



Economic Outlook from a Sovereign Risk Perspective

Allard Bruinshoofd
International Macroeconomic Research

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Recent developments

“Markets can stay irrational longer than
you can stay solvent”

John Maynard Keynes (attributed)

Agenda

- The Great Recession
- The Great Rescue
- How successful were the measures?
- Which countries are most vulnerable to a sovereign debt crisis?
- The Great Fiscal Squeeze?
- Global outlook



The Great Recession

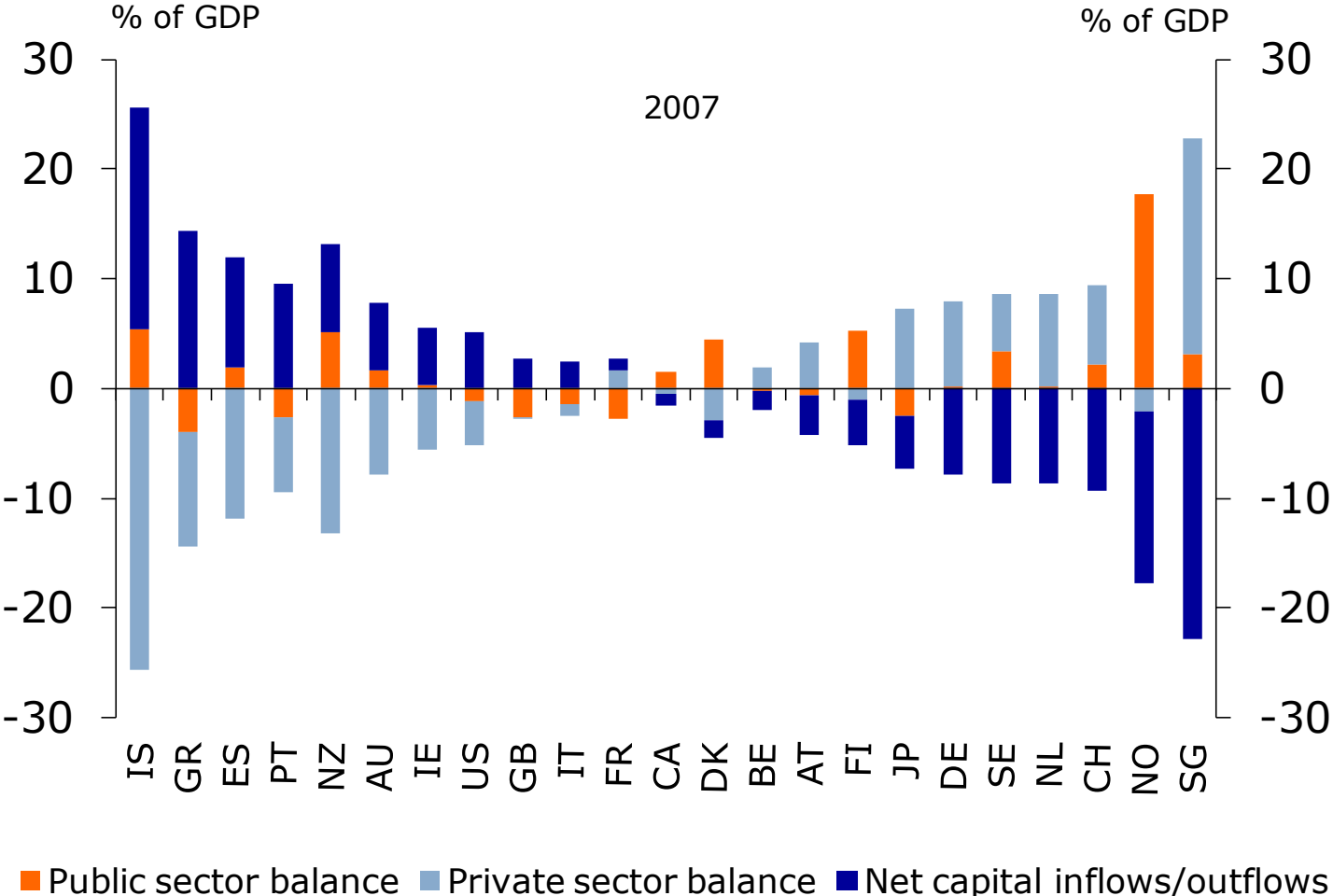
How bad was it?



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Global imbalances

The reason why we are here!

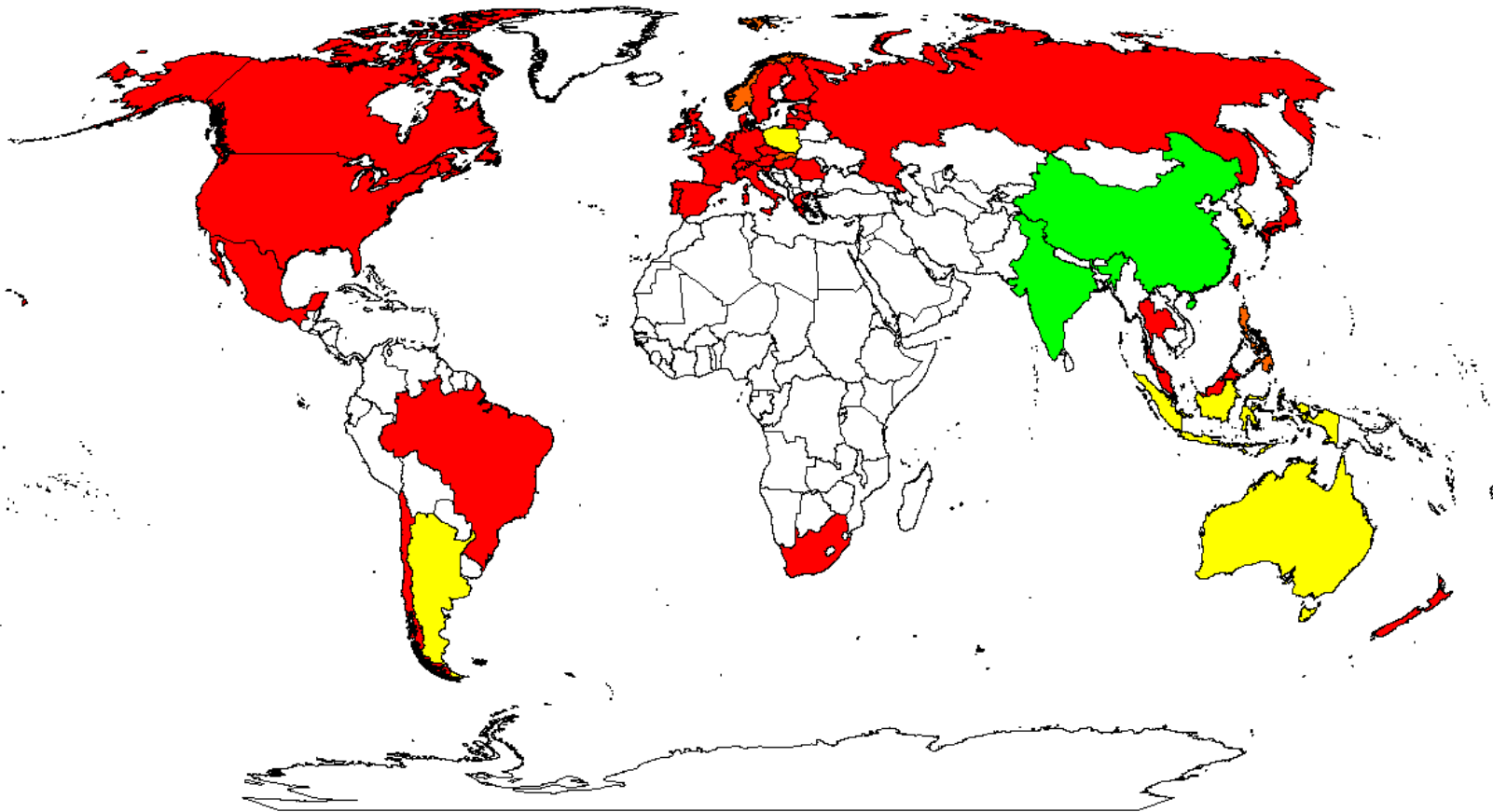


The Great Recession



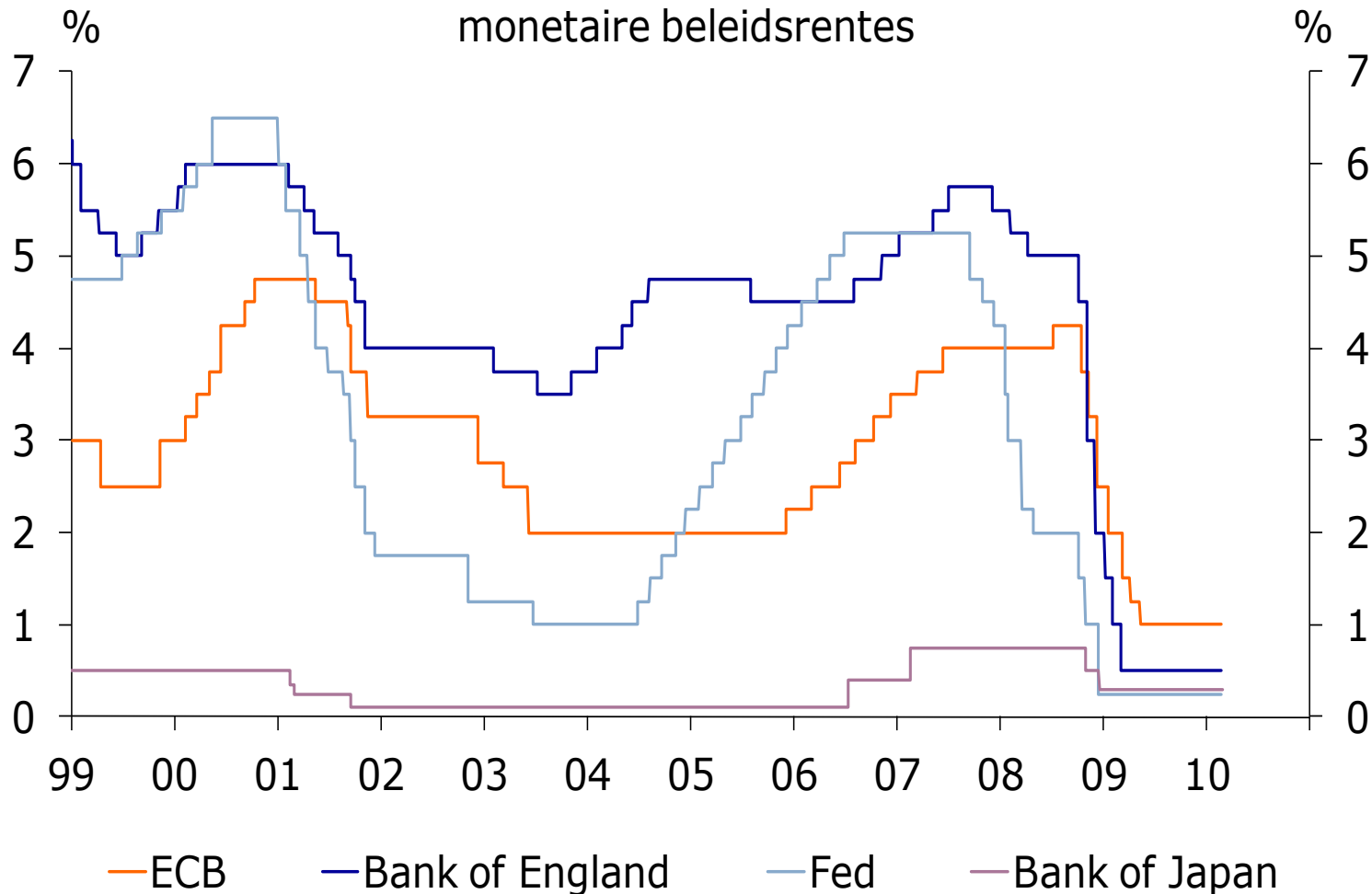
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Q1-2009



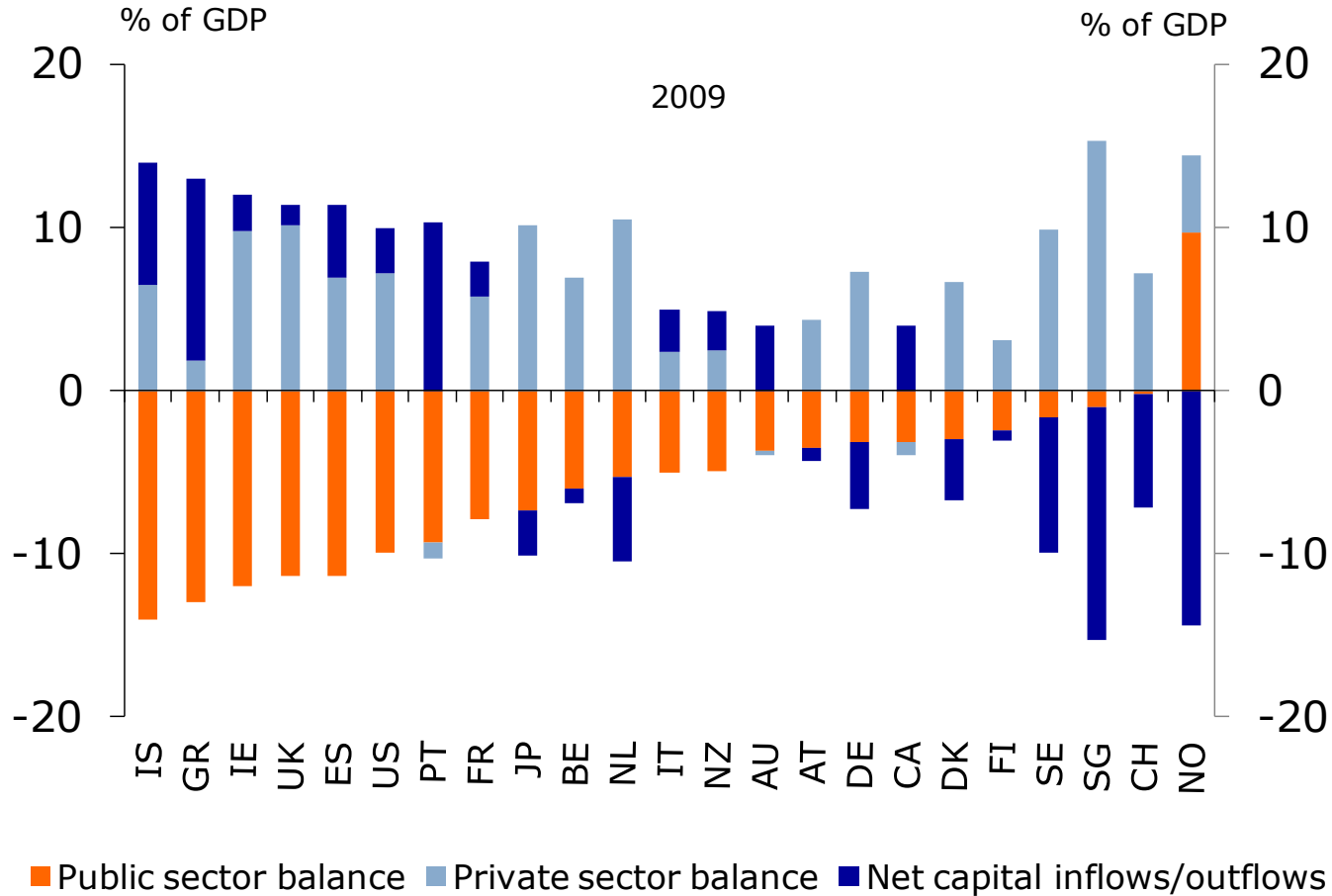
The Great Rescue

Long live the monetarists!



The Great Rescue

Long live the Keynesianists!



Causes:

Private sector losses were socialised

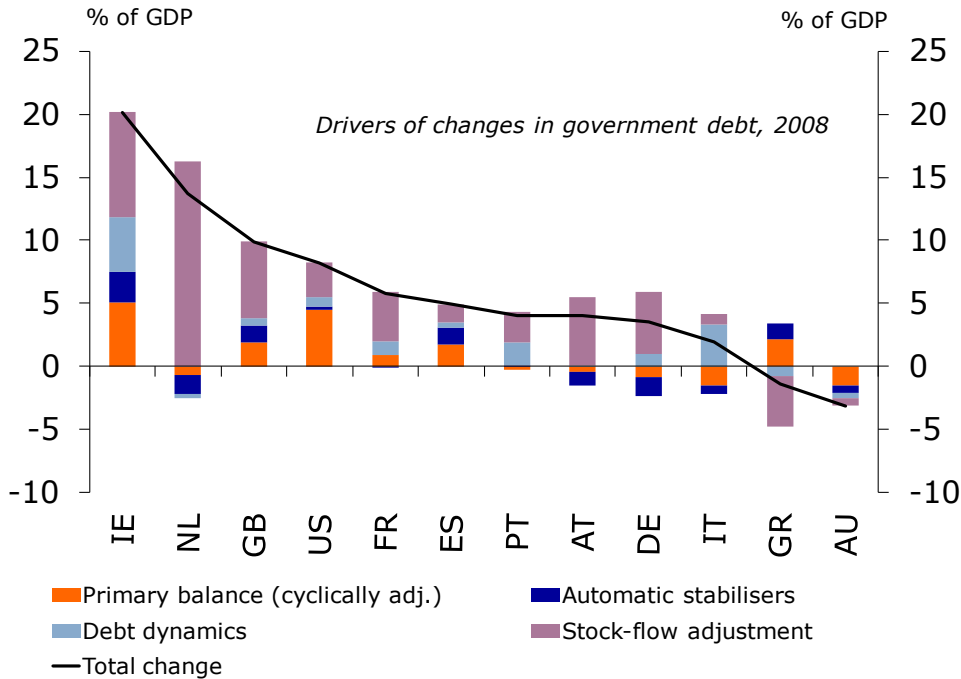
Economies were stimulated

Automatic stabilisers were allowed to operate in full

Debt ratios on the rise

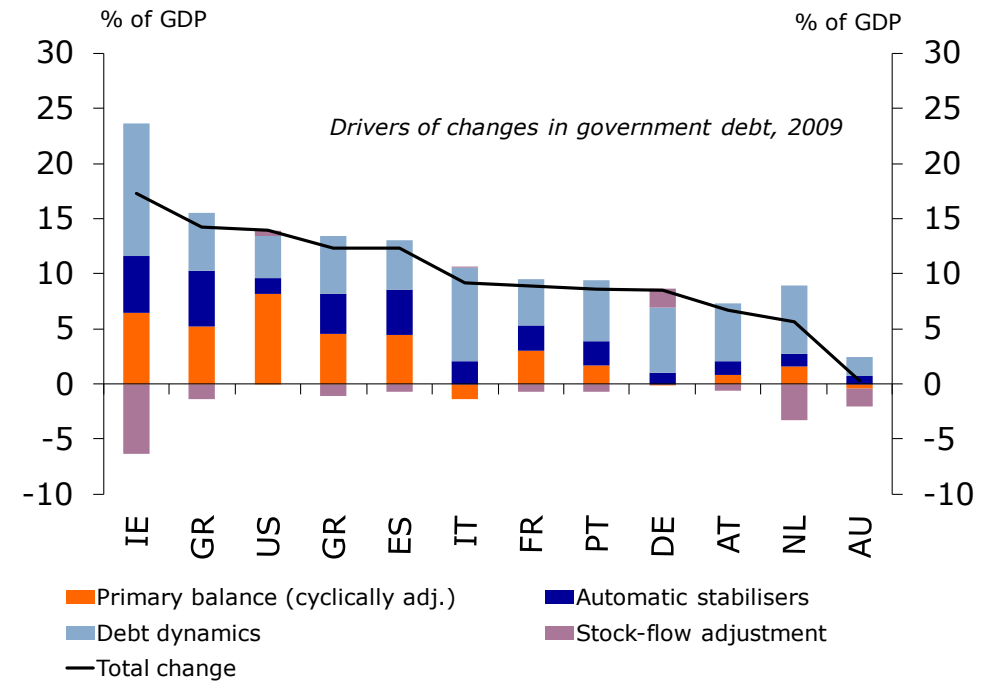


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Mostly due to snowballing effects in 2009

Mostly due to banking sector rescue in 2008



Contingent liabilities

Financial meltdown was averted



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Public interventions in the banking sector (as % of GDP)

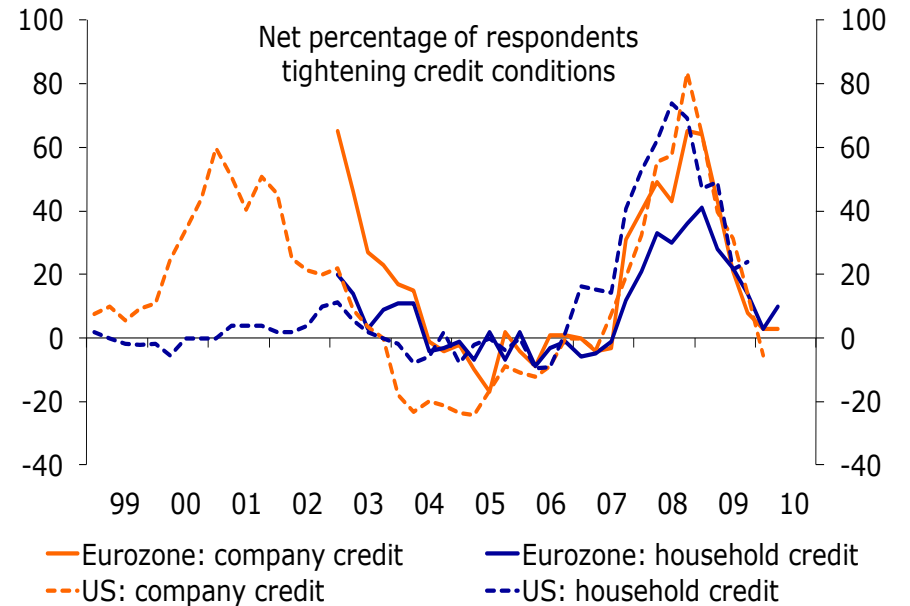
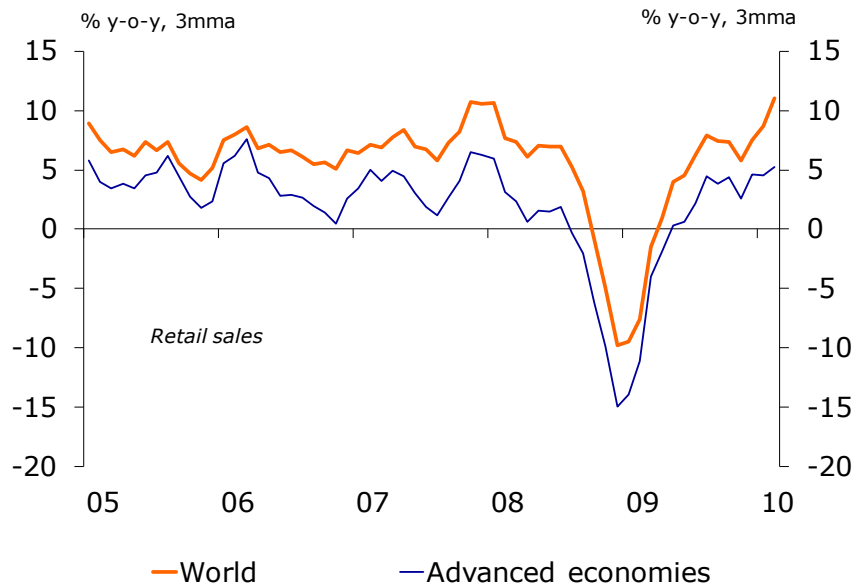
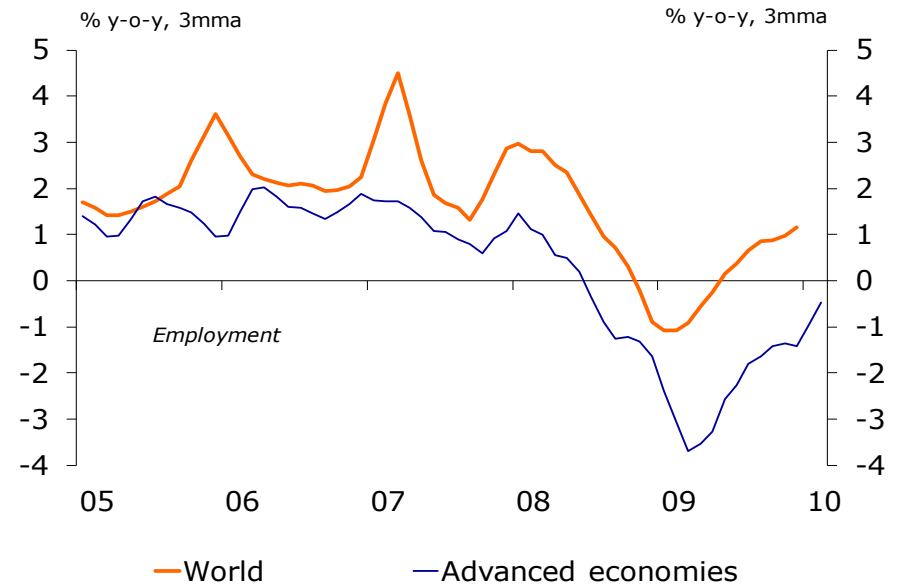
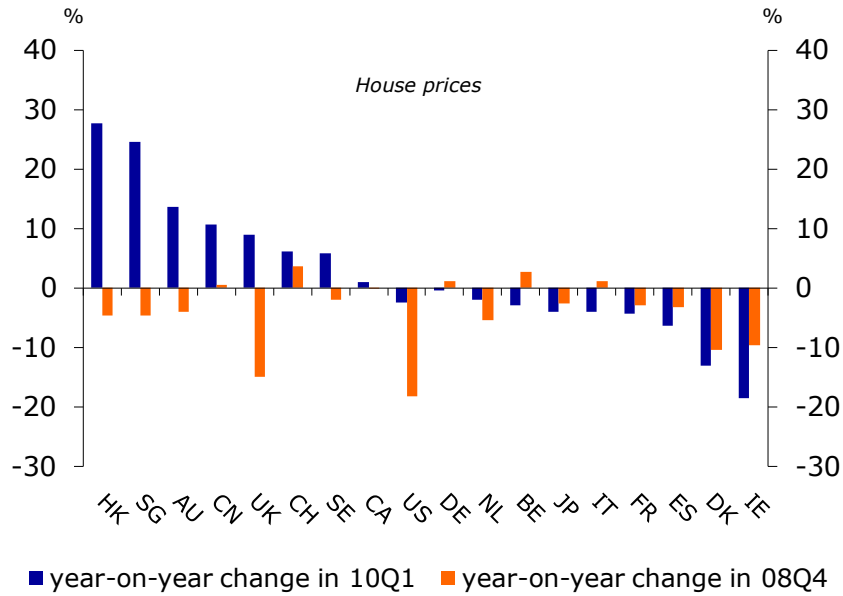
Countries	Relief of impaired asset and bank support		Capital injections		Guarantees on bank liabilities		Guarantees on deposits
	Total approved measures	Effective interventions	Total approved measures	Effective capital injections	Total approved measures	Guarantees granted	in dollars or %
BE	8.1	8.1	5.3	6.1	70.8	16.3	100000
DK	0.3	0.3	6.1	2.4	253	2.5	100%
DE	1.4	1.4	4.4	2	18.6	7.2	100%
IE	0	0	6.6	6.5	164.7	164.7	100000
GR	3.3	1.8	2	1.5	6.1	1.2	100000
ES	2.8	1.8	0	0	18.6	2.1	100000
FR	0.2	0.2	1.2	1.2	16.6	5.5	70000
IT	0	0	1.3	0.1	NA	0	103000
LU	0.9	0.9	6.9	7.9	12.4	NR	10000
NL	11.4	5.5	6.4	6.8	34.3	7.7	100000
AT	7.1	2	5.5	1.7	25.7	6.8	100%
PT	0	0	2.4	0	10	3.3	100000
FI	0	0	0	0	27.7	0	50000
SE	12.6	0	1.6	0.2	48.5	11	50000
GB	16.4	14.7	3.5	2.6	21.7	11.3	50000

Source: European Commission

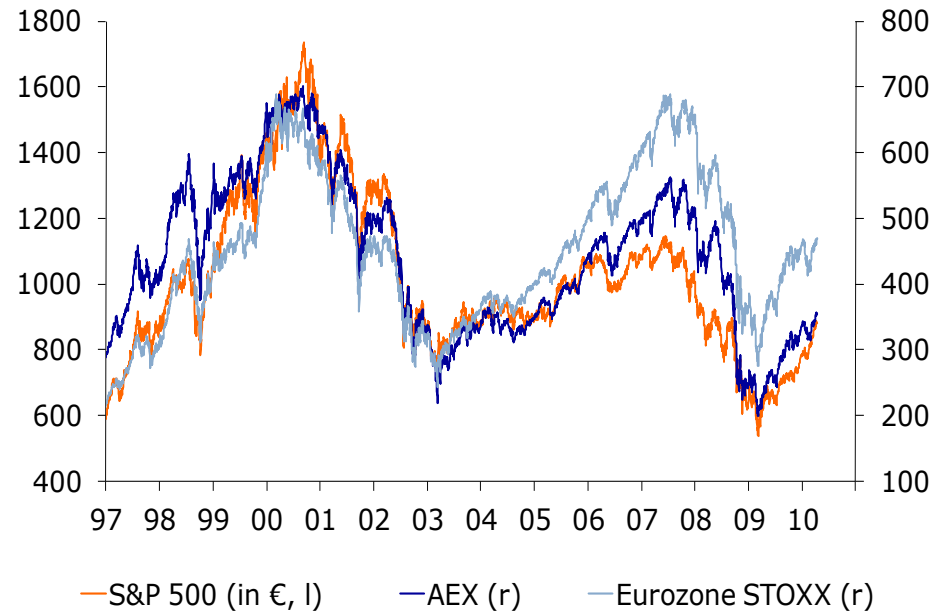
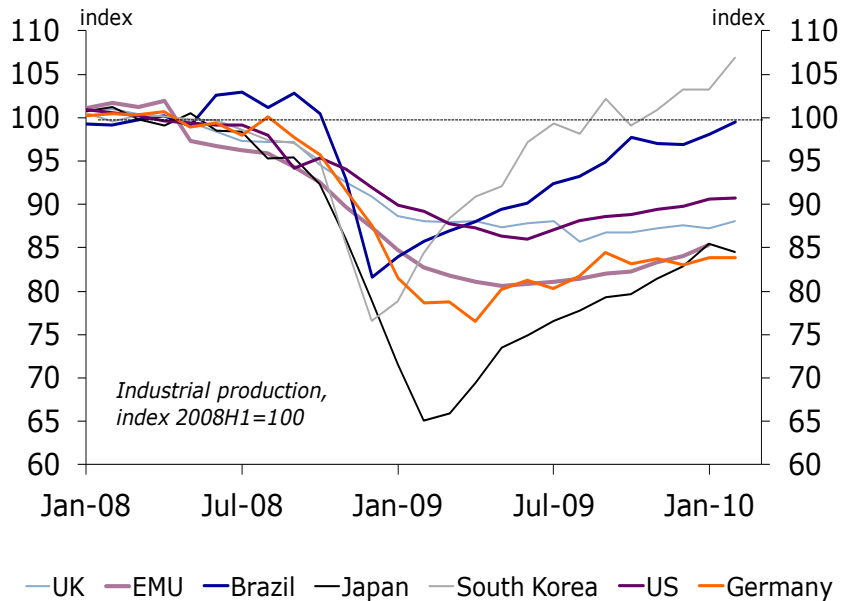
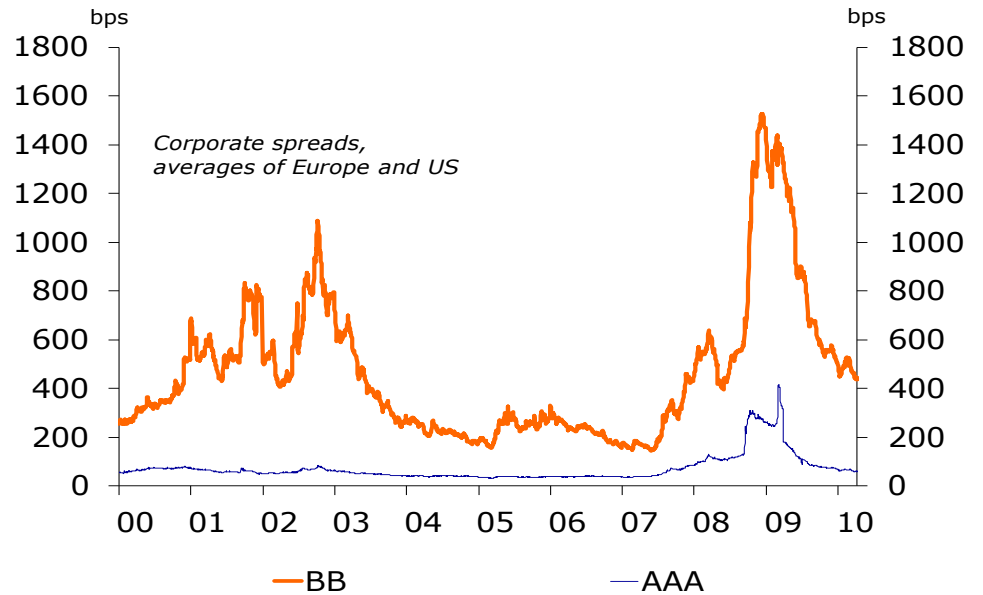
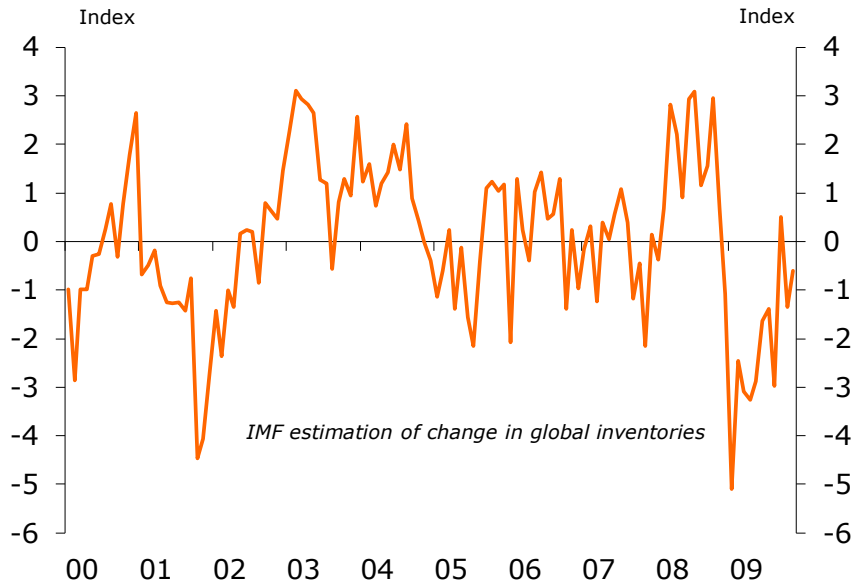


Mission accomplished?

Mission accomplished?



Mission accomplished?

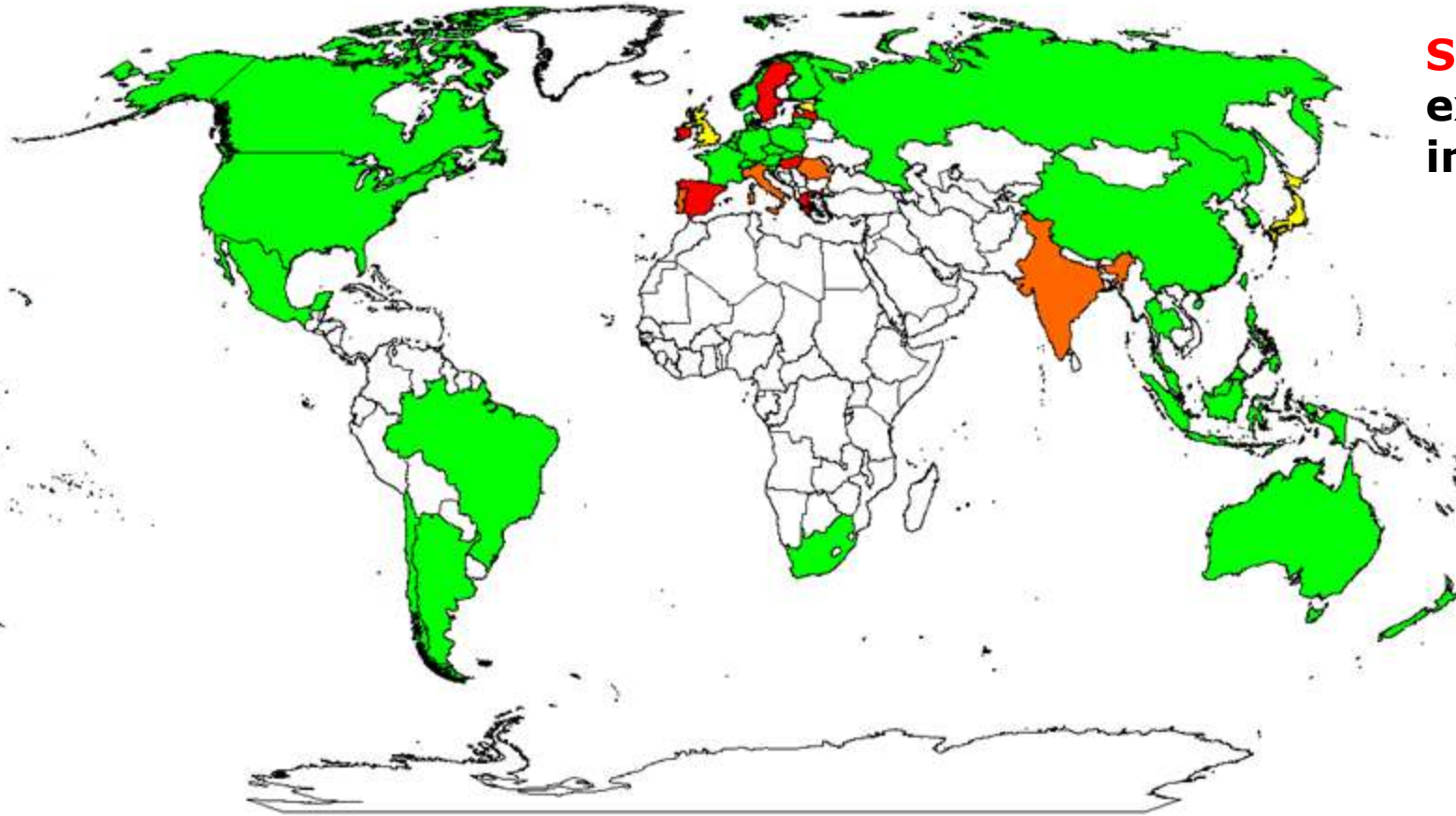


The Great Depression 2.0 was avoided Hooray!



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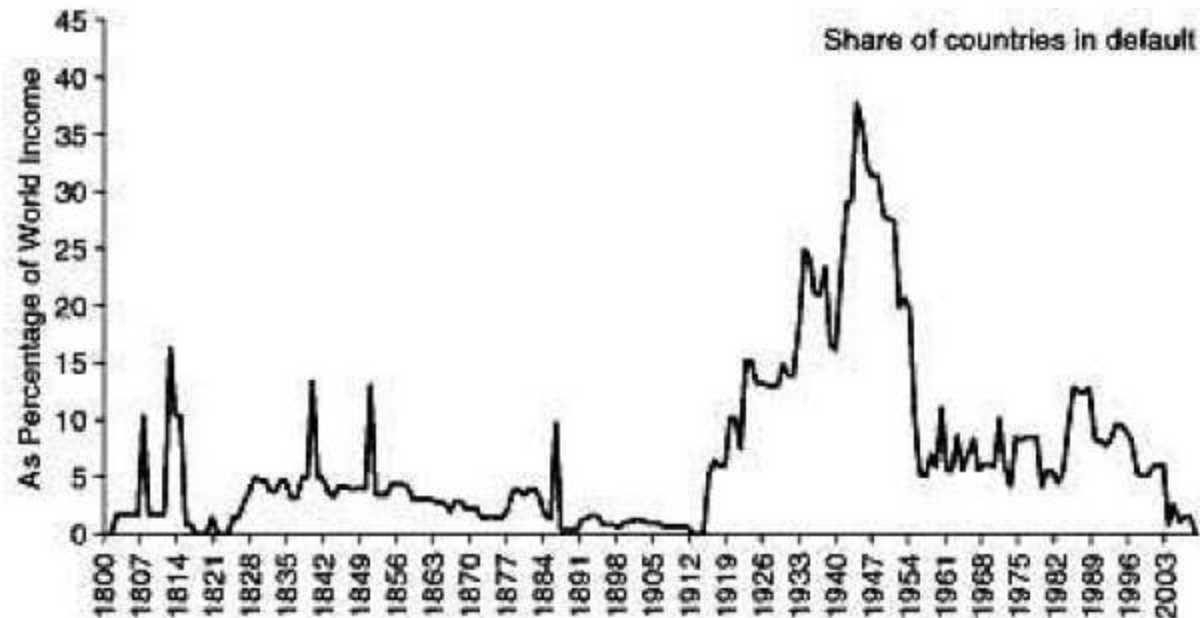
Q4-2009



**Sponsored by
extremely low
inflation rates**



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IS THIS TIME DIFFERENT?

Figure P.1. Sovereign external debt, 1800–2008: Percentage of countries in external default or restructuring weighted by their share of world income.

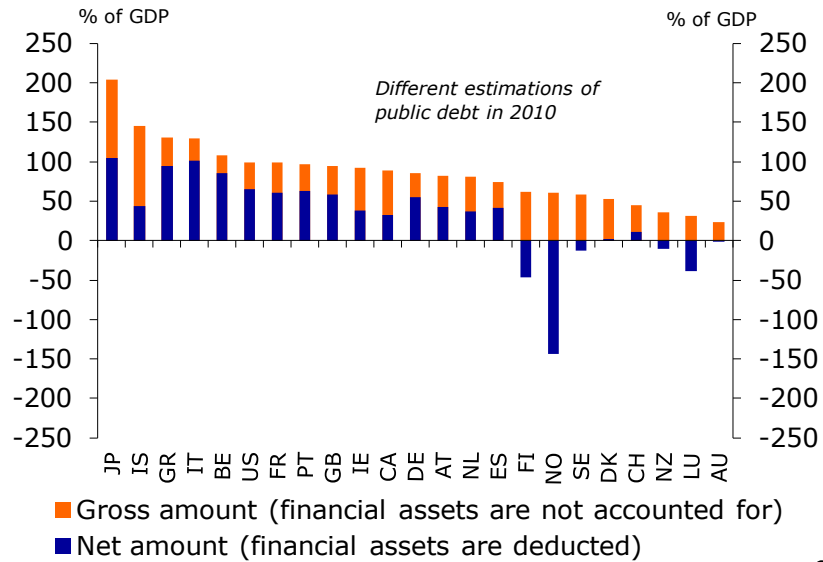
It is time to dust off the sovereign default literature

- Debt financeability**
- Debt affordability**
- Debt reversability**

Debt financeability



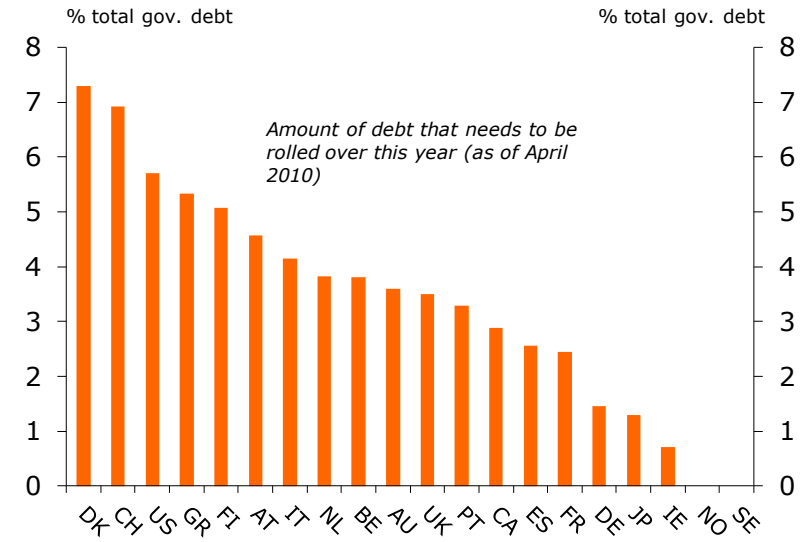
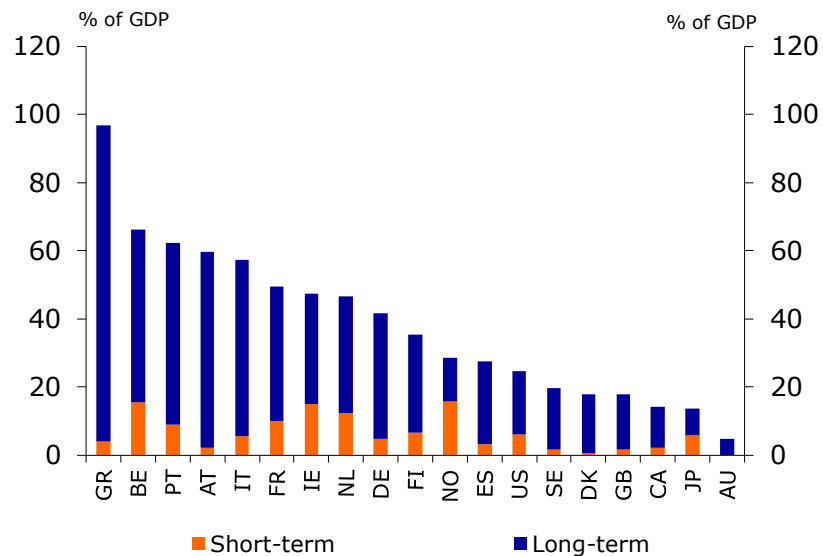
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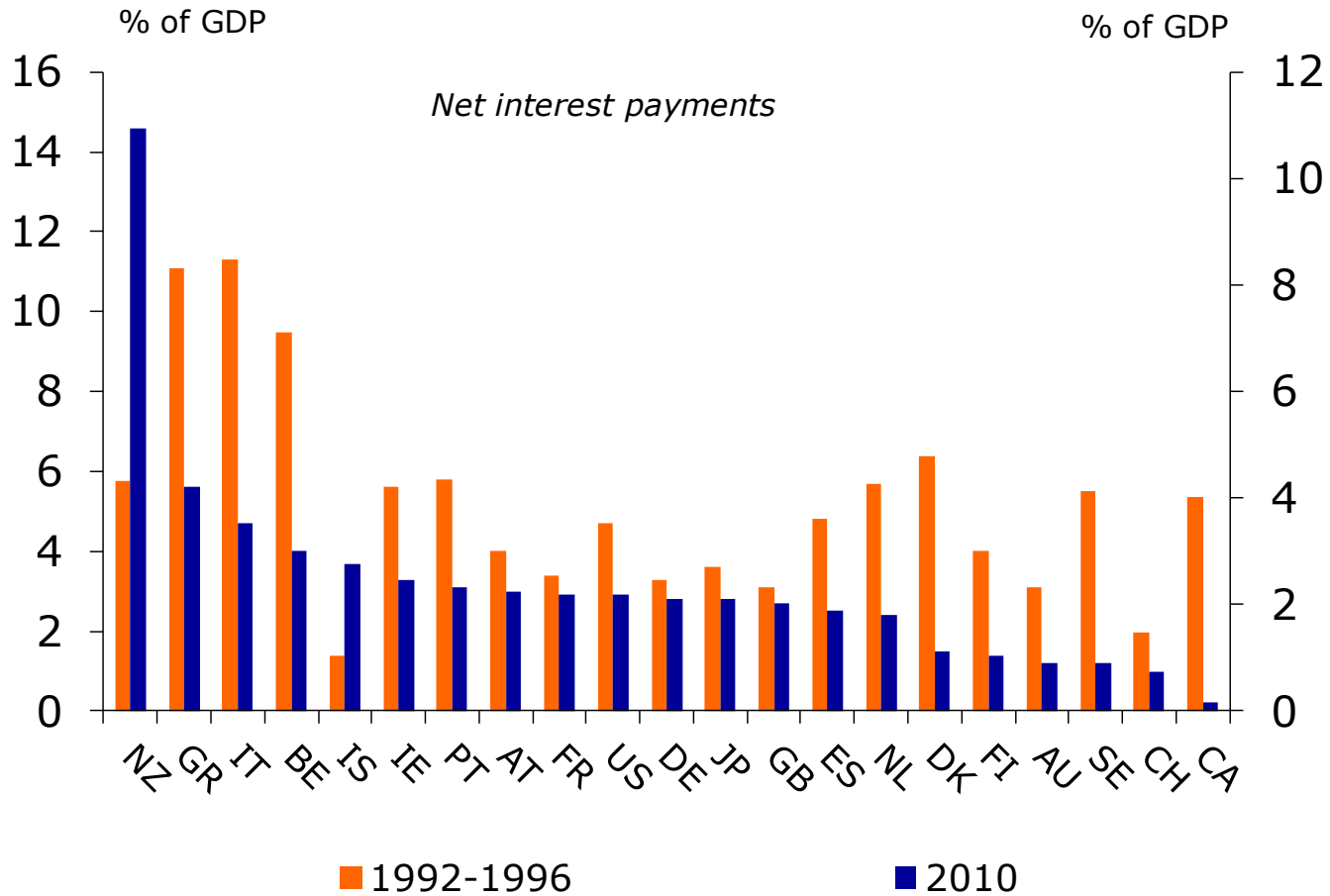
Gross versus net debt?

Are foreign investors more footloose?

Can markets digest the upcoming bond issuances?



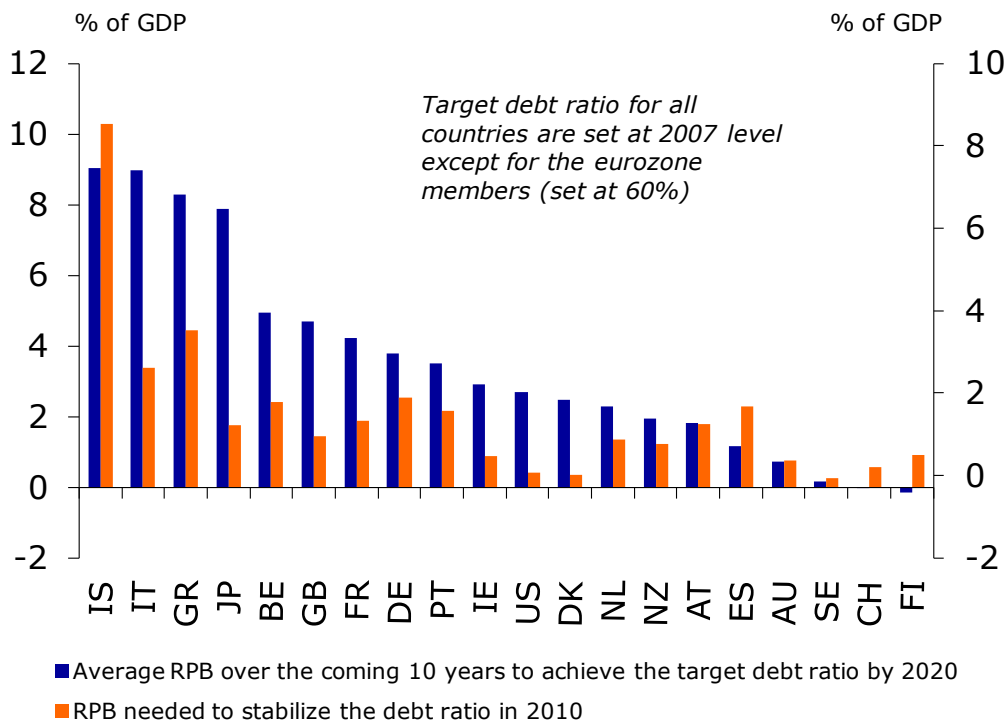
Debt affordability





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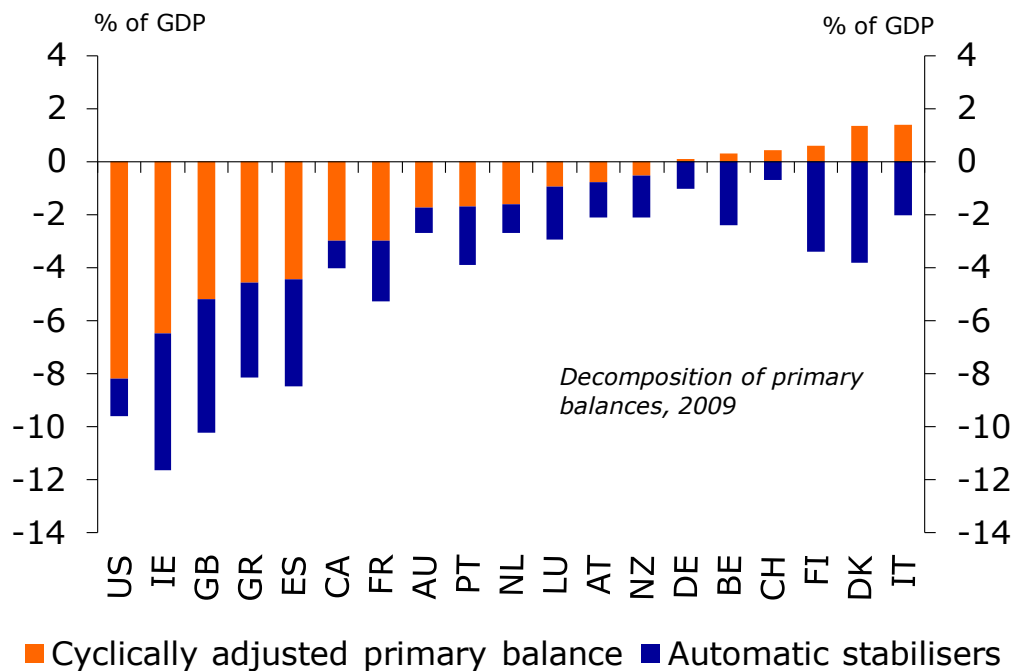
Debt reversibility



Snowball effects will force governments to press harder on the brakes to lower debt ratios...

...and this will prove all the more difficult when a large part of deficit is structural in nature.

Even removal of stimulus won't help





Dizzying amount of info?

What do the indicators tell us?

Summing it up!



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Sovereign Vulnerability Index (SVI)

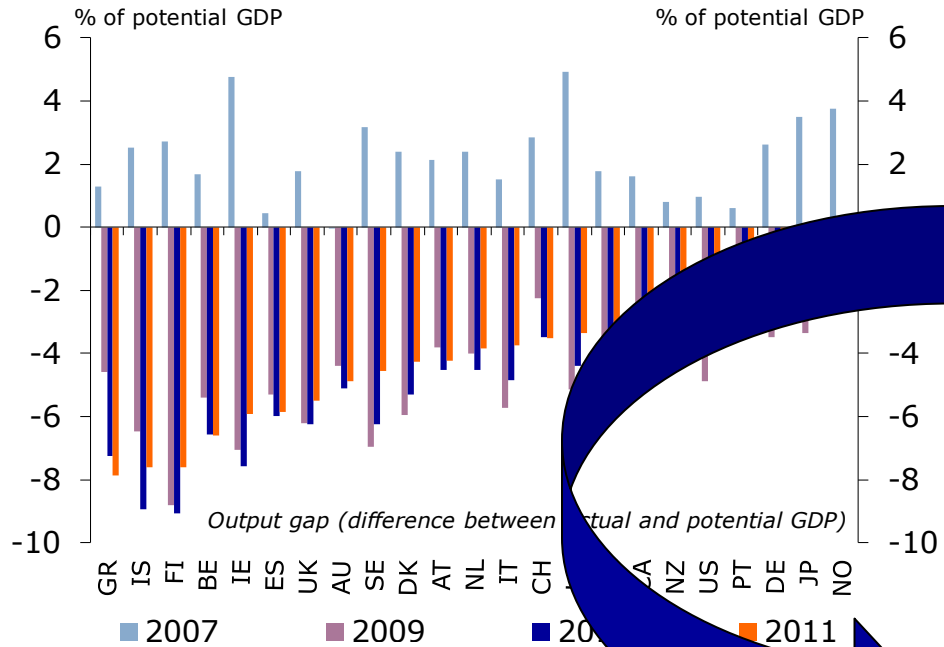
	SVI	Annual IPD derived from		Ranking based on		
		Moody's ratings	CDS spreads RR=70%	Moody's ratings	CDS spreads	SVI
Greece	22.11	0.07%	14.57%	1	1	1
Italy	17.20	0.03%	4.45%	2	5	2
Portugal	14.39	0.03%	8.49%	2	2	3
Belgium	12.22	0.02%	1.76%	3	9	4
US	12.19	0.01%	1.70%	4	11	5
France	11.98	0.01%	2.17%	4	7	6
UK	11.69	0.01%	2.41%	4	6	7
Ireland	11.17	0.02%	6.48%	3	3	8
Japan	11.06	0.03%	2.09%	2	8	9
Spain	10.61	0.01%	5.69%	4	4	10
Austria	10.43	0.01%	1.72%	4	10	11
Netherlands	8.50	0.01%	1.04%	4	16	12
Germany	8.09	0.01%	1.64%	4	12	13
Denmark	6.12	0.01%	0.94%	4	17	14
Australia	5.61	0.01%	1.24%	4	15	15
Finland	4.64	0.01%	0.74%	4	18	16
Switzerland	4.07	0.01%	1.45%	4	13	17
Sweden	0.00	0.01%	1.45%	4	14	18



The timing of exit

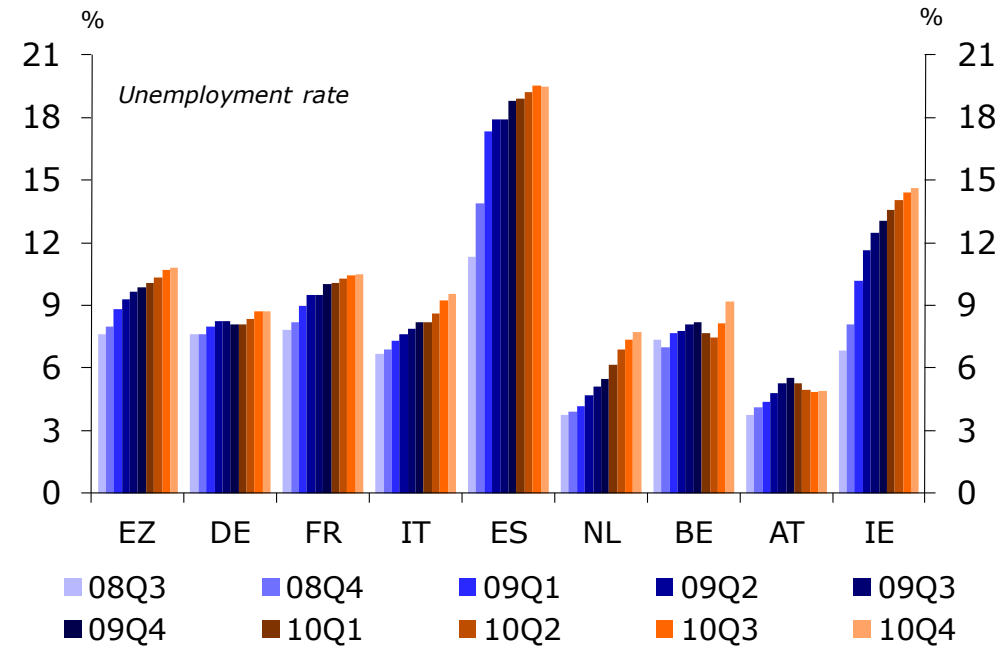
The navigable channel between Scylla and Charybdis has become quite narrow

Exit too soon and choke the recovery



Sizeable output gaps going forward

Will keep unemployment rates high

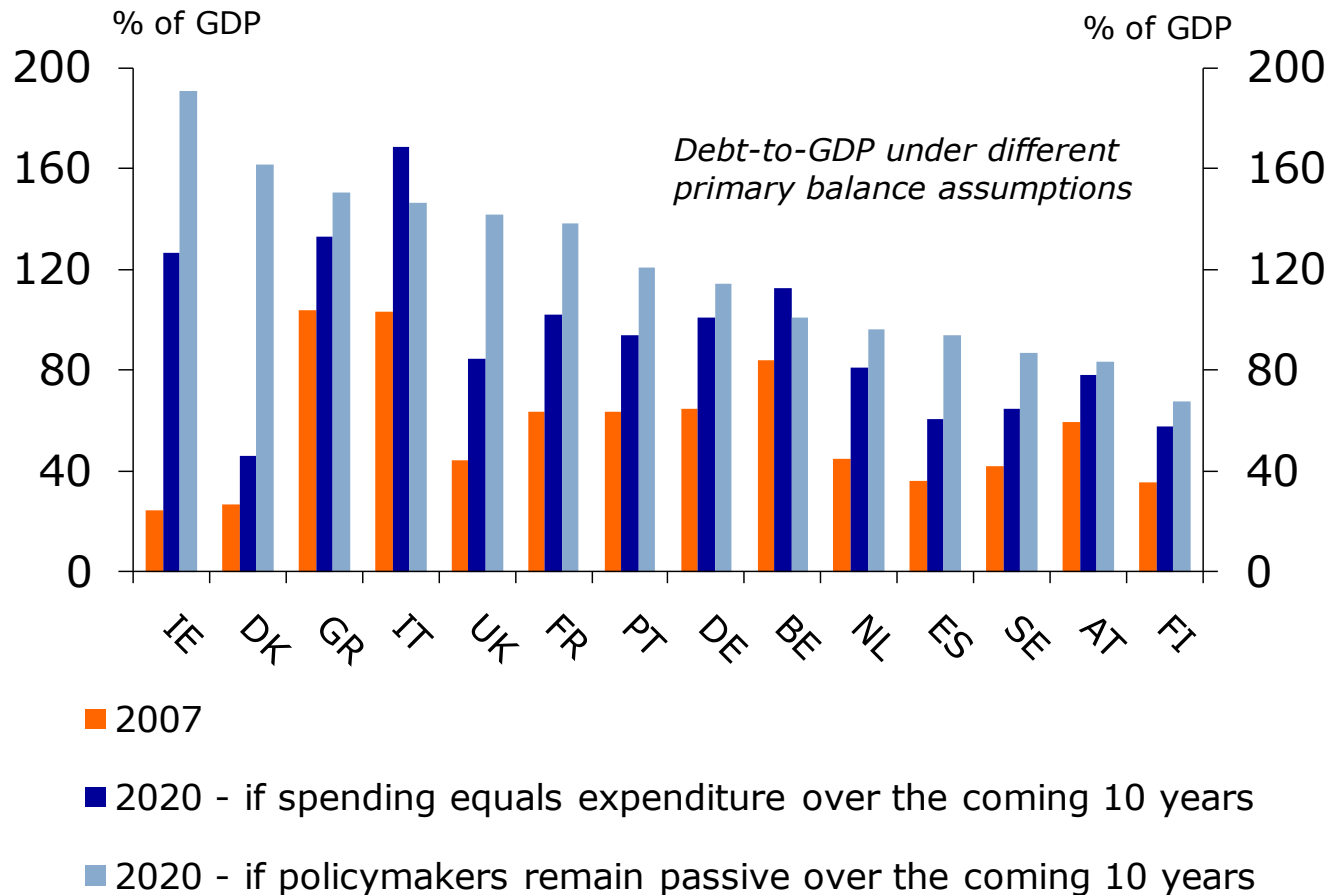


Exit too late and be doomed

Weak economy will push debt ratios further upwards...



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Higher interest rates and lower will only make matters worse.

A 40%-point increase in debt ratios could raise interest rates by 2% (IMF).

Ratings will also be negatively affected.

Ageing-related expenditure is an even extra burden.

Fiscal flexibility in response to new shocks will fall

The real-world advice you need to pay down your debt without living like a pauper

Managing Debt

FOR DUMMIES®

Proven tips to cut expenses and slash monthly payments

A Reference for the Rest of Us!

FREE eTips at dummies.com®



John Ventura
Bankruptcy attorney and author of Law For Dummies
Mary Reed
Consumer finance writer



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The road towards debt sustainability

Which policy option is the least costly?

Option 1 - Default

The *dirty* road




Pros:

- ✓ Easily engineered (just don't pay).
- ✓ Least costly option in the short-run.

Cons:

- ✓ Possible exclusion from important political decisions at the EU or EZ level.
- ✓ Loss of market access.
- ✓ Marked increase in borrowing costs (for both public and private sector).
 - Leading to snowballing effects.
- ✓ Sovereign debt crisis do not occur in isolation.
 - It can result in the collapse or severe impairment of the domestic financial system, with severe contractionary effects on credit, financial intermediation, and ultimately output.
 - According to the BoE, sovereign debt crises overlaps with currency and banking crises in $\frac{3}{4}$ and $\frac{2}{3}$ of their sample, respectively.
- ✓ **Overall, the BoE estimates that output can drop anywhere between 5-10% after a sovereign debt crisis.**



A 40%-point increase in debt ratios could raise interest rates by 2% (IMF)

Option 2 – Implicit default

The *sneaky* road

Pros:

- ✓ Relatively easily engineered (money printing)
- ✓ Beneficial in the short-run

Cons:

- ✓ Call it what you like, but it is a default nonetheless and so all the costs are applicable
- ✓ Pushes the value of debt denominated in foreign currency higher since exchange rate usually depreciates.
- ✓ Tough to control (or bring down) when unleashed (remember Volcker?).
- ✓ **All in all, inflation will only reduce debt ratios if it is constantly raised in an unanticipated way. Not only is that impossible, but it will also be detrimental to growth.**

Country	Debt ratio	Average inflation	Debt ratio		Drop in debt ratio when inflation is 6%
	2009	forecasted (2009-2014)	with av. Inflation equal to Forecast (2009-2014)	6%	
Australia	16.4	1.9	26.1	23.8	-2.3
Canada	83.6	1.3	74.1	69.4	-4.7
France	78	1.3	96.6	86.7	-9.9
Germany	74.3	1.1	88.6	81.3	-7.3
Italy	115.1	1.5	127.2	115.3	-11.9
Japan	218.7	-0.6	247.6	225	-22.6
Mexico	44.9	4.4	42.5	38.8	-3.7
Turkey	46.8	4.8	46.6	43.4	-3.2
UK	68.8	2.3	93.8	86.2	-7.6
USA	83.8	1.6	103.1	94.6	-8.5
Average	83.1	2	94.6	86.4	-8.2

Option 3 – Withdraw banking sector support

The *sensible* road (to be taken later)

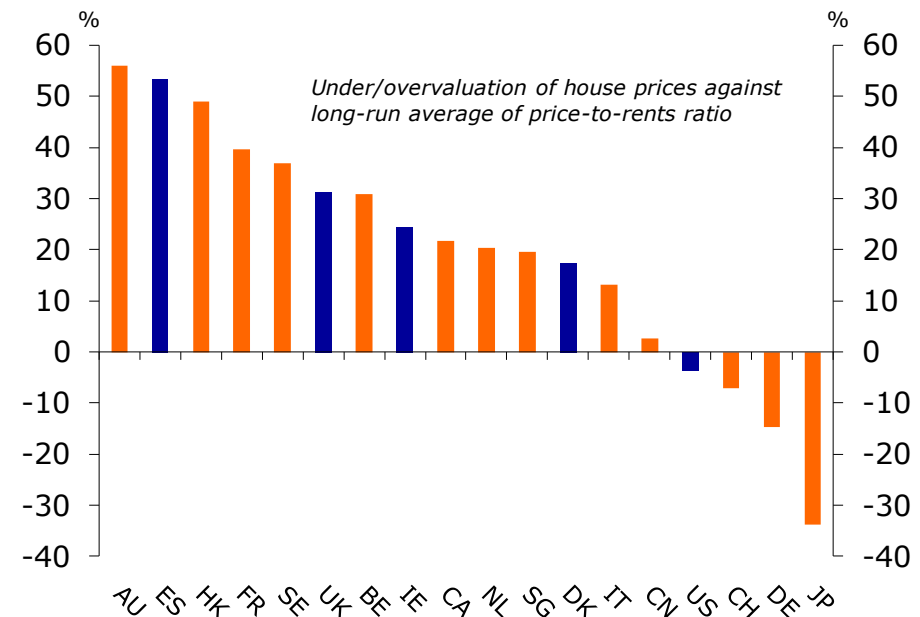


Pros:

- ✓ Return a lot of money into government's coffers
- ✓ Politicians can score points with the voters

Cons:

- ✓ Banking sector is not ready to stand on its own feet in the short term (right?)
- ✓ Profits are bound to drop when yield curve flattens
- ✓ Funding is still difficult
 - Transaction volumes in the interbank market are still low
 - Securitization market is still in a coma
 - Long-term interest rates for banks are still high
- ✓ Risks to the sector still lie to the downside
 - Further asset price corrections can be very painful
 - Uncertain regulatory environment (Basel III, bank levies, etc.)
 - Slowdown of the global recovery (?)
- ✓ It is simply a "one-off" approach



Option 4 – Structural reforms

The *uncertain* road



Pros:

- ✓ IMF: A 1%-point increase in growth for 10 years (holding spending constant and assuming a 40% tax rate) lowers government debt by a whopping 29%-points of GDP
- ✓ Not only will debt ratios fall but also country's potential GDP will rise

Cons:

- ✓ Politically difficult to be implemented
 - Reforming pensions?
 - Liberalize labour markets?
 - Increase immigration?
 - Privatise?
 - Promote competition in some industries?
 - Interest rates at the long-end of the yield curve for banks are still high.
- ✓ Subject to lags and uncertainties
- ✓ Weak external demand can still reduce GDP
- ✓ **Based on the findings of the IMF (2010) and Giannitsarou and Scott (2007), we know that GDP and inflation do not play a large role during fiscal consolidation**

Option 5 – Austerity measures

The *only* road?



Pros:

- ✓ Sovereign maintains its credibility in the financial markets
- ✓ The high costs of default are avoided

Cons:

- ✓ Depends on the state of the global economy and the confidence of agents (investors and consumers) in the policy measures.

Country	Episode	Change in structural budget balance (as % of GDP)	GDP growth during austerity period	Trend GDP growth 1 year before austerity period	GDP growth (5 years prior to austerity period)	GDP growth (5 years after the austerity period)
Sweden	1994 - 1998	9.9	3.1	1.6	-0.1	2.9
Italy	1992 - 1997	8.4	1.3	2.0	2.9	1.8
Belgium	1993 - 1998	8.2	2.0	2.2	2.9	2.0
Ireland	1986 - 1989	8.0	3.9	3.1	2.6	4.3
Luxembourg	1992 - 1997	8.0	3.1	5.6	7.2	6.0
United Kingdom	1994 - 1999	7.6	3.4	2.5	0.8	2.8
Denmark	1983 - 1986	7.4	3.9	2.2	1.7	0.7
Belgium	1984 - 1987	6.5	2.1	1.8	1.5	2.9
Greece	1996 - 1999	6.0	3.2	2.3	1.3	4.5
Ireland	1991 - 1994	5.2	3.4	4.7	4.6	9.7
United Kingdom	1979 - 1982	4.3	0.3	1.7	1.3	3.7
Germany	1982 - 1985	3.8	1.6	2.0	2.5	3.3
Denmark	1996 - 1999	3.5	2.7	2.4	2.4	1.5
Unweighted average	4.7 years	6.7	2.6	2.6	2.4	3.5

The experiences of Sweden, Denmark, Greece and Ireland in the 1980s as well as UK in the 1990s shows that GDP growth during fiscal contraction can even surpass the economy's trend growth rate.

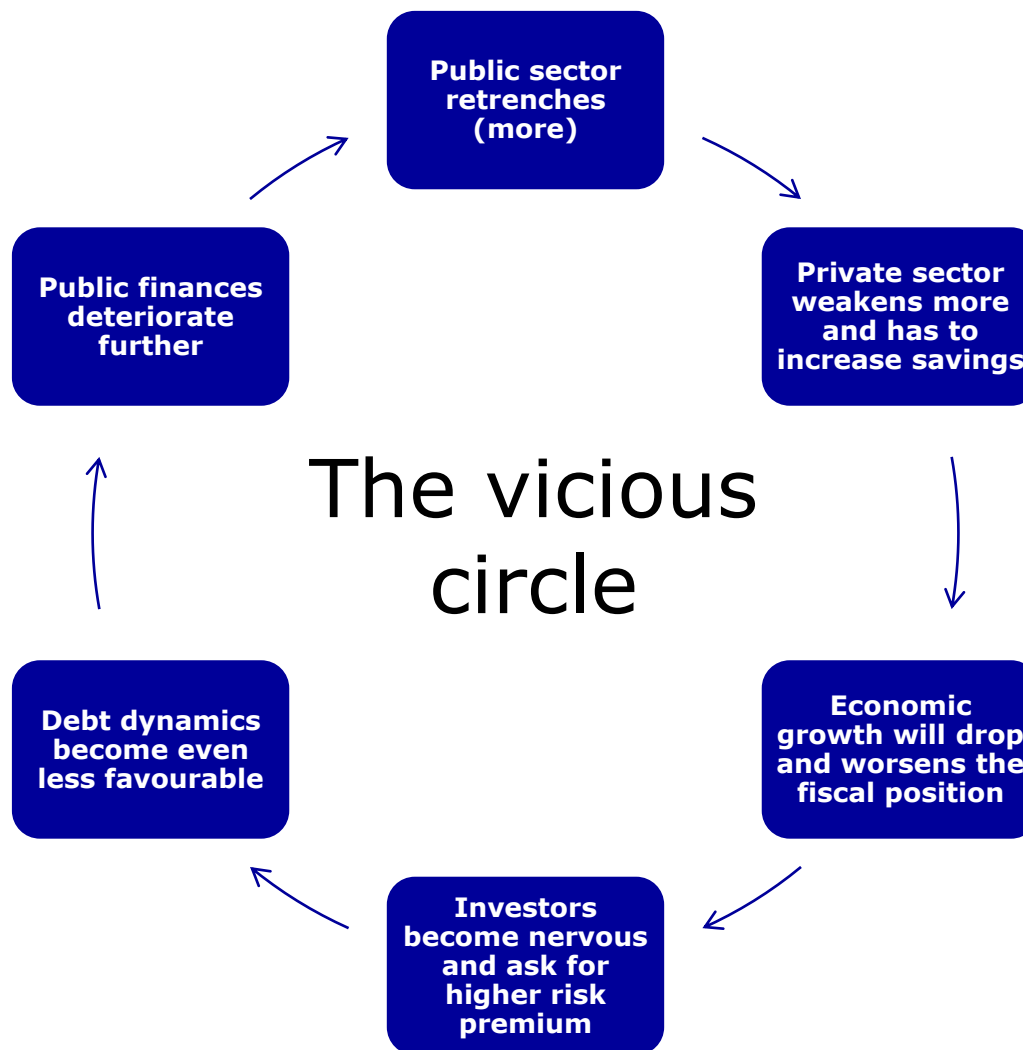
In Sweden and Finland, for example, successful consolidation halved the interest rates on a 10yr government bond between 1994 and 1998

Option 5 – Austerity measures

but we can't be sure if it works



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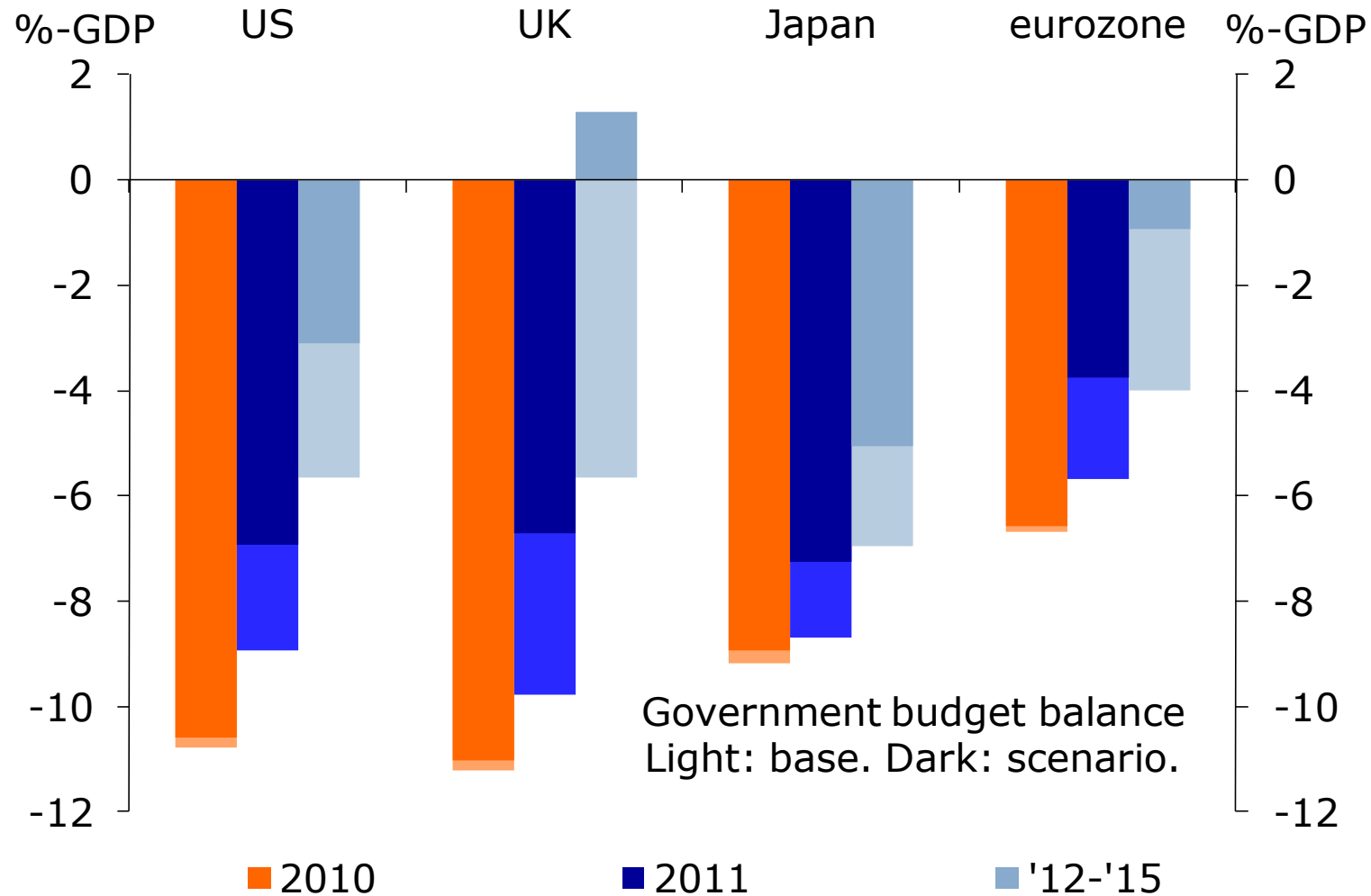
Debt-deflation worries

Past austerity episodes

Country	Austerity episode	Structural improvement government-balance	Trend growth prior to austerity episode	Average annual growth in austerity episode	Growth in the 5 years following austerity
Sweden	'94-'98	9.9	1.6	3.1	2.9
Italy	'92-'97	8.4	2.0	1.3	1.8
Belgium	'93-'98	8.2	2.2	2.0	2.0
Ireland	'86-'89	8.0	3.1	3.9	4.3
Luxembourg	'92-'97	8.0	5.6	3.1	6.0
UK	'94-'99	7.6	2.5	3.4	2.8
Denmark	'83-'86	7.4	2.2	3.9	0.7
Belgium	'84-'87	6.5	1.8	2.1	2.9
Greece	'96-'99	6.0	2.3	3.2	4.5
Ireland	'91-'94	5.2	4.7	3.4	9.7
UK	'79-'82	4.3	1.7	0.3	3.7
Germany	'82-'85	3.8	2.0	1.6	3.3
Denmark	'96-'99	3.5	2.4	2.7	1.5
Average	4,7 years	6.7	2.6	2.6	3.5

Debt-deflation worries

Model analysis: additional austerity

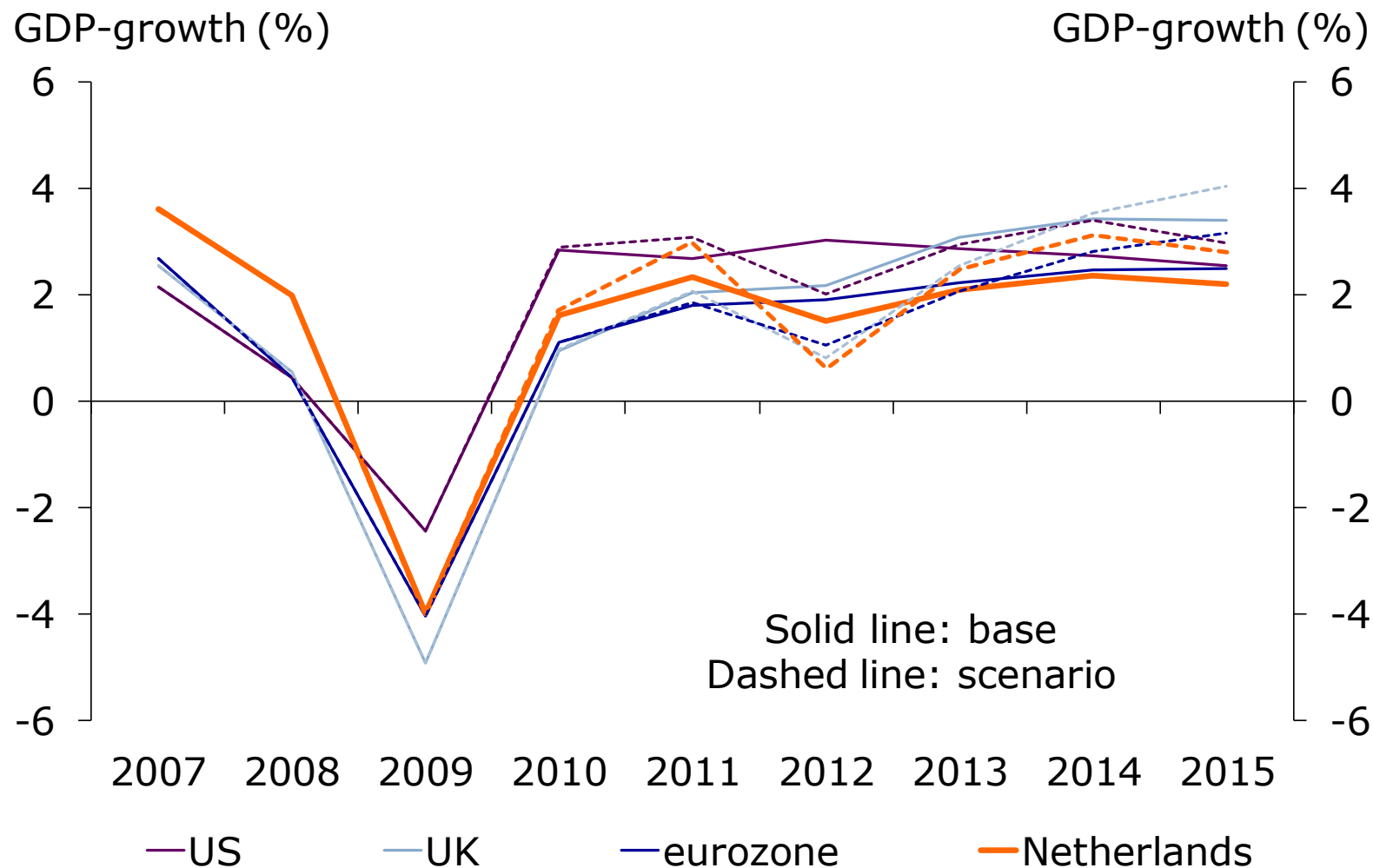




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Debt-deflation worries

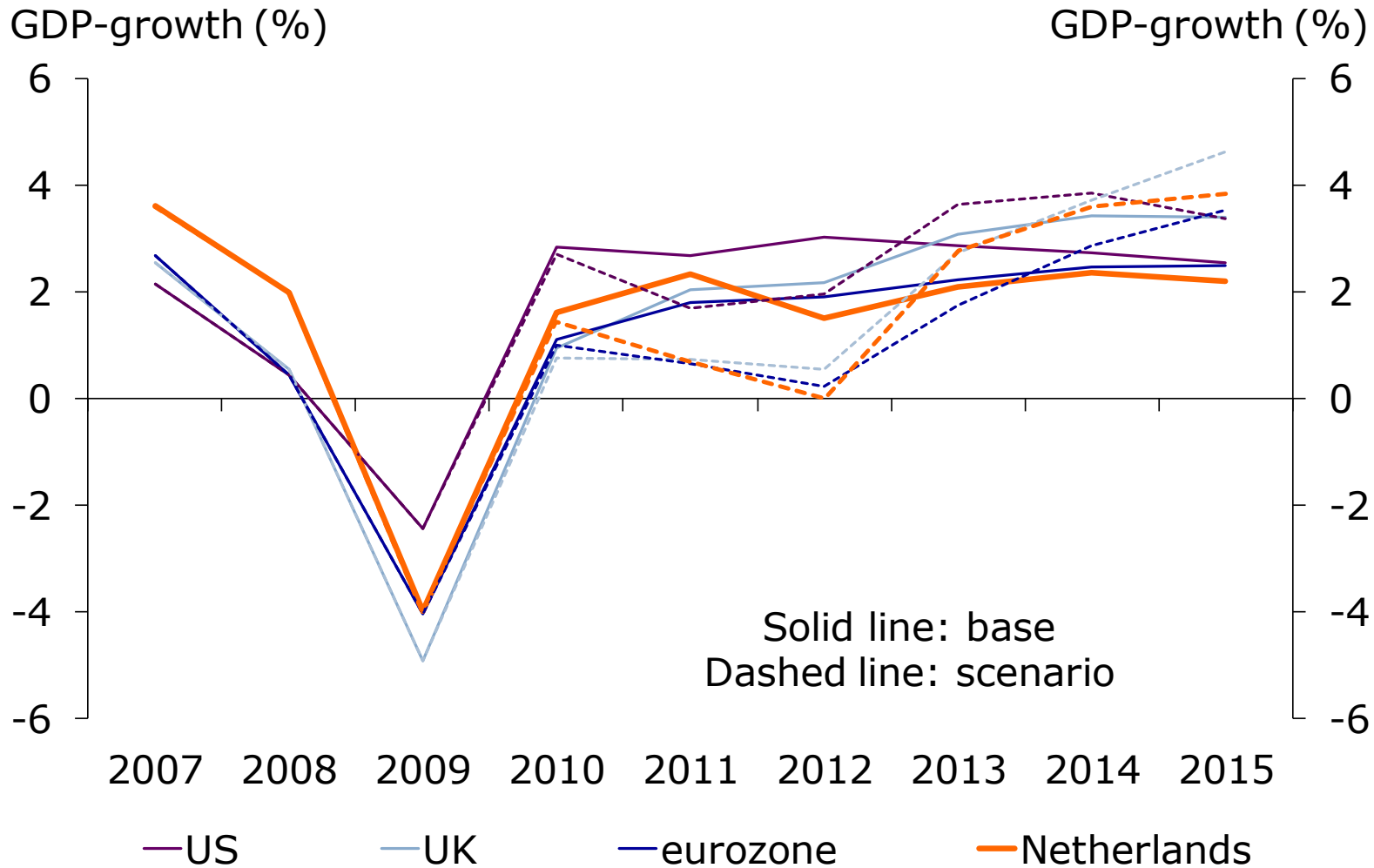
Model analysis: forward looking expectations





Debt-deflation worries

Model analysis: backward looking expectations *Rabobank*



A number of mitigating factors

- Announce a credible plan and carry them out when private sector has strengthened
- Take a longer horizon to correct the fiscal imbalances
- Set a higher target for debt ratios
- Place most of the burden on spending cuts rather than tax increases
 1. Tax-driven adjustments to budgetary policy have the effect of crowding out investment
 2. It is easier for the private sector to fill the gap left by the budgetary adjustment if it does not face the additional burden of increased taxation during the adjustment process.
 3. Unit labour costs are usually lower in expenditure-driven adjustments.



Caution!

Slippery road ahead for the
world economy

Outlook


What will shape the recovery?

Short-term *good*

- Global restocking
- Low inflation
- Fiscal stimulus
- Ultra low policy rates

Long-term *bad?*

- Credit conditions will remain tight?
- Further drop in house prices?
- Premature exit of governments or default?
- Premature exit of central banks?
- Inventory cycle coming soon to an end?



Therefore, the strength of the private sector remains key



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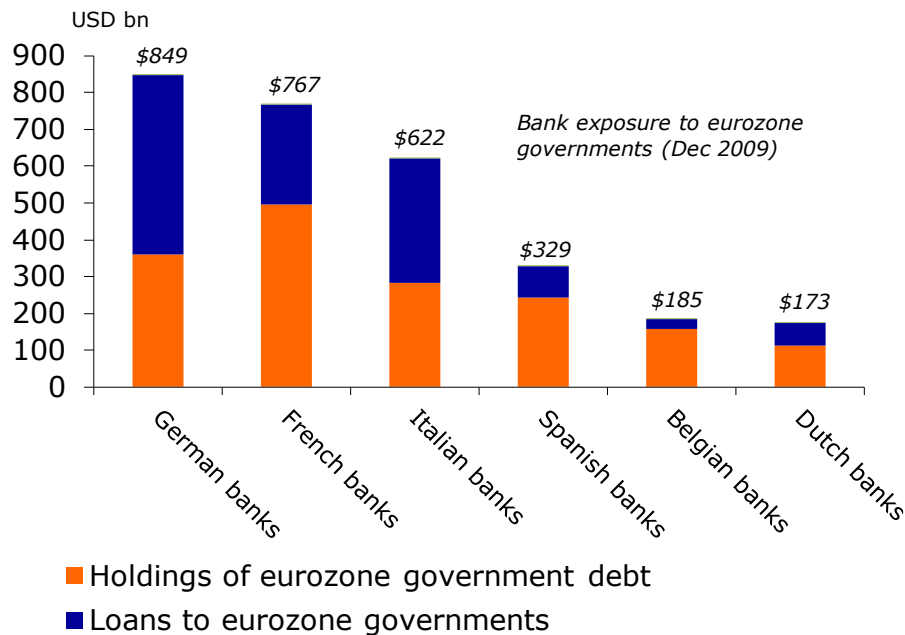
More information:

www.rabobank.com/kennisbank

Will default be even tolerated?

“Game of chicken” continues

- The BIPS vary in size (as a share of eurozone GDP) – the smallest being Portugal (1.8%) and largest Italy (17%).
- But each eurozone country is *too-interconnected-to-fail*.



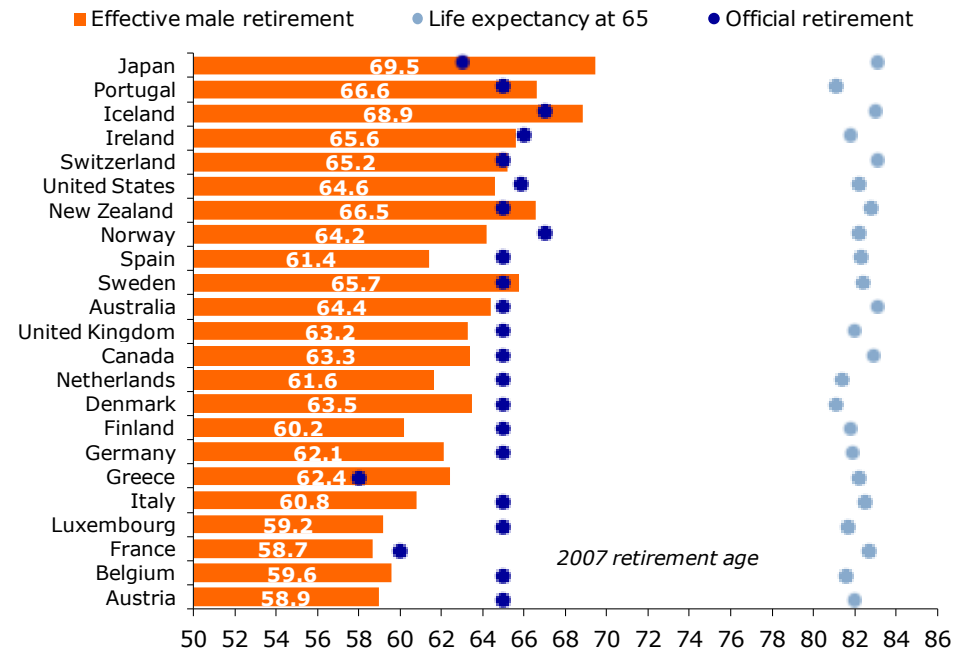
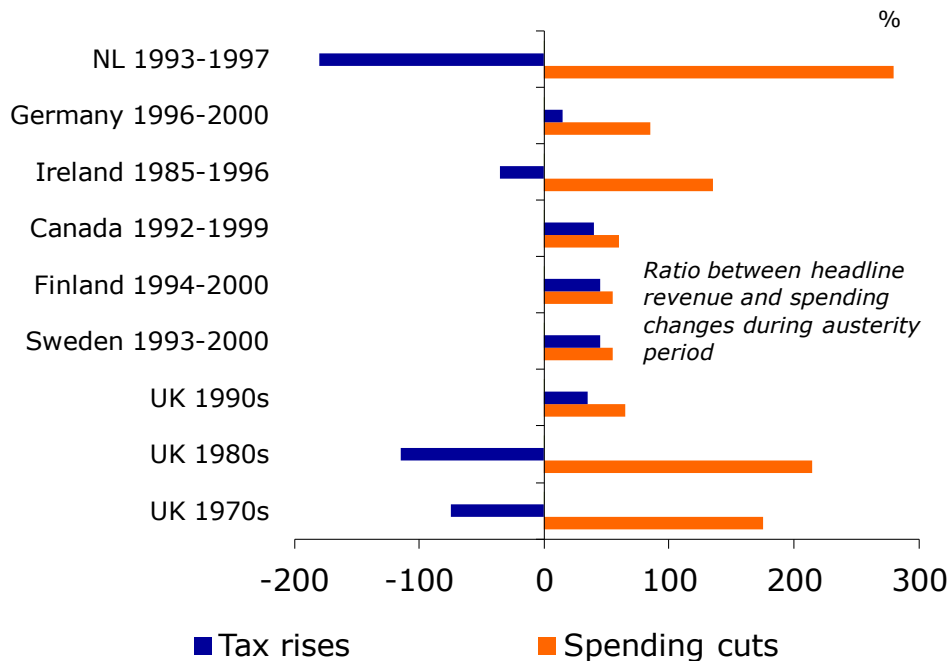
Banking exposure (as %GDP)

	Portugal	Ireland	Italy	Greece	Spain	Total
	1	2	3	4	5	6
Austria	1%	2%	4%	1%	2%	10%
France	1%	2%	17%	3%	7%	30%
Germany	1%	5%	6%	1%	6%	19%
Ireland	2%	n.a.	17%	3%	12%	34%
Italy	0%	1%	n.a.	0%	1%	3%
Netherlands	1%	4%	8%	1%	14%	29%
Portugal	n.a.	8%	2%	4%	11%	24%
Spain	5%	1%	3%	0%	n.a.	9%
UK	1%	7%	3%	0%	5%	16%
Switzerland	1%	3%	3%	12%	3%	21%
US	0%	0%	0%	0%	0%	1%
Japan	0%	1%	1%	0%	1%	2%

How will fiscal belt-tightening take place?



- Historically, successful consolidations have typically placed around 80% of the burden on spending cuts.
- Common areas to experience cuts include defense, civil service employment and benefits.



Costs of inflation



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Study	GDP will only contract if inflation rises above
Sarel (1996)	8%
Khan and Senhadji (2001)	1-3%
Ghosh and Phillips (1998)	2-3%
Burdekin et al. (2004)	3%
Espinoza, Leon and Prasad	10%
Chistoffersen and Doyle (1998)	13%
Barro (1995)	15%
Pollin and Zhu (2006)	15-18%
Drukker et al. (2005)	19%
Bruno and Easterly (1996)	40%
Overall range	1% - 40%

Study	4%-points rise in inflation reduces GDP growth by
Barro (1995)	0.1%-points
Fischer (1993)	0.15%-points
Gylfason and Herbertsson (1996)	0.18%-points
Rousseau and Wachtel (2002)	0.01%-points
Caporin and Di Maria (2002)	0.0025%-points
Motley (1994)	0.1%-points
Andres and Hernando (1997)	0.004%-points
Kamalodin (2007)	0.01%-points
Overall range	0.0024% - 0.18%