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THE GREAT SOVEREIGN RISK SHIFT

Post-GFC, sovereign risk has shifted from emerging to developed economies

In their fantastic survey of financial crises, *This Time is Different*, Carmen Reinhart and Kenneth Rogoff provide a chronicle of the 'hundreds of episodes in which sovereign nations have defaulted on their loans from external creditors', with examples ranging from Edward III's Fourteenth-century defaults on loans from Florentine financiers through to the great rash of sovereign defaults triggered by the Latin American debt crisis of the 1980s, and beyond.[1]

One of the messages of their book is that the historical pattern is one of international waves of defaults, followed by periods of relative calm which are then once again followed by another wave of defaults. The quiet periods can last for up to one or two decades, lulling investors into a false sense of security, with the most recent of these lulls occurring between 2003 and 2008. Reinhart and Rogoff identify five previous default cycles:

1. During the Napoleonic Wars (1799-1815);

2. From the 1820s to the late 1840s, when at times nearly half of the world's economies were in default, including all of Latin America;

3. From the 1870s to the 1890s;

4. From the Great Depression of the 1930s to the early 1950s, when once again nearly half of all countries were in default;

5. The emerging market debt crises of the 1980s and 1990s.

Are we due for another wave of defaults? And if so, where from?

Sovereign risk is the risk that a government will default on its financial obligations due to some combination of inability or (more commonly) unwillingness to pay. Reinhart and Rogoff's book confirms that over the (very) long run, few countries have avoided sovereign defaults at some point in their history, arguing that sovereign risk should be an ongoing source of investor concern.

In recent times, sovereign debt crises have typically been associated with emerging markets. To find the last wave of *developed* economy defaults, we have to look back to the 1930s and then the run up to, and aftermath of, the Second World War. Since then, sovereign risk concerns have typically been the preserve of investors with exposure to emerging markets.

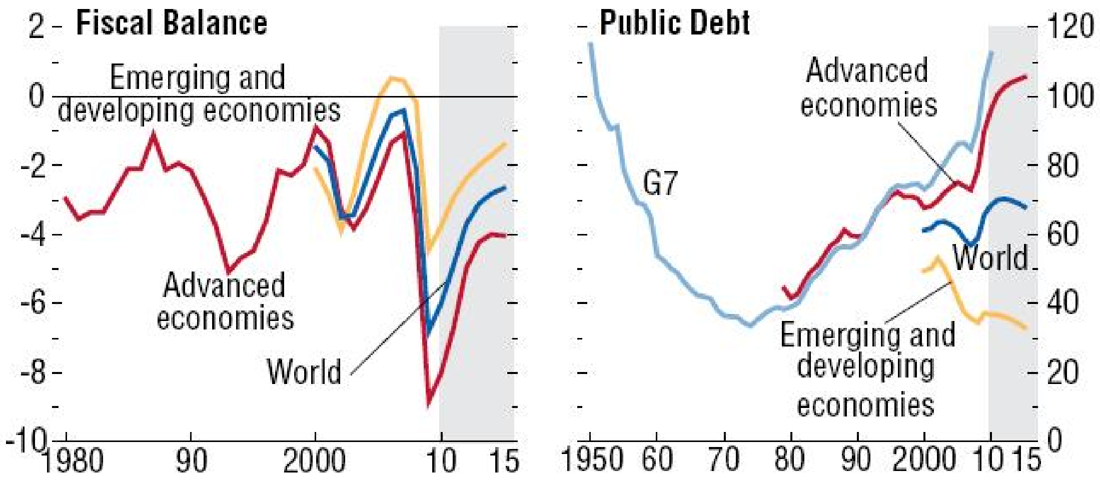
The global financial crisis has now challenged this presumption, however, and done so in a rather dramatic way. Our post-GFC world economy has generated a large gap between the fiscal and debt performance of developed and developing economies, in favour of the latter:

- According to the IMF, the financial crisis saw the general government fiscal position in advanced economies worsen by almost eight percent of GDP between 2007 and 2009, moving from an average fiscal deficit of about 1 percent of GDP to a shortfall of almost 9 percent of GDP over the period. [2]

- The comparable fiscal deterioration in emerging and developing economies over the same span was both smaller (about 5 percent of GDP) and occurred from a relatively stronger starting position (a modest surplus of about ½ percent of GDP).

- At the same time, the crisis has seen the stock of advanced country public debt increase by about 17 percent of GDP, rising from about 73 percent of GDP in 2007 to 90 percent of GDP in 2009.

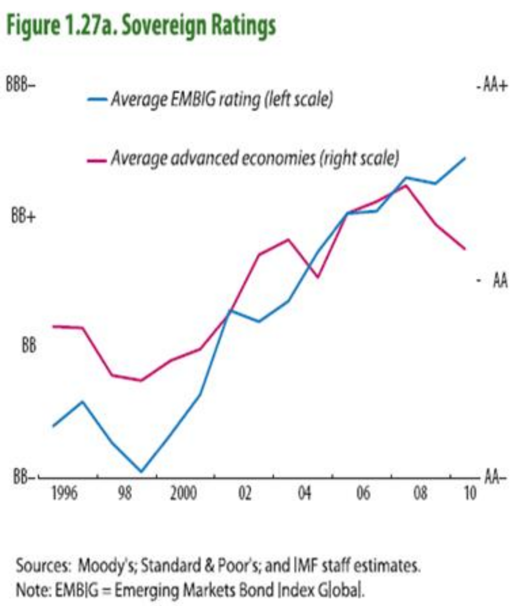
- Once again, emerging and developing economies have done better, with an increase in public debt of only around 1½ percent of GDP, from less than 36 percent of GDP in 2007 to around 37 percent of GDP by 2009.

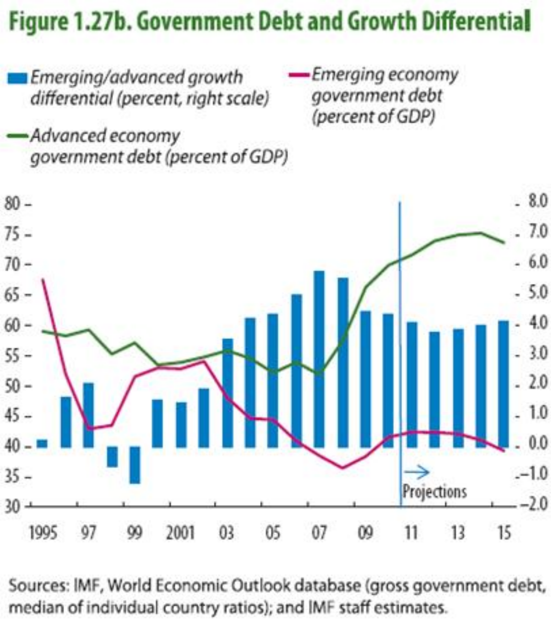


Source: Figure 1.12 in International Monetary Fund (IMF), *World Economic Outlook: Recovery, risk and rebalancing* (2010).

What's more, while the Fund thinks that the debt burden of the developed world will continue to deteriorate, reaching 106 percent of GDP by 2015, it also reckons that emerging and developing economies will see *their* ratio of public debt to GDP back down at about 33 percent by the same year.

These diverging developments in debt and deficits have been reflected in sovereign ratings. The latest IMF *Global Financial Stability Report* points out that there has been a decoupling in rating changes for advanced and emerging sovereigns in favour of the latter.[3] So while developed country sovereigns have experienced some 25 downgrades since early 2008, emerging market sovereigns have so far seen 21 upgrades during this year.





Source: Figures 1.27a and 1.27b in International Monetary Fund (IMF), *Global Financial Stability Report: Sovereigns, funding and systemic liquidity* (2010).

Since most forecasts assume both a continued gap in growth performance between the developed and developing world and a gap in debt burdens, one notable consequence of the recent global financial crisis has been a major reversal in the relative sovereign risk profiles of the developed and developing economies.

What are the implications of such a shift? Well, for developed economies facing lower credit ratings, it implies an increase in the future cost of funding (something which will itself contribute to a worsening of debt-growth dynamics) to compensate investors for the increase in sovereign risk. For emerging markets, it suggests a further dose of capital inflows as investors rebalance their portfolios to take into account the new pattern of risk and reward. Moreover, to the extent that these countries are able to climb the ratings ladder, it also allows access to a new tier of investors who are restricted to higher-rated investment classes and – as a result – is likely to prompt yet more inflows.

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[1] Carmen M Reinhart and Kenneth S Rogoff, *This time is different: Eight centuries of financial folly.* Princeton, Princeton University Press, 2009.
[2] Data from Figure 1.12 in International Monetary Fund (IMF), *World Economic Outlook: Recovery, risk and rebalancing.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2010.
[3] International Monetary Fund (IMF), *Global Financial Stability Report: Sovereigns, funding and systemic liquidity.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2010.