Global Sovereign Risk Threatens Economic Recovery Process

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The worst of the world financial crisis since 2007 may have passed, but the global economy in 2010 is increasingly wary of high levels of government borrowing.

In some cases, such as Greece and Dubai, emergency action was needed to avoid governments defaulting on loan repayments while sovereign risk remains a serious concern in many countries.

Resulting government austerity measures from 2010 will affect consumers and businesses, most directly in advanced economies but with knock-on effects.

Key points
* Sovereign risk is a broad term that refers to the danger of a government being unable to meet its financial commitments. It is most commonly related to state debt, but can also include, for instance, the risk of default on contracts that private-sector companies have entered into with the government, and unexpected changes in government legislation that can affect the business environment;

* Perceptions of sovereign risk are vital because they affect the cost at which governments can borrow, and reflect confidence in the business environment. The economic and financial crisis since 2007 has sharply raised sovereign risk worldwide because most governments had tax revenues fall but expenditure rise;

* Some governments, such as those in Greece, Iceland or the emirate of Dubai, have effectively had to restructure their state debt and take bailout funds from other countries or entities in order to avoid default;

* Advanced economies had the highest ratios of public debt-to-GDP in 2009 in the world, with the worst of the major economies being Japan (183.8%), Italy (115.2%), Greece (113.3%) and Singapore (113.1%).

Some regional governments also have high borrowing: the US state of California, according to some industry estimates, had debt (including pension deficits) of around 37% of its economic output in 2009;

* High sovereign risk and borrowing is affecting the business environment and consumers. Many governments are imposing sharp cutbacks on spending: for instance reducing welfare benefits, raising taxes and freezing public-sector recruitment or salaries.

These are likely to mostly affect advanced economies, whereas emerging countries have lower sovereign risk levels due to more dynamic economic growth, which has generated high current account balances and government revenues. However, higher interest rates still pose a risk to emerging market debt.

Advanced economies are most at risk
* Advanced economies have the highest levels of borrowing and debt in the world, placing them most at risk. In 2009, for instance, the Greek general government borrowed the equivalent of 12.9% of GDP, with the USA borrowing 12.5% of GDP and Spain 11.4% of GDP, according to the IMF.

Lending helped fund economic stimulus measures and service existing debts which, in the case of Greece, resulted from a long period of structural imbalance in government finances, made worse by financial mis-reporting and poor tax collection;

* Advanced economies suffer from a number of problems, such as an ageing population that places heavy burdens on state pensions; less dynamic economic growth; and since 2007 significant expenditure on economic stimulus packages and bailouts to avoid collapse in the banking industry amid the global financial crisis.

These also affect some emerging economies such as those on the edge of the eurozone, for instance Latvia or Romania, which have high public borrowing;

* Countries with more reliable sources of government revenues, such as oil or other commodities, have lower levels of sovereign risk, even though they may still have public debt. Norway, for instance, was a net lender in 2009 (9.7% of GDP). These countries are able to borrow money at lower rates because their financial position is stronger;

* Major emerging economies have lower sovereign risk and public debt levels as they are perceived to have more dynamic economic growth prospects and a lighter welfare burden. China had public debt of 12.4% of GDP in 2009 and South Africa had 21.7% of GDP.

These advantages place government finances in a stronger position even though some countries such as Argentina or Russia have had default problems in the past. Higher interest rates pose a risk to emerging economy debt levels in the medium-term.

Rising public debt

* Iceland and Latvia have seen amongst the biggest rises in public debt in the world (as a percentage of GDP) since the global financial crisis. Latvia's public debt rose from 9.0% of GDP in 2007 to 39.3% in 2009, while Iceland's public debt jumped from 23.9% of GDP in 2007 to 76.9% in 2009 due to a banking and financial crisis;

* Public debt in the USA also increased sharply from 36.5% of GDP in 2007 to 54.8% in 2009 due to the financial and economic downturn, which hit tax revenues and placed major burdens on expenditure through state-led stimulus programmes and bailouts;

* China's public debt overall has fallen since 2004, when it was 18.5% of GDP, to 12.4% of GDP in 2009. China also has the world's largest foreign exchange reserves, at US$2.4 trillion in 2009, meaning it is well placed to avoid sovereign debt problems;

* A high government debt does not necessarily imply a greater risk of default. Lebanon, for instance, has consistently run public debt of over 100% of GDP (in 2009 it was estimated at 147.0% of GDP according to national statistics) but has never defaulted on a loan.

Implications of sovereign risk

* Governments with high sovereign risk are less appealing as business customers (and a drawback to the overall business environment) because they are perceived as risking default. Risk is rising in countries which are altering legislation to generate higher government revenues;

* Perceptions of sovereign risk affect currency values of individual countries or blocs. Fears over government debt levels in the eurozone, for example, caused the euro's value to fall from US$1.51 in December 2009 to US$1.20 in early June 2010.

This has benefits and drawbacks for companies in different parts of the world, but in general, currency volatility is considered to be negative;

* Lower state spending in advanced economies, as governments try to repair their finances, means fewer public sector contract opportunities. This will directly affect many companies and will lead to rising unemployment;

* More cautious consumer attitudes amid government austerity measures will lead to lower expenditure. In Spain, for instance, consumer expenditure fell by 5.1% in real terms in 2009 whereas it rose by 12.0% in Libya in the same period.

This is affecting advanced economies more than emerging ones: Portugal, for instance raised VAT and income tax in April-May 2010, which will hit consumer spending power;

* Previous examples of countries defaulting include Argentina in 2001-2002. This had a major impact on businesses as foreign investment dried up and large amounts of capital left the country, meaning local companies found it difficult to get bank financing and the currency was devalued;

* Similarly, the impact in Greece in 2010 has been severe. The country has been afflicted by strikes, which have paralysed the business environment. It has also spilled over into violence and protests against the EU/IMF bailout;

* Ratings agencies play a critical role because they assess the risk levels of government issued debt or bonds, affecting the market value of this debt and, in wider terms, confidence in that business environment.

Their role has become controversial because they wield a great deal of power: by downgrading government debt, this effectively forces governments to take more stringent spending cuts in order to convince agencies that they can improve their financial positions.

Wider implications

* Higher public debt in advanced economies is creating a shift in financial power towards emerging, dynamic economies such as China, India and major commodity producers such as Saudi Arabia.

These countries often own much of the advanced economies' debt: China, for instance, directly holds US$755 billion of US state debt and is thought to be the single-largest owner of US debt;

* Lower financial resources for governments in advanced economies will also curtail spending on areas such as defence. Over the longer term, this may reduce the strategic power of advanced economies at the expense of emerging economies who have the financial resources to play a stronger global strategic role;

* Worries over sovereign debt have prompted investors to move money out of riskier forms of trading such as stock markets or currency exchange, into assets such as gold or the US dollar, which are perceived as 'safe havens'. The price of gold (in US$ per oz) increased by 9.7% between 10th December 2009 and 10th June 2010;

* Changes to the business environment in advanced economies may prompt companies and investors to focus on opportunities in developing economies, even though other forms of risk such as political instability may be higher there. Annual disposable incomes per capita in China are forecast to rise by 9.2% in annual average real terms over 2009-2012, against just 1.4% in Japan.

Prospects
Global real GDP growth is forecast to be 4.6% in 2010 and 4.3% in 2011, according to IMF revisions, but this could be lower if sovereign debt problems trigger a 'double-dip recession', particularly in advanced economies.
Generally, growth in the more mature regions will be less dynamic than in less mature ones: real GDP growth in developed countries is expected to be 2.6% in 2010 compared to 6.8% in emerging and developing countries.

Many countries are undertaking large-scale restructuring and spending cuts in order to address debt. European countries such as Italy, Portugal and Spain have all announced public-sector pay and recruitment freezes in 2010, or are cutting spending on education or welfare. Many, including France, plan to raise the retirement age.
Austerity measures will weigh on economic growth potential into the medium-term as consumers and businesses are affected.

It is unlikely that a major economy would default on its payments, but further downgrades are expected in ratings of some high-risk economies such as Hungary or Spain.

Sovereign risk is likely to remain high in the short-term, particularly given the possibility of legislative and fiscal changes to raise government revenues, prompting cautious approaches amongst investors and consumers.

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