

# Be Aware and Prepared: A Sovereign Debt Crisis is Near

By Toon van Beeck

The free-flowing credit party is over, and actions need to be taken to prevent nations from defaulting on looming maturing debt

Global deleveraging could result in another recession or credit freeze

Sovereign debt is possibly the greatest risk to the global financial system and its continued recovery. While China may be in a property bubble and inflation remains a concern, *any* collapse in the country would certainly be shattering for global expansion. However, there is a growing concern that certain sovereign nations will be unable to pay their bills because they have billions in debt, creating an unnerving situation in today's environment.

In the midst of the global financial crisis, central banks across the world printed trillions of dollars while governments pumped money into the financial system in order to stabilize their economies and renew growth. Overall debt levels are beginning to show the effect of these overspending actions, and the time has come for nations to deal with them.

#### It's a global problem

So far, attention has been placed on Greece and the so-called PIIGS (Portugal, Italy, Iceland, Greece and Spain). However, debt levels for many nations across the globe are far beyond what is considered healthy and sustainable. Today, debt-to-GDP ratios are at similar levels to what they were during World War II. However, war is no

longer the driver of debt. Many years of overspending have placed several nations in the firing line of credit downgrades and potential defaults. Of the G-20 nations that comprise about 87.0% of global GDP (2008), half have gross debt to GDP above 50.0%.

Japan sits in the number one position, with 2010 expected gross debt to GDP at 227.1%. This percentage is considerably higher than Greece's (expected to reach 133.2% at the end of 2010), which is catching all the attention today. Italy is in the second position at 118.6%, and the United States is third at 92.6%. There are other sizeable economies outside the G-20, such as Iceland and Belgium, that have expected 2010 gross debt to GDP above 100%. Moreover, any economic collapse within these "smaller" nations could spark fear and contagion, and derail the global recovery.

According to the International Monetary Fund (IMF), developed countries' GDP growth rates may slow by more than 0.5% per year unless they reduce debt to pre-recession levels. Many economies at the top of the list will experience much more difficult economic growth conditions. Governments are aiming to reduce debt levels by slashing spending and raising taxes. However, these actions may push their economies

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The US has the third highest debt-to-GDP level of all the G-20 nations

back into recession, which will increase unemployment and reduce tax revenue, and limit their ability to pay down debt and the interest payments on those debts. As a result, central banks will need to print money with the aim of eating into the value of debt, but the consequences may further exacerbate economic problems.

Interest rates in the EU currently sit at very low levels, making growth through monetary policy efforts extremely difficult. Governments will need to enact spending cuts along with freezes on pensions to rein in debt levels, and they will need to implement higher taxes in order to grow revenue. However, these measures will likely create downward economic pressures and the very real possibility of another recession. Years of deleveraging will likely occur, as governments and private households reduce debt levels, dramatically slowing economic growth for many years.

In addition to the risk of deleveraging and slowing economic growth, there is risk of yet another credit crisis. The situation surrounding sovereign debt is so tangled that it mimics the recent US housing debacle in many ways. However, the problem in monetary terms is considerably larger this time, potentially into the tens of trillions of dollars. In addition to exposure to debt and default risk through bonds from Greece and other risky nations, many market players (e.g. banks, financial institutions and insurance companies) are exposed to risk through credit default swaps (CDSs), which allow them to insure against default. Consequently, if they default, the issuers of the CDSs will be required to pay the borrowers, affecting various financial institutions around the globe as the issuers of this insurance. However, these financial institutions will likely have hedged their exposure to this risk, therefore limiting their potential losses. As a result, it creates another situation

## Gross Debt (2010)

G-20 Nation	(% of GDP)
Japan	227.1
Italy	118.6
United States	92.6
France	84.2
Canada	83.3
India	79.0
United Kingdom	78.2
Germany	76.7
Brazil	67.2
Argentina	51.4
Mexico	44.5
Turkey	44.5
South Africa	34.7
South Korea	33.3
Indonesia	27.5
China	20.0
Australia	19.8
Saudi Arabia	12.8
Russia	8.1

SOURCE: International Monetary Fund

where debt obligations are “hidden” among numerous companies, individuals and even governments, creating the risk of another credit freeze, as no one player will know the extent of risk to another. This trend could be disastrous for indebted nations, since they cannot attain liquidity and pay off their debts.

In the United States, there are certainly long-term concerns surrounding debt. The United States has the third highest debt levels to GDP of G-20 countries. The current stimulus efforts by the government are critical in maintaining economic growth, and strong economic expansion is considered one of the best long-term solutions to reduce government deficits. However, the catch is that this spending is creating

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The US must take action in the medium-to-long term, else face the same fate as Greece

greater deficit problems. These problems are compounded by an aging population, as a growing number of retirees will tap into Medicare and Social Security benefits, creating more government spending and huge debt concerns.

In order to rein in debt, the United States will need to perform massive spending cuts in numerous other areas and likely increase taxes. However, the United States has a card up its sleeve that separates it from many of the indebted EU nations. The United States is not bound by an international monetary fund; it has its own currency and can print money to help stave off debt problems, reducing the amount of debt with a devalued currency. Additionally, since the US dollar is the global reserve currency, the country has the ability to issue debt at a lower interest rate than would otherwise be the case. This factor makes servicing the debt more manageable. However, there are still core underlying concerns, and the United States will need to take action in the medium-to-long term, or it will fall into a similar situation to Greece.

## Time for tough decisions

It is clear that the free-flowing credit party is over and actions need to be taken to prevent nations from defaulting on looming maturing debt. Government financing needs are exceptionally high in many advanced economies, particularly Japan, the United States, Italy, Spain, Belgium, France, Greece and Portugal. Given time, attention will shift from the PIIGS to Japan, the United States and even the UK, with debt quickly rising to alarming levels. These financing needs will continue for many years, and governments will need to make tough decisions in order to resolve them or face the inevitable consequences.

Still, there is no clear-cut solution to the problem. While governments need to rein in debt, reduce spending and

increase taxes, the economic and political consequences of these actions are highly unfavorable. This factor is particularly significant at a time when advanced economies must maintain stimulus efforts – the best debt-reduction strategy is strong economic growth. The IMF notes that governments will also need to pursue debt-management strategies that address sovereign debt obligations, while trying to avoid crowding out or increasing the cost of private-sector debt. They will need to act promptly and take advantage of opportunities to refinance debt and extend maturities in order to alleviate any credit-rating-related triggers that could cause the turmoil to spread. However, the problem with this strategy is that debt holders will likely see substantial losses on their investments, as debt write-downs occur or the extended maturities decrease the attractiveness of the investments.

Ultimately, banks, financial institutions, governments, the public and other market players will pay for the years of overextension in credit, and losses will occur for businesses who hold or are exposed to debt from risky nations.

## What can companies do to brace for potential fallout?

The implications of global deleveraging, which will result in a slowdown of economic activity and the potential of another recession or credit freeze mean that more difficult times are likely ahead. Businesses and individuals have just observed some of the most testing operating conditions since the Great Depression, and a sovereign debt crisis could result in bankruptcy for many more companies.

Individual companies cannot do much to resolve this situation, but they can prepare for it. Ideally, the debt crisis will play itself out, and government bailouts and debt write-downs will alleviate some of the turmoil. However, at this stage, it

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is unclear what path the problem may take and how long it will last, so it is critical that businesses are prepared. Since a period of lower growth may be beginning in the developed world, companies can prepare by adopting survival strategies. Recently, levels of competition have been trimmed as a result of the recent financial crisis and numerous business failures, so the remaining companies may be able to snap up customers left by defunct competitors. As much as they are possible today, growing sales are certainly a positive trend, since firms can re-build their cash positions in case of any further credit freeze or slowdown in business and economic growth. Furthermore, stringent expense-management strategies will need to remain in place. A strong balance sheet will help guarantee stable financing,

particularly at a time when credit may be hard to come by.

Once these key "survival" strategies are in place, firms will need to find opportunities in this time of crisis. They will need to exploit their strengths and focus on the customer. Businesses need to ask themselves what they have that the competition does not and use their advantages to grow sales.

Finally, customer loyalty is critical to growing revenue, so relationship building and up-selling will be a requirement for survival. Firms may need to avoid dealing solely with developed nations and consider emerging economies. Emerging nations have a considerably lower level of debt than developed economies, and will likely continue to demand high amounts of goods and services even as developed nations slow down.

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