The year of sovereign defaults?

Just before the beginning of the year, The Economist had a “Leader” (the magazine insists on calling itself a newspaper and its editorials as “Leaders”) speculating on the possibility that 2011 may turn out to be the year of sovereign default in developed economies. At the time of writing, there is a deadlock in the U.S. Congress about increasing the ceiling on federal debt: earlier this year, in a budget deal, the Republicans got what they wanted (tax cuts for the rich), and the Democrats got what they wanted (extension of the unemployment benefits). In the process, both shut their eyes to the deficit this would lead to. Federal debt, already bloated by the costs of bailing out the financial system, and the wars in Afghanistan and Iraq, was to have reached the statutory ceiling last Friday night. Chances are that some compromise would be worked out to postpone the day when the Federal Government may have to start shutting down some of the services it provides. Many state and local governments are in even more dire straights.

The position is not much better across the Atlantic. Portuguese bond yields are close to 10%, even as the Government was defeated a couple of weeks back on a bill to cut expenditure. (The country will have an election and a new government shortly.) It has applied for EU/IMF assistance of the Greek/Irish variety. The EU/Euro zone problems have been further exacerbated because of political differences between the major countries, and the electoral defeat suffered by the ruling Christian Democrats in recent local elections in Germany. Across the Pacific from the U.S., Japan, the world’s third largest economy, was already boasting of the globe’s highest ratio of national debt to nominal GDP. The ratio has gone up further with the recent tragedies (the earthquake, the tsunami, nuclear radiation leakages, etc.).

The traditional ways of diminishing the debt burden through inflation (which increases the denominator, the nominal GDP) are not easy for the U.S. and Japan because of political/

economic compulsions; indeed, for the last few years, Japan has been trying to reverse the deflationary spiral, but without success. Incidentally, the route is not even open for Portugal because of the existence of a supranational central bank controlling the money supply.

While economic growth has resumed in the U.S., this is yet to result in job creation on any significant scale. On the other hand, as Buttonwood commented in a recent column in The Economist (March 26) "*the benefits of recovery seem to have been distributed almost entirely to the owners of capital rather than workers."* Nouriel Roubini cautioned a couple of months back that *"the path of least resistance becomes continued monetization of fiscal deficits* (QE II). Eventually (once the slack in goods and labour markets is reduced), this would push inflation expectations—and yield curves—higher." So could oil prices. No wonder the European Central Bank has increased interest rates late last week, for the first time since 2008 – and the JPY yield curve has steepened, if only marginally.

In principle, there are two solutions other than inflation:

- Reduce the fiscal deficit by increasing taxes and cutting expenditure, particularly on public servants; and/or
- Restructure the debt.

The former is difficult for democracies: as Raghuram Rajan wrote recently (MINT, March 28).in a different context, *"Democracies are necessarily soft-hearted, whereas markets and nature are not…..So how can this one-way betting be stopped? The scary answer may be that it does not end until governments run out of money (as in Ireland) or the public runs out of sympathy (as in Germany vis-à-vis the rest of Europe)*"

As for the latter, restructuring (in the form of lowering coupon or principal of existing debt) of course has serious implications for financial markets: after all, sovereign bonds are supposed to be credit risk free and thus the benchmark for all other interest rates in the economy. On the other hand, many euro zone countries have always paid higher interest than the benchmark German bond: the investor clearly was conscious of the higher risk. And, having earned higher returns in good times, (s)he should be willing to make some sacrifice in the restructuring, given the inevitable risk: reward relationship.

Are there any lessons for us in India from the dilemma which some of the developed countries are facing? To my mind, there clearly are: there are limits to what the state can afford, but for too many of our political masters, as would be amply manifested in the forthcoming state elections, the only way to win them is by distributing freebies. The risks are even higher for economies dependent on foreign capital, directly or indirectly, to finance the resources gap. (This surely is one of the problems in the euro zone countries in the southern cone.) However, our policymakers are still in thrall of the Western model of free capital flows and market determined exchange rates, whatever their impact on the current account and on output, and therefore, on savings and jobs.

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