The Sovereign Crisis: When Debt is No Longer Risk Free

Lawrence Goodman
President

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Key Themes -- Distortion

- **Policy matters.** Advanced economies now embody traits of emerging markets.
- **Prioritize future growth in Europe** via a three-pronged strategy to reduce debt, remove the threat of contagion, and limit the use of official resources.
- **The appetite for Treasury debt is weakening.** The refunding of US Treasury debt presents an equal challenge to the oft-discussed budget deficits. Fiscal policy is poorly understood in the US.
- **The role of the US dollar as a reserve currency** is changing.
- **Sovereign debt is no longer risk free even in the US** - despite low yields.

Contents

I. The Global Economy and Policy Distortions

Spectrum of Fundamental Drivers:
Why Advanced Economies look more like Emerging Markets.

Advanced Economies | Middle Income Emerging Markets | Fragile States

More strictly **_ECONOMIC_** analysis

More strictly **_POLITICAL_** analysis

Economics

Politics

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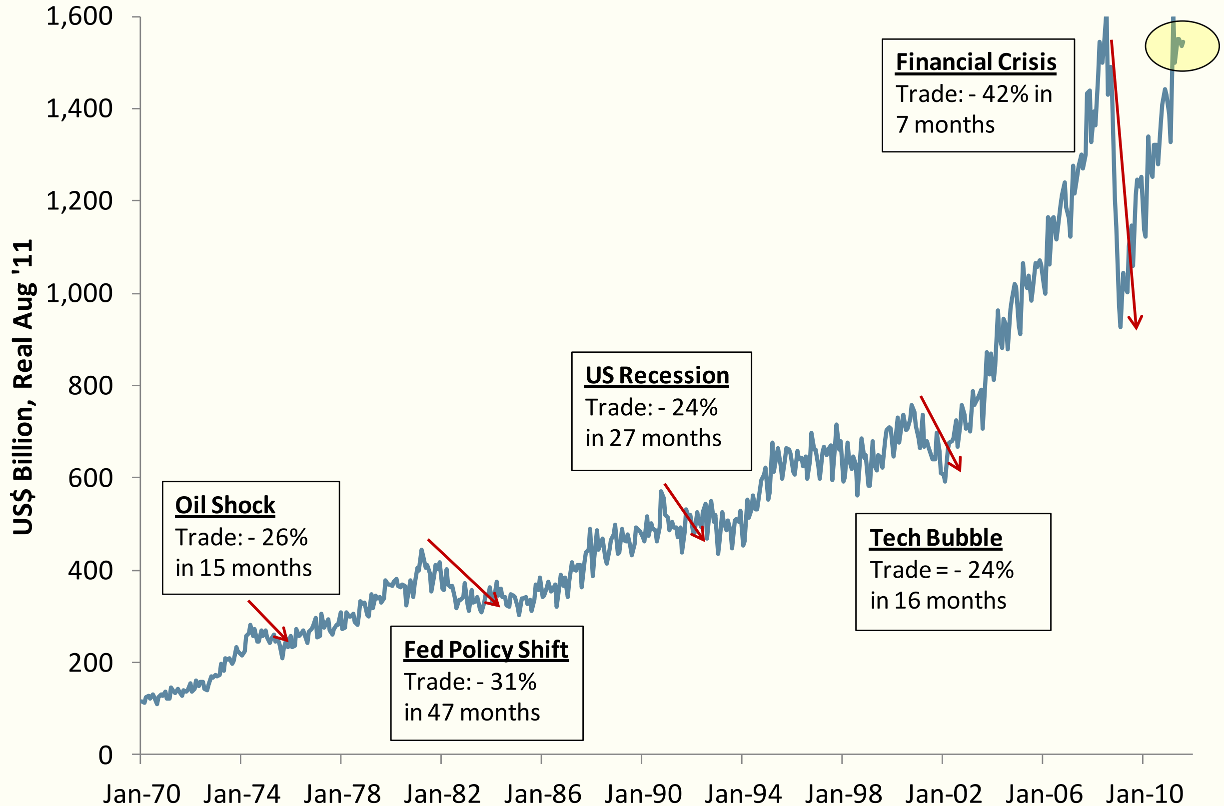
World Trade: Extreme Policy Response limits Duration of Recession…*Distortions Remain*



Source: IMF Direction of Trade Statistics and Center for Financial Stability .

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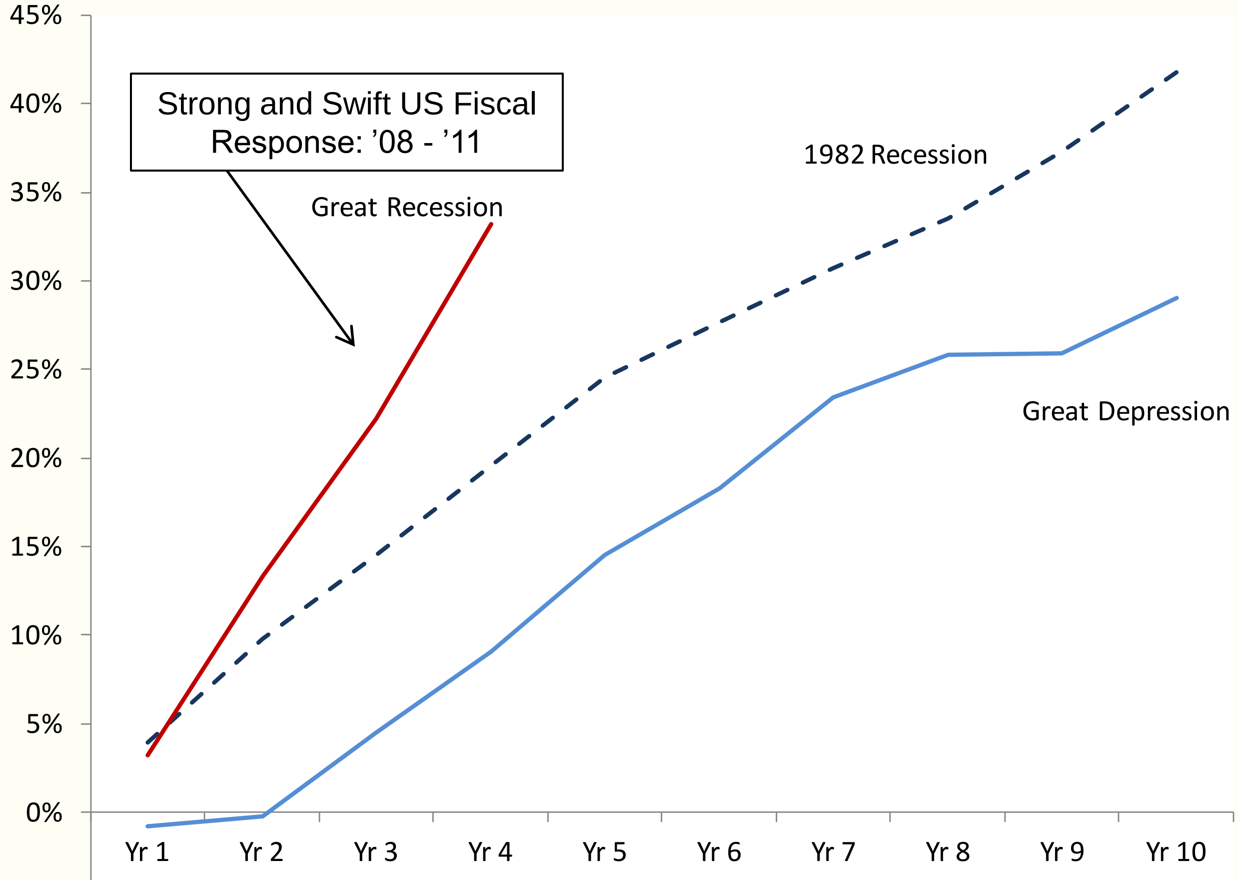
Cumulative Deficits in Deep Downturns, % of GDP



Source: Office of Management and Budget, Historical Financial Statistics and Center for Financial Stability .

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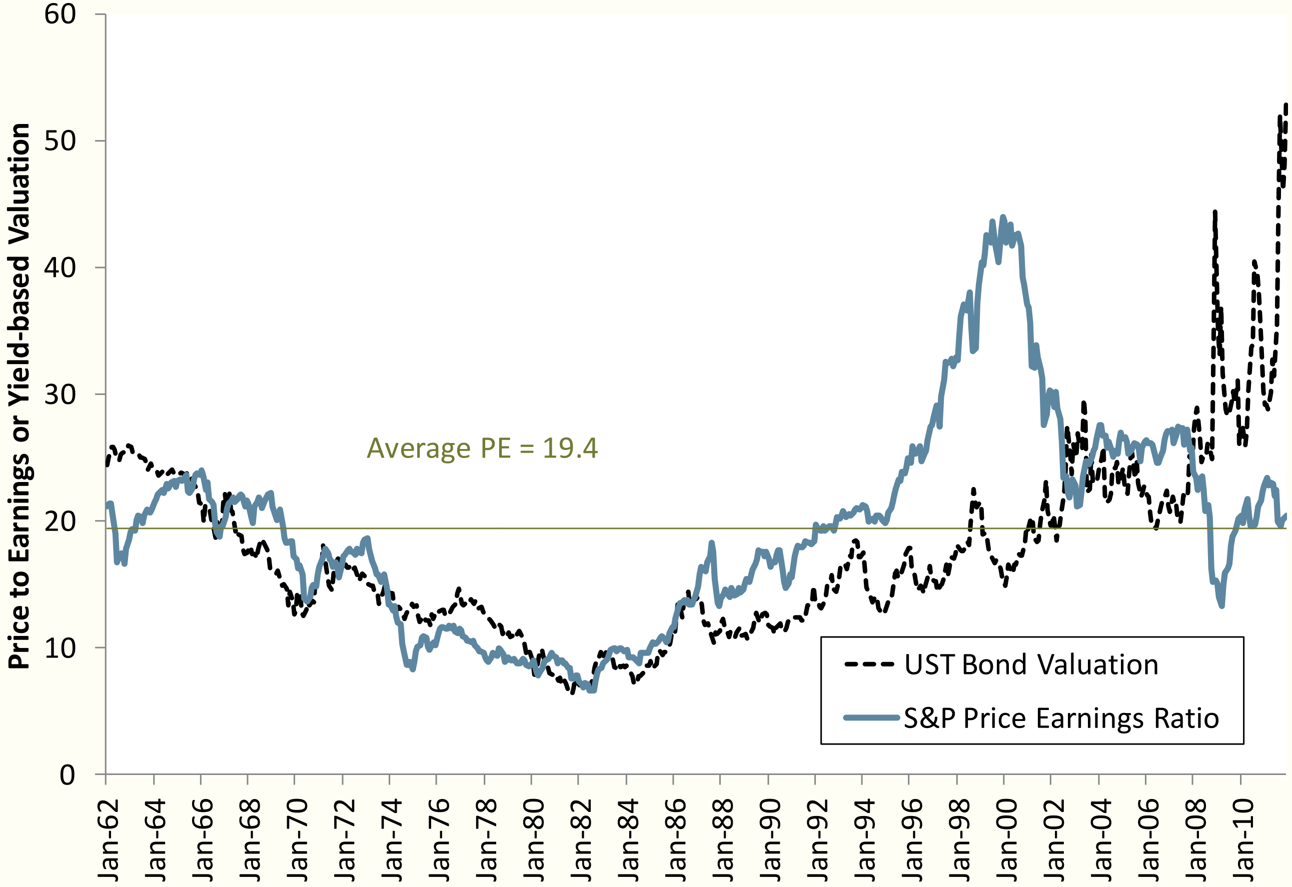
Policy Distortions Influence Financial Markets



Source: Datastream, Robert Shiller (Yale University), and Center for Financial Stability .

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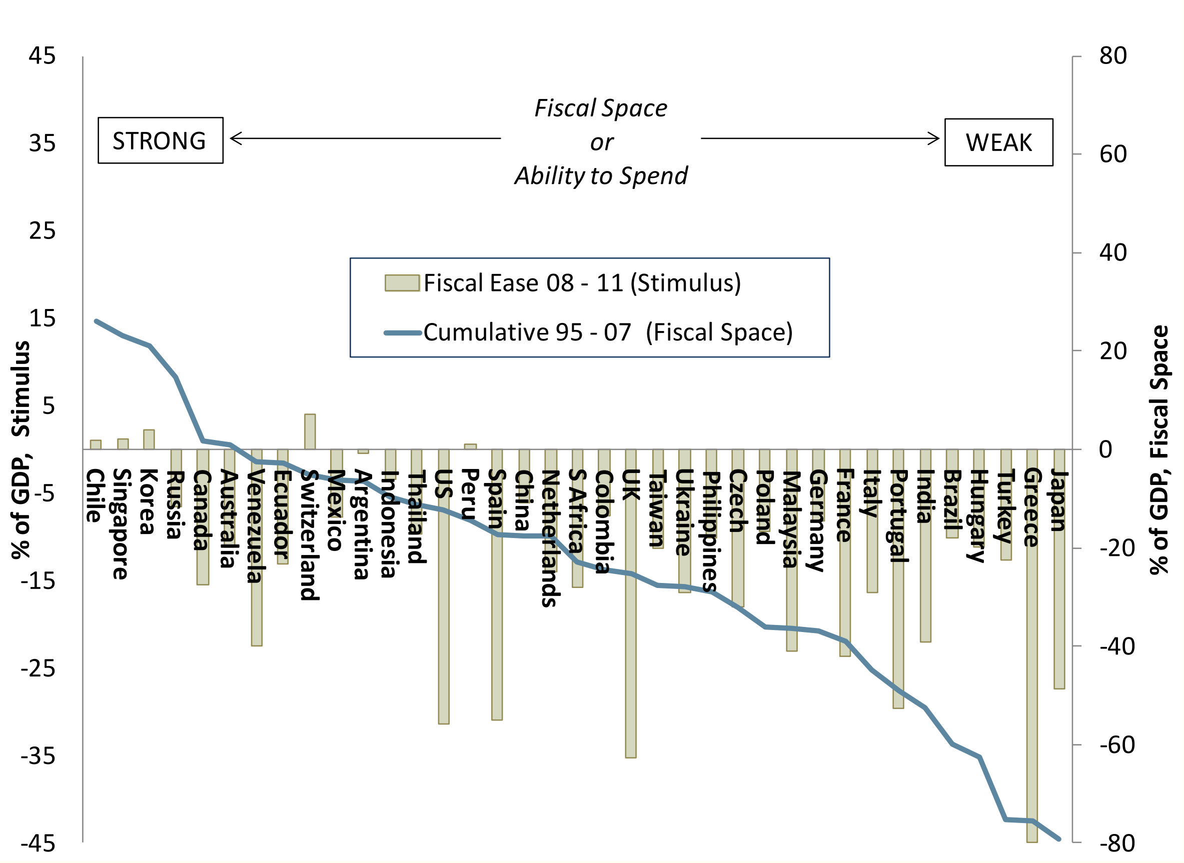
Fiscal Stimulus and Capacity to Expand



Source: Datastream and Center for Financial Stability.

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II. The European Sovereign Debt Crisis: A Way Out

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Debt Restructuring: The Way Forward

The Economic Subcommittee (ESC) to Bank Advisory Committees during the Brady Debt restructuring era provides a blueprint for:

1) identifying common ground for the benefit of creditors and debtors alike and

2) paving the way for **future** growth.

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New Strategy: Financial Program

Substitute Math for Rhetoric: Lessons from Emerging Markets

Economics - restoring growth for a long-term solution,

Finance - identifying sustainable levels of debt and potentially needed support for banks. **Mobilize sovereign and private balance sheets.**

Official Institutions - highlighting available official resources to support and ensure implementation of a successful program.

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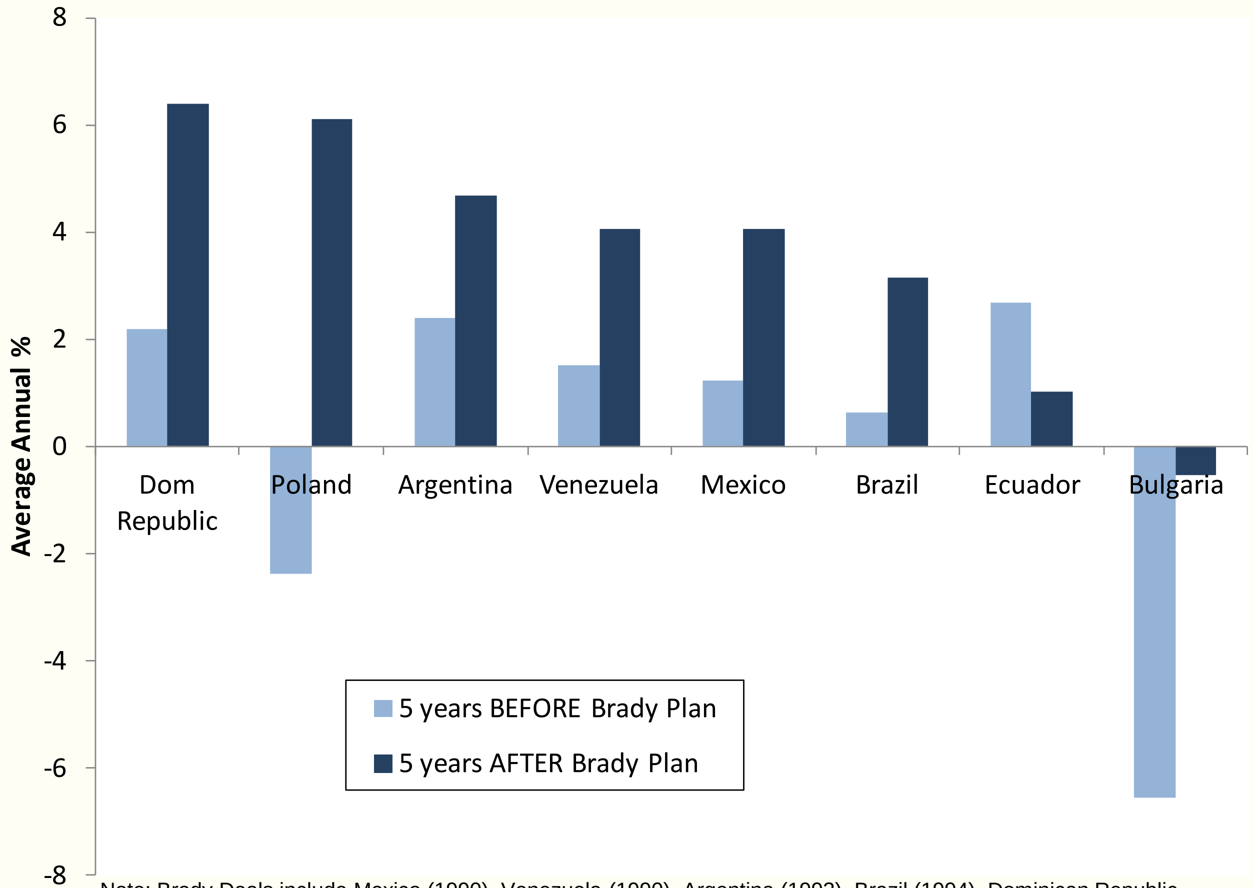
Economic Growth Improvement Post Debt Reduction



Note: Brady Deals include Mexico (1990), Venezuela (1990), Argentina (1993), Brazil (1994), Dominican Republic (1994), Bulgaria (1994), Poland (1994), and Ecuador (1995).
Source: Datastream, IMF and Center for Financial Stability.

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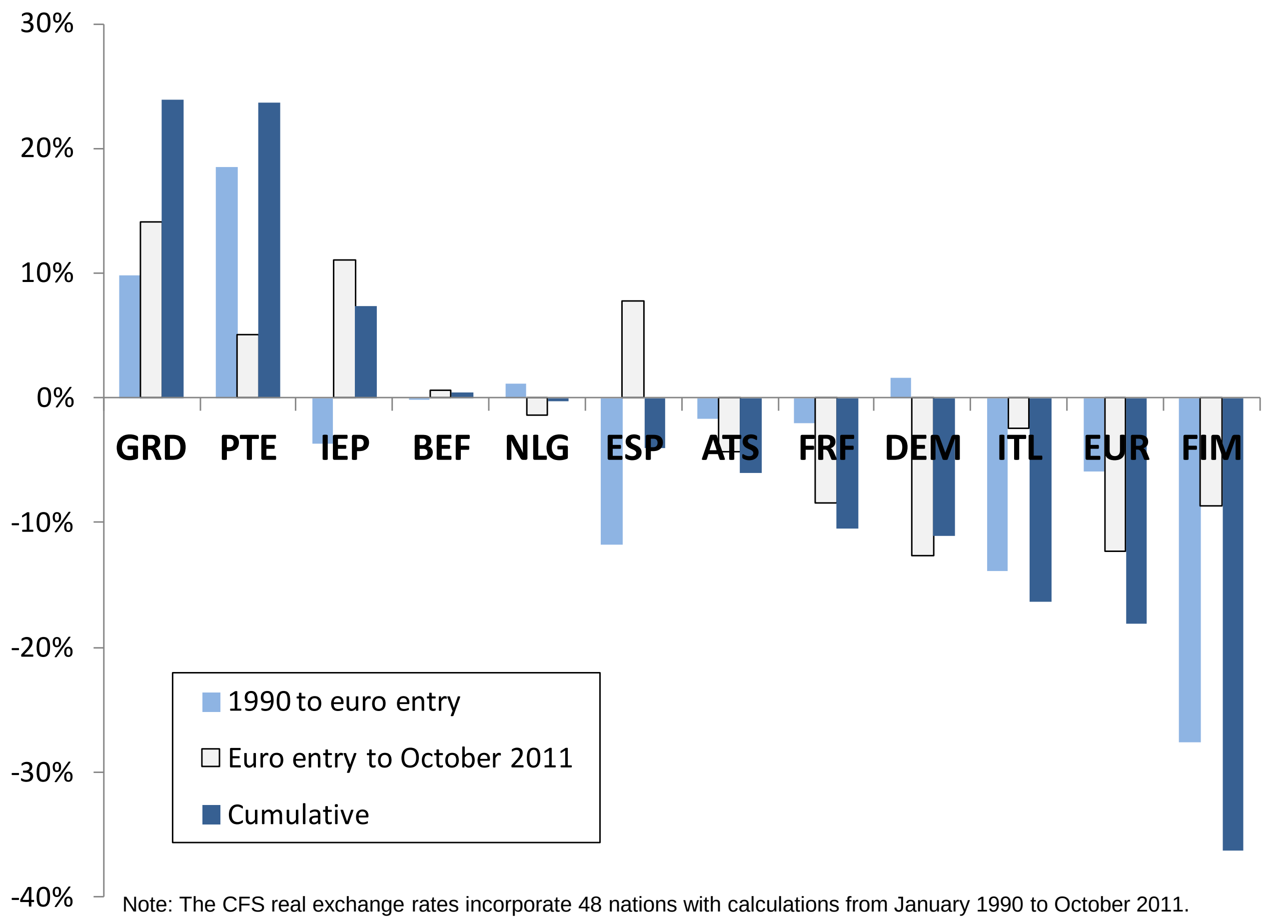
Component Currency Strains in the Euro

Real Appreciation / Overvaluation

Real Depreciation / Undervaluation



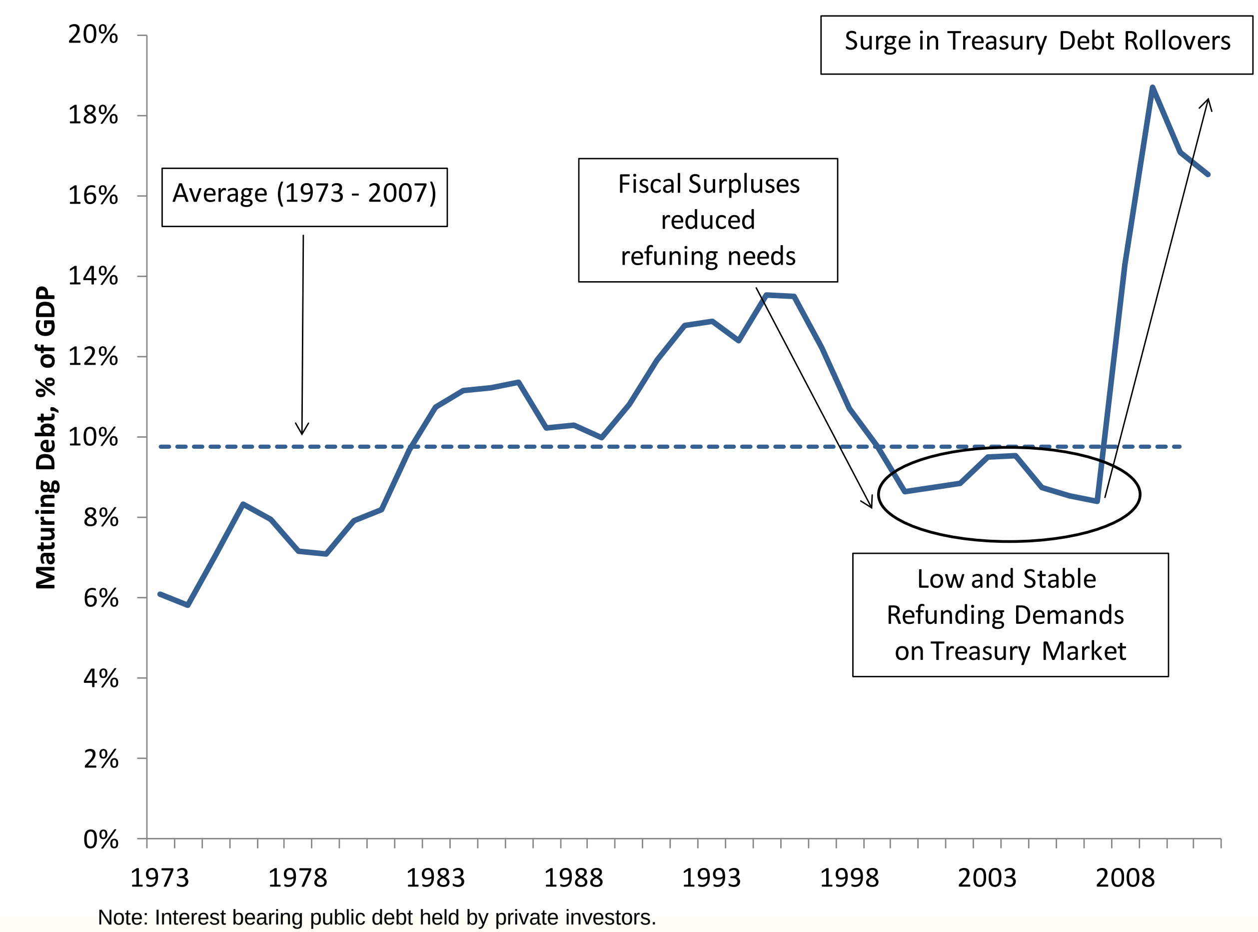
Note: The CFS real exchange rates incorporate 48 nations with calculations from January 1990 to October 2011.
Source: International Financial Statistics, Direction of Trade Statistics, and Center for Financial Stability.

III. United States: It's the *Principal* Matters!!!

Despite legitimate concerns regarding the budget deficit, large refinancings of debt represent an equally severe – yet lesser known challenge. The experience of Emerging Markets and some advanced economies suggests that…it is the repayment of principal that often triggers a crisis rather than simply the size of the debt or deficit.

From: "Treasury Maturities: The Other Fiscal Problem", March 10, 2011 (http://www.centerforfinancialstability.org/research/USFiscal031011.pdf)

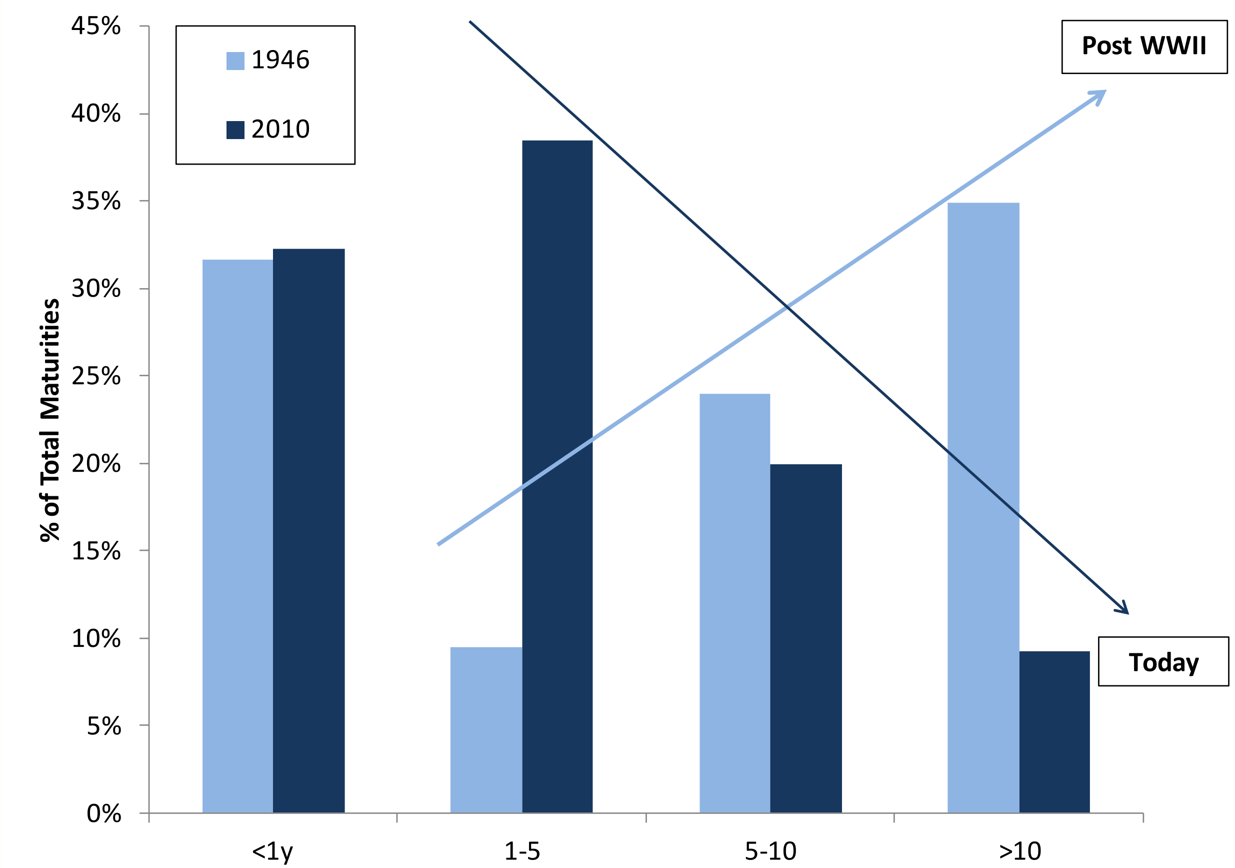
USG Debt Maturities Spike in Coming Year



Note: Interest bearing public debt held by private investors.
Source: US Treasury and Center for Financial Stability .

More Dangerous Treasury Debt Profile

Although US public debt-to-GDP was higher after the post-WWII period, the profile of maturing obligations was much safer!



Note: Interest bearing public debt held by private investors.
Source: US Treasury and Center for Financial Stability .

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Funding the US is Misunderstood:

Example of Conventional Wisdom

Blinder's myth "that America's deficit problem is so acute that government spending must be cut right now, despite the struggling economy. And any fiscal stimulus, even the payroll-tax extension, must be "paid for" immediately."

"Wrong. Strange as it may seem with trillion-dollar-plus deficits, the U.S. government doesn't have a short-run borrowing problem at all. On the contrary, investors all over the world are clamoring to lend us money at negative real interest rates. In purchasing-power terms, they are paying the U.S. government to borrow their money!"

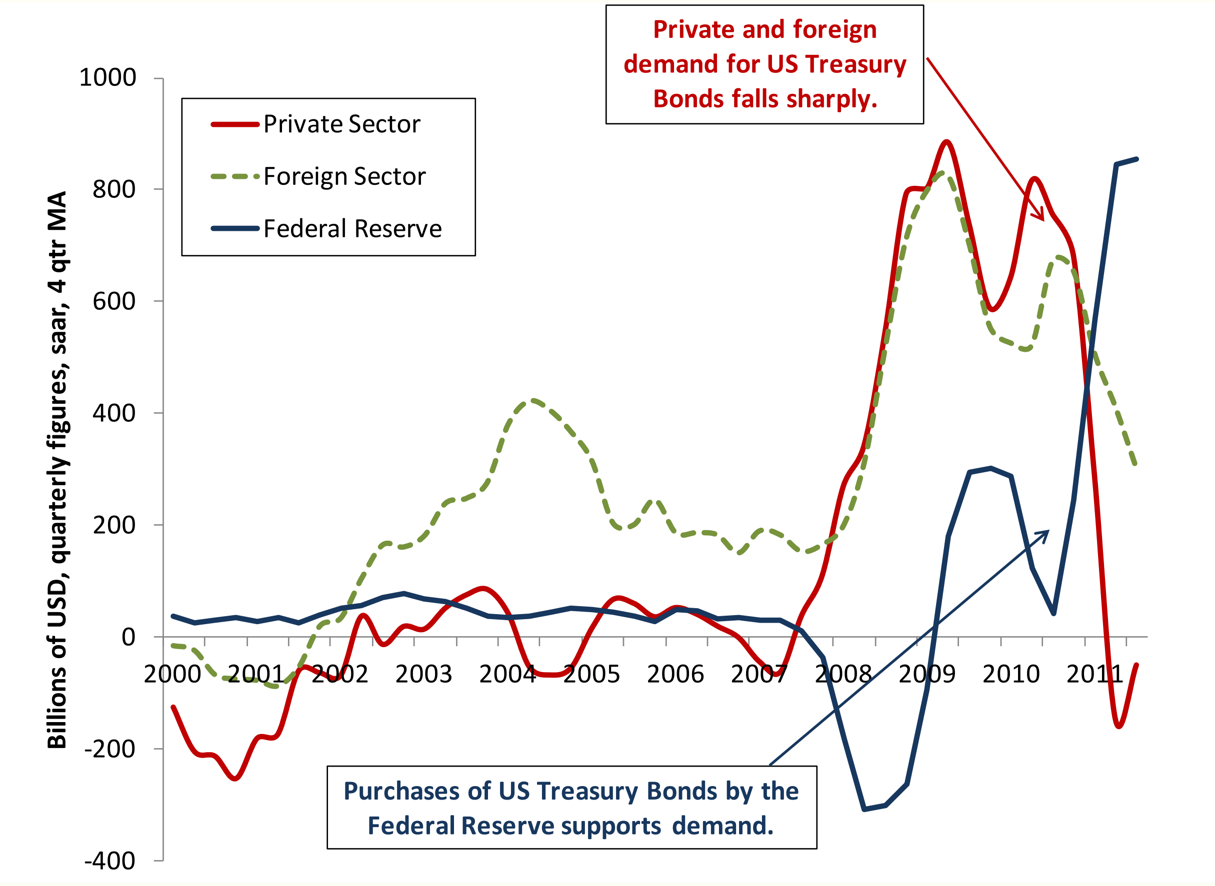
From: "Four Deficit Myths and a Frightening Fact" by **Alan S. Blinder** – *The Wall Street Journal*, January 19, 2012.

Who is "clamoring" to lend to Treasury?

Net Purchases of Treasury Securities

Answer:
The Fed

Fed purchases of Treasury bonds distort market relationships (see pg 8) leading to potentially unintended risks.



Source: Federal Reserve, Flow of Funds Accounts and the Center for Financial Stability.

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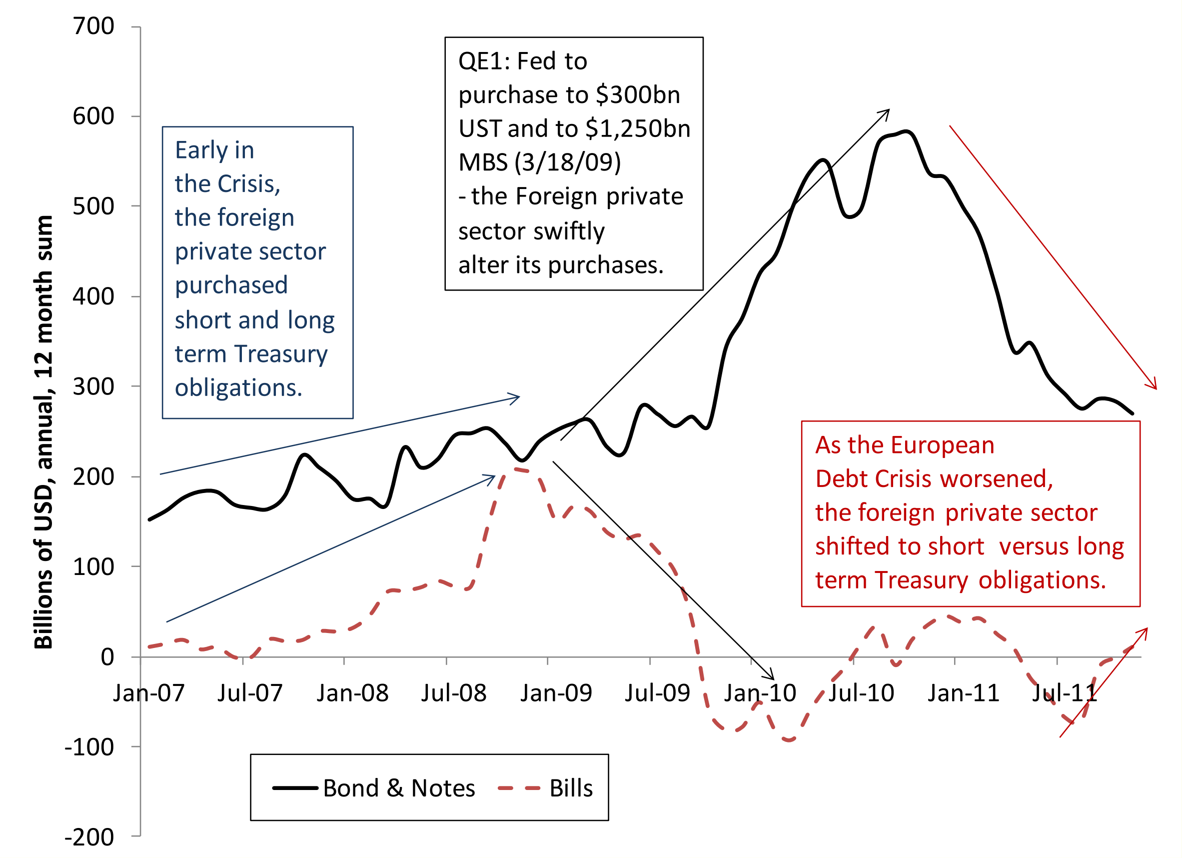
Foreign Private Sector: Duration Preferences



Source: Treasury International Capital (TIC) reports and the Center for Financial Stability.

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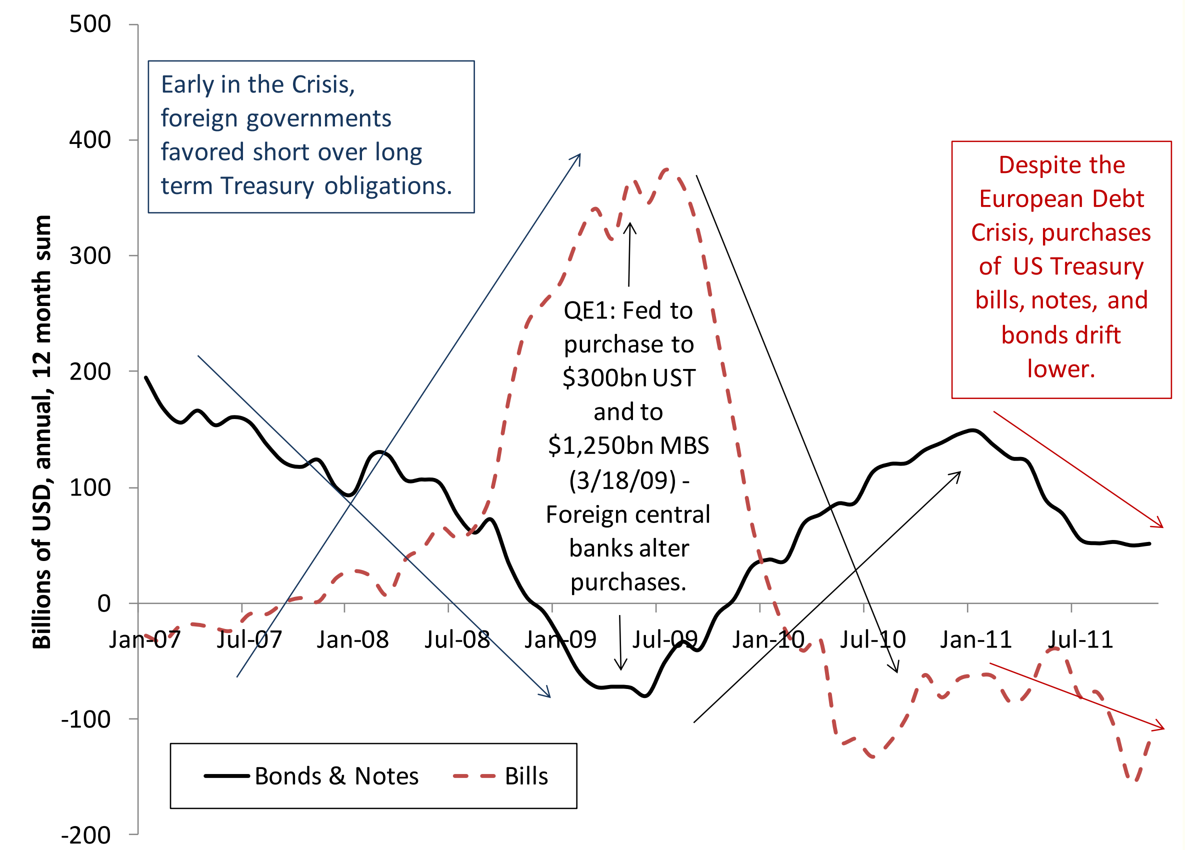
Foreign Governments: Duration Preferences



Source: Treasury International Capital (TIC) reports and the Center for Financial Stability.

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Limits to the Fed's Quantitative Easing (QE)

With thanks to William Barnett, Director of Advances in Monetary and Financial Measurement and Jeff van den Noort Chief Technology Officer at the Center for Financial Stability.

Source: Federal Reserve, other official, bank rates, and the Center for Financial Stability.

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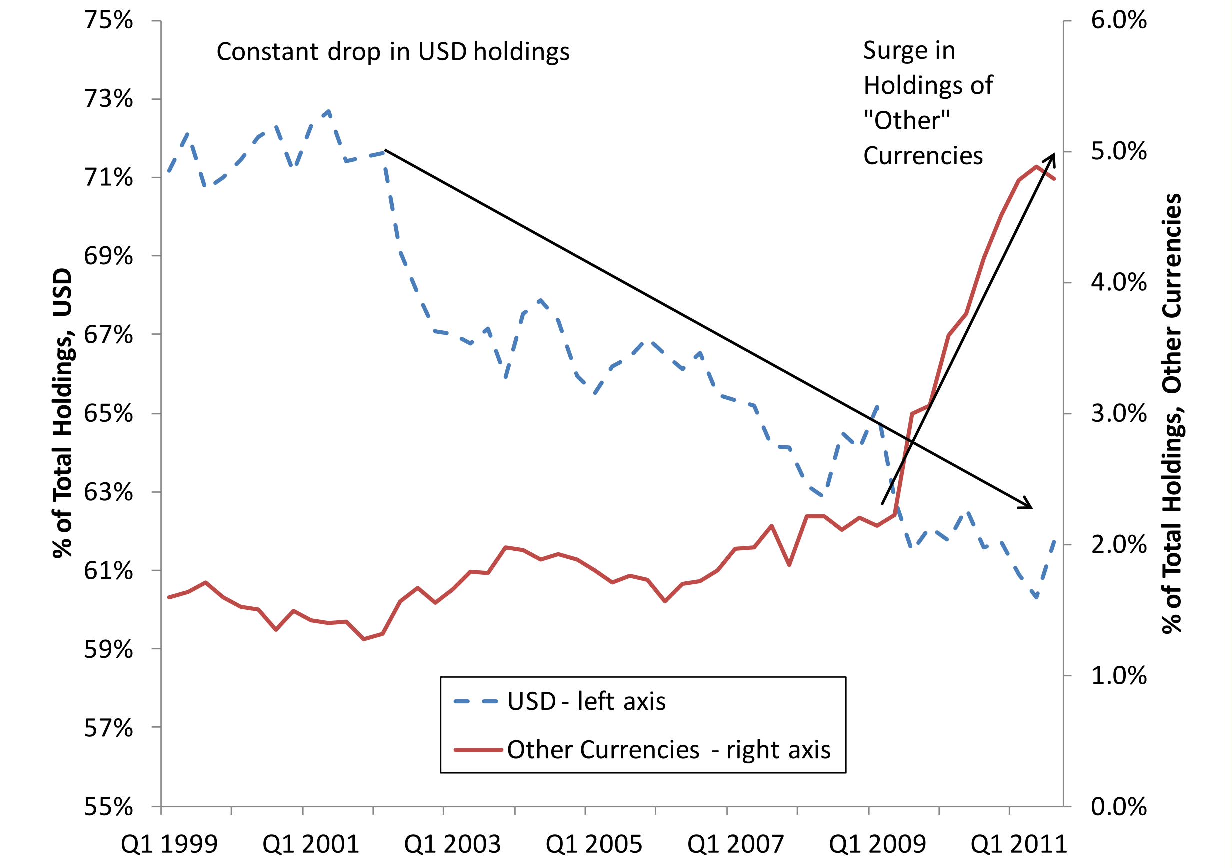
IV. Implications for Reserve Currency Status

Reserve Currencies: Shifting “Stores of Value”



Note: Composition of World Central Bank Reserves. “Other” is largely AUD, CAD, NOK, SEK and NZD.
Source: Datastream, International Monetary Fund (COFER) and Center for Financial Stability.

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Concluding thoughts…

- **Sovereign debt is no longer risk free even in the US**, where Fed purchases mask signals from market interest rates.
- **Reserve currency** competitors are surfacing.
- **Refunding risk** presents an equal challenge to large budget deficits. There is **not** an infinite appetite for Treasury bonds.
- The **European crisis** would improve from a strategy to reduce debt, remove the threat of contagion by balance sheet action, and a limited use of official resources.
- **Policy matters more than ever for advanced economies.**

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