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What Sovereign Debt Crisis?

At a recent investment conference where I was a guest speaker, I made the point that—as long as a nation does not have foreign currency debt—it will never fall into a sovereign debt crisis, no matter how much public sector debt the country has accumulated. Many attendees strongly disagreed with me and an intense debate erupted. My opponents believe that no government can and should overspend what it collects, and if it does, a final price will be paid. “Look at what has happened in Greece!” a somewhat irritated investor pointed out.
All emotions aside, I still think that I am right. What is a debt crisis? A debt crisis occurs when bondholders collectively rush for an exit, wanting to redeem their holdings of papers for the most liquid asset—cash. Obviously, when a run occurs in the private sector, the redemption demand can quickly deplete liquid assets held by the borrowers who do not have unlimited access to credit lines. Ultimately, a default or bankruptcy will follow. This is why corporate default rates tend to rise sharply during economic downturns or recessions.

However, it is utterly wrong to apply the same logic and analysis to the public sector. The key difference here is that a sovereign government always has a steady line of credit open to it—the central bank’s printing press.

The central bank is the ultimate provider and creator of the most liquid asset, cash, and the sovereign government can always guarantee the solvency of its outstanding debt with creditability so long as

1. The liabilities are written in the local currency and
2. The central bank is willing to act as “the buyer of last resort” for the outstanding public debt.

It’s not an exaggeration to say that it is virtually impossible for a sovereign government to default on its local currency debt. This is simply because a central bank can monetize the entire debt stock if it chooses to do so. The economic limitation of such action is how much inflation, currency devaluation, or both, the central bank wants to endure. However, there should never be country solvency risk in this case.

Of course, if a nation has accumulated a large foreign currency debt load, the country solvency risk could escalate easily. This is easy to understand: the central bank of the debtor nation cannot print foreign currency or currencies and as a result, the government’s ability to borrow from abroad always faces a hard constraint. If and when a run occurs in foreign-currency-denominated bonds, the only defense the debtor nation has is its liquid foreign assets, primarily its foreign exchange reserves. Once the reserves are depleted, a country sovereign default will inevitably follow.

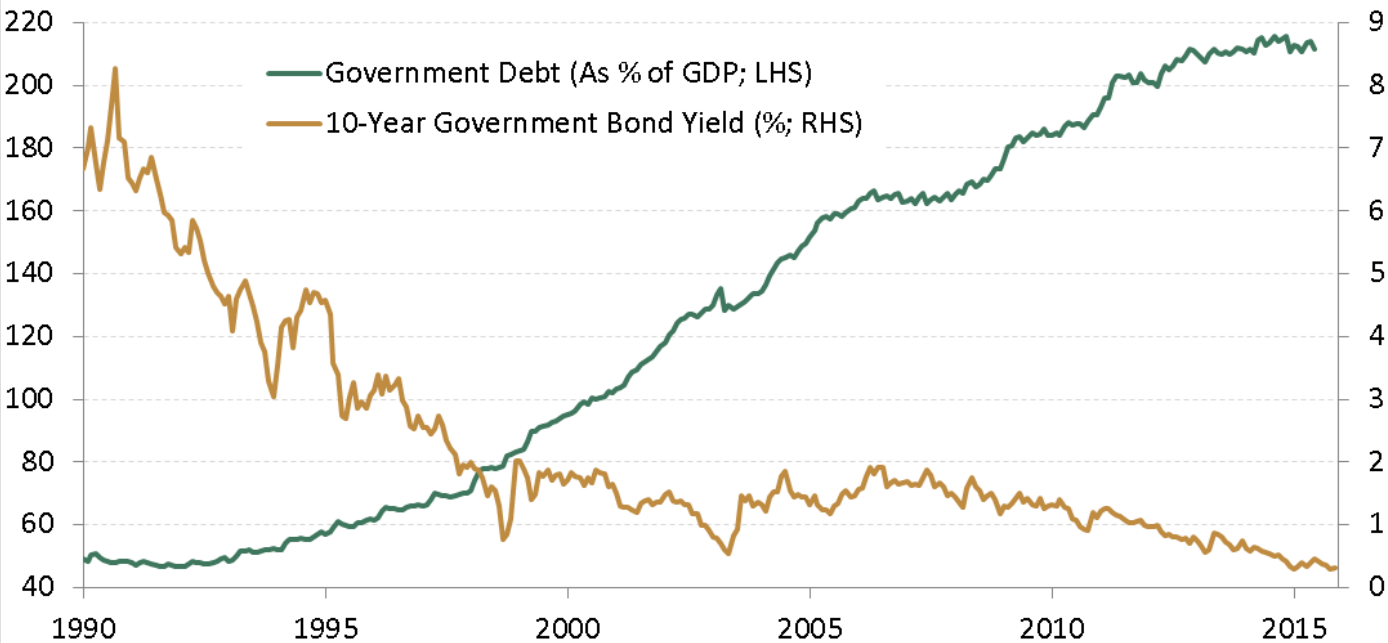
In postwar history, large scale country sovereign debt crises have occurred twice: the less developed country (LDC) debt crisis in the 1980s and the emerging market (EM) debt crisis in the late 1990s. In both episodes, large amounts of *foreign currency debt* were involved. In the LDC crisis, many oil producing countries issued massive amounts of U.S. dollar-denominated debt when oil prices boomed and the dollar crashed in the 1970s. When interest rates started to rise as the Federal Reserve (Fed) tightened monetary policy and the dollar strengthened sharply in the 1980s, oil producing countries in general—and Latin America in particular—fell into financial crises. Their local currencies collapsed, inflation soared, and one country after another defaulted on their dollar debt—particularly most Latin American countries.

The EM debt crisis in the late 1990s was a similar story. In the early 1990s, interest rates were falling in the U.S. and the dollar was weakening as a result of the Fed easing monetary policy in order to fight the savings and loan crisis and recession. Many EM countries took advantage of low rates and a falling dollar and issued a large amount of dollar-denominated debt.

Both the dollar and interest rates reversed their direction and went up sharply as the Fed began to tighten monetary policy in 1994. This first sent Mexico into a currency and debt crisis, which eventually spread to Asia and the entire EM universe. Large sovereign defaults happened across Southeast Asia, Russia, Argentina, Brazil, and Turkey.

These two crises are examples of how foreign-currency debt could trigger widespread panic and sovereign default. By the same token, Japan is a classic example on the other end of the spectrum: it has accumulated a huge amount of public sector debt and yet, its bond yields have drifted ever lower (see Chart 1). Investors have feared a Japanese debt crisis for so long, and yet, there has never been a sovereign default at all. The Japanese yen has not only been largely stable, but has also gained real value for more than two decades via falling price levels.

Chart 1: Japan Government Debt & 10-Year Government Bond Yield *Percent; As of 11/10/15*



Source: Thomson Datastream

The key reason for Japan's "financial tranquility" is that the large public sector debt and deficits are simply a mirror image of the private sector's excess savings; Japan has been a net creditor to the rest of the world. These factors illustrate that the government's borrowing is inherently stable and systemically sustainable.

What about Greece? Hasn't that country been going through a debt crisis even though its debt is mostly denominated in euros? The answer is "yes" but the root cause of the Greek crisis is the European Central Bank (ECB), which has been reluctant to commit itself to buying Greek bonds. The ECB's lack of commitment has effectively turned Greek government debt into "corporate paper." The ECB's refusal to be the "buyer of last resort" has cut off the credit line for the Greek government, forcing it to stop honoring its outstanding debt obligations.

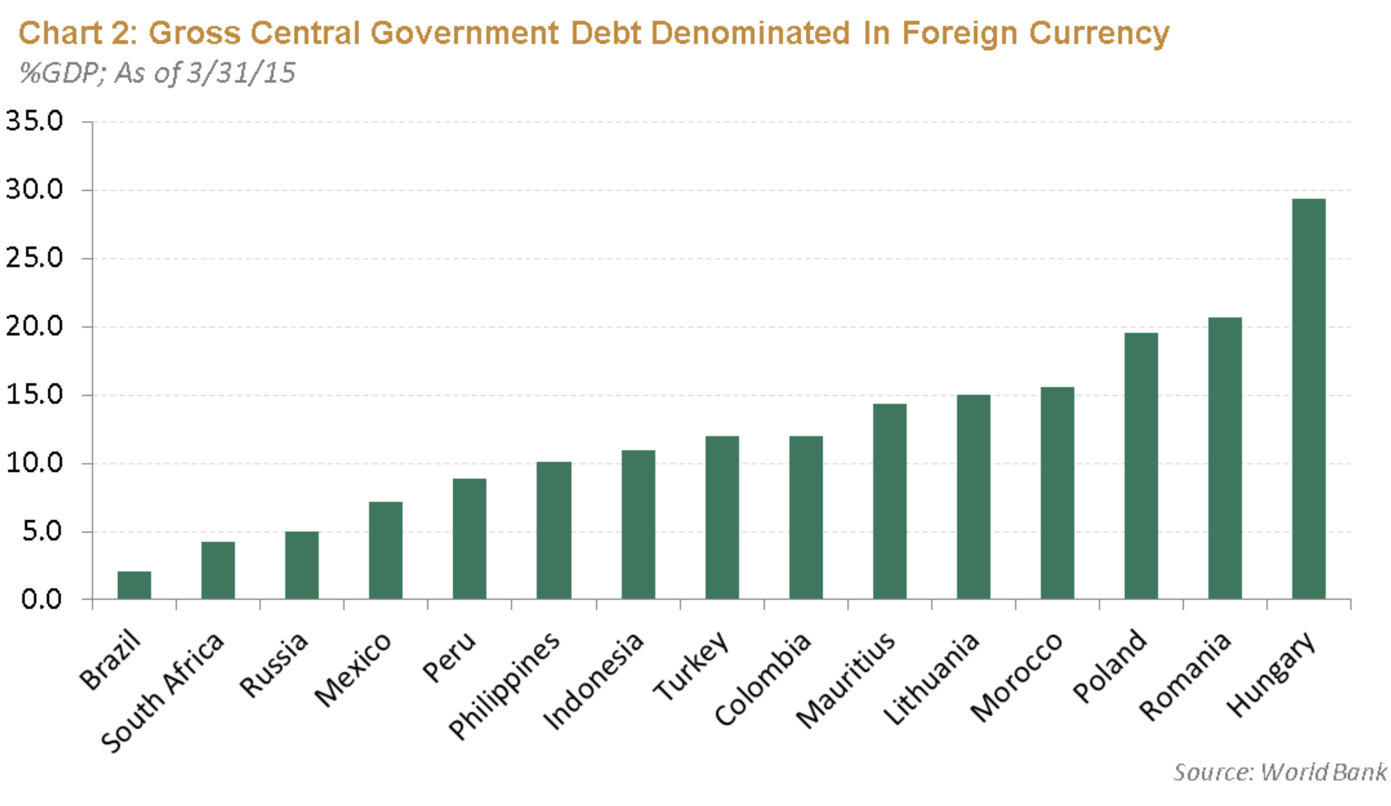
Of course, the euro-zone debt crisis reveals many shortcomings in the monetary arrangement. Nevertheless, it still does not change the fact that the euro-zone debt crisis is essentially a manmade disaster that has been driven primarily by regional politics. By the same token, one could argue that if the ECB is given the power to act as a true central bank of a sovereign entity called the "United States of Europe," the euro-zone debt crisis wouldn't have existed at all.

What are the key takeaways?

First, it's rare for a sovereign debt crisis to occur, unless the government has incurred a large amount of foreign-currency debt. Many strategists and investors often use the public-sector-debt-to-gross-domestic-product (GDP) ratio as a gauge for country solvency risk. I believe this metric can be quite misleading.

The debt/GDP ratio is an accounting concept that does not tell us anything about the sustainability of the public sector debt dynamics. Investors must assess the debt ratio in conjunction with other key variables, such as exposure to foreign-currency debt and the country's domestic savings-investment balance to get a better idea of sovereign risk.

Second, although most EM currencies and bonds have been under downward pressure for some time, there is no evidence that the EM universe as a whole has accumulated too much foreign-currency sovereign debt. Therefore, the odds of a large scale country sovereign default are low, as evidenced in Chart 2.



Finally, there has been a rapid increase in private sector foreign debt in EM countries due to low interest rates and particularly the falling dollar in the past decade. However, with the dollar having reversed its weak trend and gained much strength since 2012, the economic stress in the EM universe has sharply increased.

A strong dollar together with the negative terms-of-trade shock since 2010—when both commodity and global manufacturing prices entered a deep deflation—has pushed several EM economies into recession. If the dollar continues to strengthen on the back of a strong U.S. economy and the expectations of Fed monetary tightening, the economic weakness and financial pains in the EM world could persist or even worsen.

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