability depends largely on economic policies and measures taken by the authorities. Of course, there are a number of external factors, but their influence is not overwhelming.

Regarding the outlook for sovereign debt, we will make the following remarks, not without leaving room for further studies and conclusions:

- The sovereign debt issue is not new, the recent crisis has only intensified it;
- The will of authorities to repay must be well outlined, in order to restore confidence;
- The purchase of securities by central banks (see the case of the ECB) should not take away them from the traditional objectives; of course, such practices are sometimes welcome, counteracting the liquidity crises, deflation, or *carrying out the monetization ensuring the solvency of the sovereign issuer* (Landau; 2012, 219);
- Ensuring economic growth on different channels, as well as the intensification of international trade and exports in particular can have positive effects on the sustainability; recording some outstanding economic results helps maintaining sustainability even in a context of massive debt;
- The use of ratings should be done with care, in order to avoid misinterpretations; the subjectivity, the conflict of interests or even the error can be associated with the activity of rating agencies, despite their notoriety;
- The need for a better control of public spending, which has exploded in recent years, exceeding for many countries the growth rate of GDP; as we have seen in recent years, the cost of financing sovereign debt is rapidly increased by the degradation of the state public finances; it is therefore necessary that the countries of the world, especially developed ones, rebalance their budgets;
- Orienting a more significant fraction of debt towards investment, given that very often states are borrowing in order to ensure current expenses or to repay older debts; it is also obvious the need to increase public investment profitability, and, why not, to question the role of the state in the economy.
- The need for a better coordination between countries in terms of adopted policies, and the need for economic growth.

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