THE SOVEREIGN DEBT CRISIS

Monroe Newman
Professor Emeritus of Economics, Pennsylvania State University

With the news full of the sovereign debt crisis, with governments mustering remedies for it, and with the streets full of people objecting to its real and potential impacts, it may be useful to keep some basics in mind.

-Sovereign debt is the accumulated obligations of government, the national debt that was accumulated to cover the past shortfall of government receipts when compared to government expenditures.

-For every debt, there is an equal asset held by those who made the loans so we might speak of a sovereign asset crisis for those who count the evidence of debt, the bonds, as part of their assets.

-Every time the proceeds of an addition to national debt are spent, an equal amount of income is generated, initially equal to the amount of the new asset created as the new bondholder exchanges money assets for the bond.

-Similarly, every time the national debt is reduced there are fewer bonds outstanding, to that extent bondholder wealth is now in the form of money, and someone has less disposable income to spend to generate income.

-Customarily, the evidence of debt – a bond – has a limited period before it is scheduled to be repaid (matures) so much of the activity in sovereign debt consists of selling new assets to redeem old ones.

-In addition to the activity associated with this rolling over of existing debt, net additional debt may be accumulated if governmental outlays exceed revenues.

-Persuading investors to buy all these new assets involves, among other things, offering them a rate of return that includes a risk premium which varies with the perceived likelihood that the scheduled interest payments and redemption at maturity will not occur.

-Paying this rate of return results in income redistribution in favor of the asset holders, except in the unlikely event that they paid extra taxes of an equal amount to cover the burden of these payments.

-If the asset holders are not nationals of the issuing country, the redistribution is international, purchasing power is transferred to those outside its borders.

-An analogous income redistribution occurs if domestic sources are tapped to redeem (buy back) assets held abroad.

What then is the crisis? Again, it may be helpful to break the possibility of crisis into its basics. A crisis can arise if:

-Government is unable to meet its immediate obligation to make the periodic payments, i.e. interest payments, to the asset holders of its bonds.

-Government is thought to be unable or unwilling to make future periodic payments, particularly if to do so requires a substantial portion of its revenues.

-Government is either unable to find buyers for bonds it must issue to rollover existing debt or can only do so at interest rates that are exorbitant.

-Government's continuing deficits require sale of additional bonds for which there are insufficient buyers or buyers who can only be induced to purchase at exorbitant rates.

The present crisis has elements of the last three of these possibilities.

The most common prescription for overcoming them involves finding willing, rather short term, lenders among other governments and international organizations. They expect repayment within a few years, effectively requiring that a substantial portion of existing and new debt be redeemed or rolled over by then. In exchange for their involvement, these lenders are requiring severe restrictions on future government deficits, with emphasis on reducing outlays for personnel and government benefits, programs and services. This concentrates the initial adverse effects of adjustment within the country's borders.

It is important to note that none of the burden of this reduction is to be borne by holders of previously issued government bonds. In the language common today, interest payments to bondholders and redemption of bonds are continued because they are "obligations." However, the denigrating designation of "entitlements" is used to describe promised benefit payments, such as those to retirees, which are being reduced.

Are there alternative approaches?

This is far from the first time that governments have confronted problems stemming from their sovereign debt. The traditional response has been to devalue the currency (or what is the same thing, issue a new monetary unit), which adversely affects all those with assets denominated in the "old" units. This is particularly true of those holding sovereign bonds and one of the reasons why a risk premium is included in the periodic interest payments they receive. A blunt instrument, devaluation has proven painful but effective, giving breathing space for revisions in government revenue and expenditure policies.

Clearly, this requires a government having control over its monetary unit. Belonging and remaining in a currency zone, such as the eurozone, precludes this remedy.

Faced with the fact that the current prescription for dealing with the crisis concentrates the initial adverse effects within its borders, a country might try an alternative. It might, for example, treat foreign holders of its bonds differently than domestic ones.

Foreign holders of debt could be told that their assets have been "renewed," i.e. will be paid off at some future date but with no change in their interest rate, so that their annual interest receipts remain unchanged. Domestic holders could be given a different rate of return and redemption rights under certain circumstances.

Obviously, the result will be different changes in value for the bonds of each group of holders. Differential impacts characterize every policy and one of the functions of policy is to decide how each group is affected. That is one of the prerogatives of sovereignty.

If a country were to take this step, it would transfer abroad some of the downward pressure on economic activity that necessarily accompanies the conventional prescription. Requiring that existing lenders continue in that role avoids some of the onerous, depressing domestic effect of the current form of international assistance.

By doing this, the state avoids the costs and difficulties of rolling over existing foreign-held debt. However, it would still face a current deficit in a budget that included the cost of financing existing and new indebtedness in addition to the other costs of government. The size of that deficit would be limited by its ability find holders of new indebtedness.

History makes it clear that private foreign lenders might expect unacceptable risk premiums, or be unwilling to lend at all. They would be responding to the "renewal" of existing foreign-held debt, which they would see as a modified default.

How might government deal with this? Reconstituting the taxation system would obviously help, a task possibly made easier by the fact that no new international income redistribution would be necessary. In addition, tax revenues would not be as depressed as they might be by the fall in income resulting from a larger decline in government spending.

The marketing of bonds domestically would continue. Those purchases might increase, thanks both to the knowledge that all net new proceeds would go to preserve domestic programs and also to attractive loan terms.

The sum of these two – tax proceeds and other revenue plus net new bond purchases – would establish the ceiling on government outlays. To the extent that they were insufficient to cover obligations, painful choices would be unavoidable. As the process is taking hold, it might be necessary to pay some commitments with short term, interest-bearing securities and/or a secondary limited currency.

In summary, the overall effect would be a) to transfer abroad to investors some of the depressive effect of readjustments, b) investors at home and abroad would continue to be compensated fully for the anticipated risk they previously accepted, c) make manifest the need for domestic income producers to support public outlays through taxation or lending, and d) focus attention on the need for setting priorities and making changes in the pattern of public expenditures, separate from any "discipline" imposed from abroad.

Is the foregoing messy and does it have undesirable aspects? Of course. The more important question asks -- Is it less undesirable than the conventional approach, which makes principal payments to bondholders obligatory and all other government programs discretionary and which has more severe depressive effects domestically. Your answer clearly depends in part on whether you hold foreign sovereign debt among your assets.