

## Viewpoints

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### Sovereign Credit Risk Is the Risk Factor Du Jour



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In the past investors did not question actions taken by the fiscal authority to help the private sector. Even in recent times, investors have welcomed such actions worldwide. This view is evolving. Today, investors have made sovereign credit risk their risk factor du jour. No longer are they sitting ready with blank checks to underwrite any amount of debt that governments wish to issue. In 2010 signs of discomfort with sovereign debt are surfacing, with investors putting upward pressure on interest rates in developed nations in Europe, in particular several nations that face continued financial distress – Portugal, Ireland, Spain and (especially) Greece – and that are all part of the Economic and Monetary Union.

Investors are more discerning than ever before, dropping their long-held biases toward investing in developed nations and letting new criteria dictate their country selection. The focus on sovereign credit risk amid worsened fiscal situations in the developed world leaves investors with a shrunken list of developed countries to choose from. Many investors are turning to the emerging markets instead, where debt-to-GDP dynamics for many nations are far better than they are in the developed world and where economic growth is exceeding that of developed nations. Like bankers, investors these days are asking themselves, "Would I rather lend money to nations whose debt burden is worsening, or to nations where it is improving?" Increasingly, the focus on sovereign credit risk means that the answer is the latter, not the former.

For the U.S., its long-established economic power means that any loss of dominance will occur over many years. This will help to sustain the U.S. dollar as the world's reserve currency. Moreover, with Europe under duress, there is no alternative to the dollar and there is no other bond market for the world to house its \$8 trillion of reserve assets. Investors can't turn, for example, to China, whose balance sheet is unmatched, because China has a restricted domestic bond market. This all means that the U.S. probably can kick the can down the road before it has to worry about whether foreign investors will continue to invest in U.S. Treasuries.

#### The U.S. Primary Balance Needs to Stabilize

Still, the day of reckoning won't be put off forever if the U.S. continues to run massive budget deficits and shows no sign it will tackle the thorniest budget issue: entitlement spending. The U.S. budget deficit, which in fiscal year 2009 was an estimated \$1.4 trillion

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or 9.9% of the U.S. gross domestic product (GDP), will likely stay high for many years, running around 4% or 5% of GDP in 2015 when factors related to the aging of the baby boomers (those born between 1946 and 1964) accelerate the increase in entitlement spending. In addition, the tremendous accumulation of U.S. debt during the crisis years will likely boost its interest payments massively – by 2020, interest payments may exceed all discretionary spending. This will likely be the result of the U.S.'s failure to reduce its so-called primary deficit, which is the budget deficit minus interest payments. A zero primary balance, which the U.S. has maintained (or come close to maintaining) most years, is what is needed to stabilize the debt-to-GDP ratio. The problem is that many top Wall Street forecasters expect the U.S. to run a primary deficit of around 2% into the middle of the decade and the Congressional Budget Office expects the overall deficit to begin rising again in 2015 in part because of a sharp rise in interest payments on the U.S. debt. This means that the U.S. debt-to-GDP ratio will likely continue to rise, as many have forecast.

In the absence of substantive measures to reduce the structural elements of the U.S. budget deficit, the U.S. debt burden will worsen. Investors are smart enough to recognize this, which means the time may not be far over the horizon when investors will focus more intensely on the U.S. situation and ask perhaps the most significant question of our age: If the U.S. is backing its financial system, who is backing the U.S.? For now and in the near future, the answer will be “everyone,” including foreign investors. Dream on, though, if you feel that investors have endless tolerance for U.S. fiscal profligacy; this is an age when sovereign credit risk is in focus like never before.

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