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Who Will Solve The Debt Crisis?

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(Editor's Note: This is a transcript of a speech by John Chambers, chairman of Standard & Poor's Ratings Services' Sovereign Rating Committee, at the "Caixin Summit 2011", held in Beijing on Nov. 11- 12, 2011. The topic of the summit is "China And The World: Strategizing Sustainable Growth." Caixin Media Co. Ltd. is a Beijing-based media group.)

I have been asked to speak on the subject of "Who Will Solve the Debt Crisis"(1). Today, I will argue that:

- external imbalances are as much at the root of the current crisis as fiscal imbalances;
- better coordination among international policymakers can help to attenuate these external imbalances;
- prior domestic economic reforms will facilitate coordination;
- generally, a high level of financial claims is more of a symptom of past failures to reform than the disease itself; and
- if international cooperation and economic reform come up short (which is not our base case), global growth could sputter, public and private sector indebtedness could remain high, and some speculative-grade sovereigns could resolve their fiscal difficulties through default.

I'll divide my remarks into two parts. The first will pertain to the euro area; the second to the rest of the world. I will argue that what is taking place in the euro area in several respects is a microcosm of what is happening globally.

External Imbalances Are As Important As Fiscal Imbalances In The Eurozone

The euro was launched in January 1999. The European Monetary Union (EMU) initially comprised 11 members. Greece joined in 2001. Slovenia, Cyprus, Malta, Slovakia, and Estonia joined between 2007 and 2011. From 1999 until 2008, EMU government bond spreads converged (see chart 1). As my colleague Moritz Kraemer and others have pointed out, there wasn't a similar convergence in productivity(2). This can be seen in unit labor costs (chart 2) or in current account deficits (chart 3). It can also be seen in Standard & Poor's ratings, for our ratings were initially dispersed across four rating categories (see chart 4)(3). If our ratings had followed the market, they would have been clustered at or near 'AAA'.

Chart 1

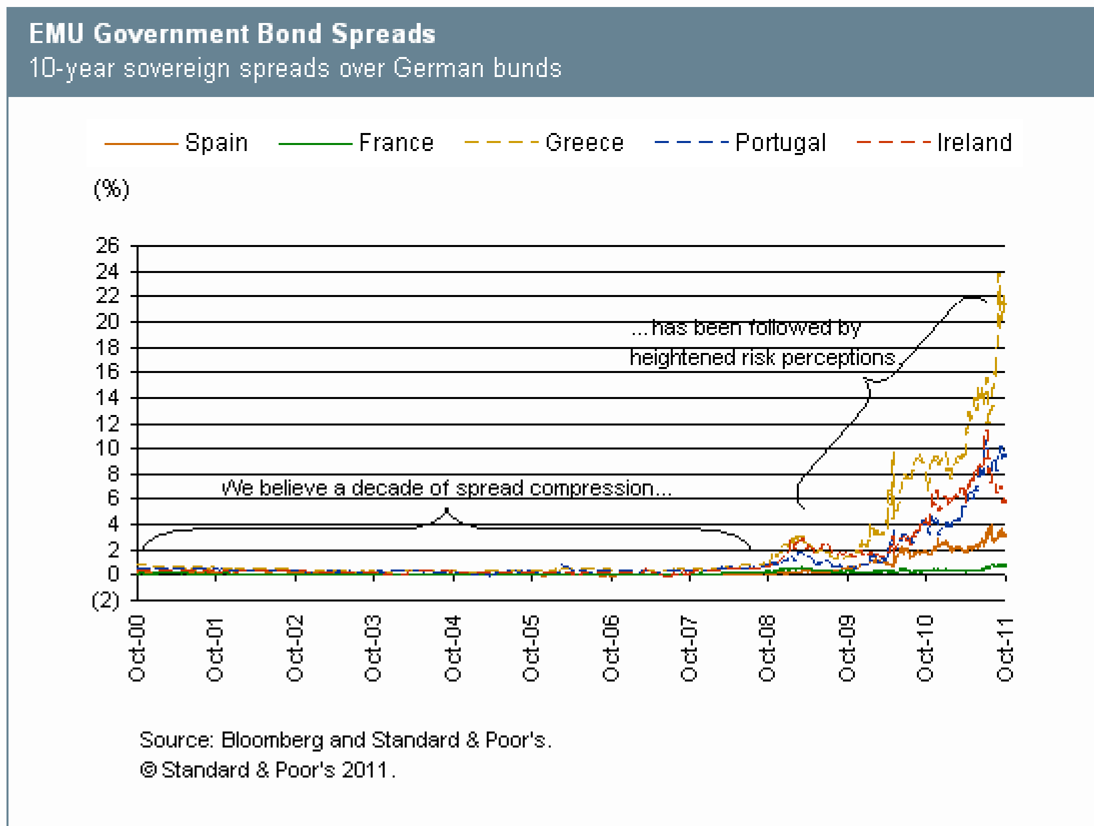

Chart 2

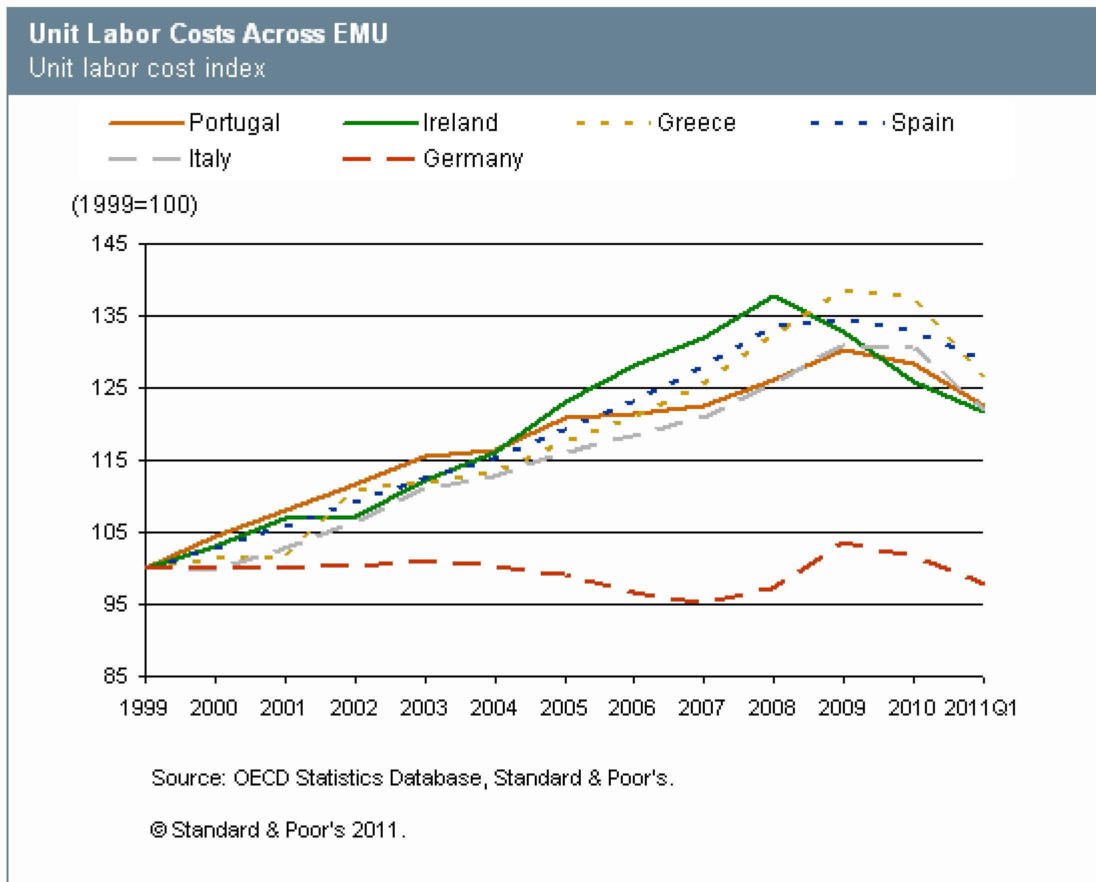

Chart 3

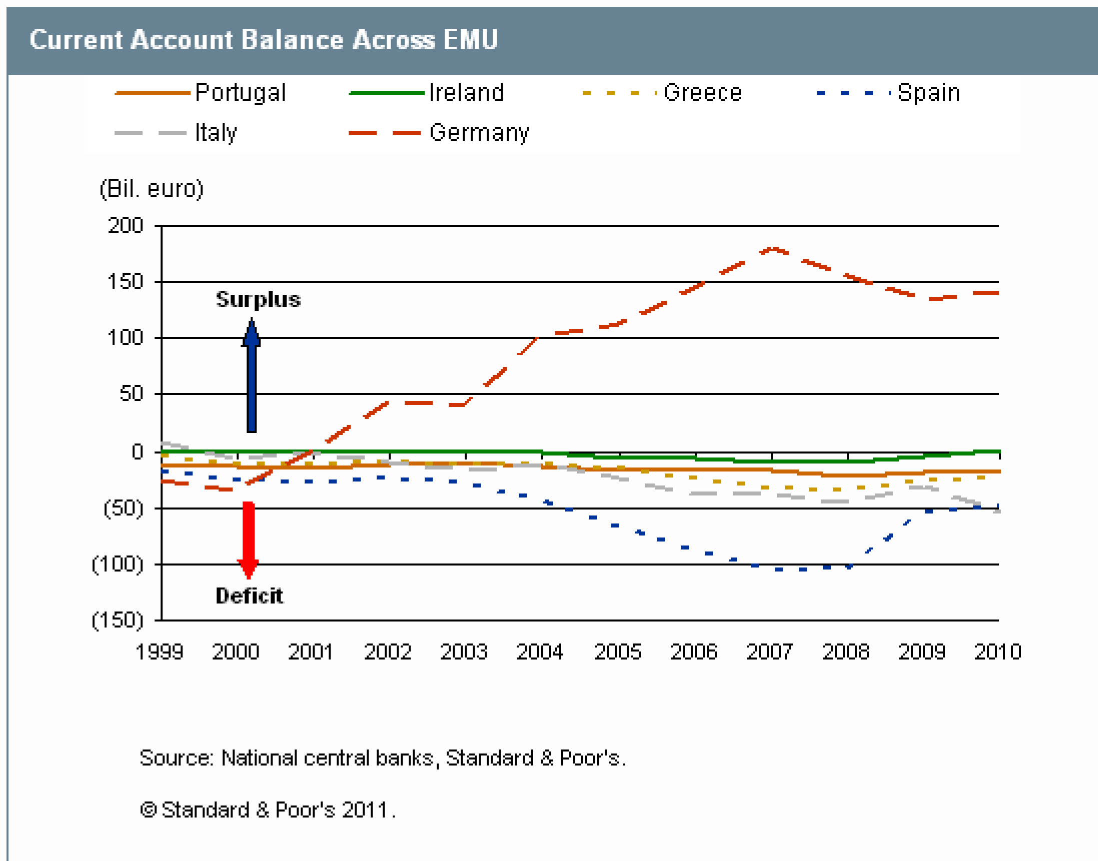

Chart 4
European High-Grade Sovereign Rating Actions

	Rating	2004	2005	2006	2007	2008	2009	2010	2011 through October
Austria	AAA/Stable								
Belgium	AA+/Negative								
Cyprus	BBB/Watch Neg					↑		↓	↓ ↓ ↓
Estonia	AA-/Stable						↓	↑	↑
Finland	AAA/Stable								
France	AAA/Stable								
Germany	AAA/Stable								
Greece	CC/Negative	↓					↓ ↓	↓	↓ ↓ ↓
Ireland	BBB+/Stable						↓ ↓	↓ ↓	↓
Italy	A/Negative	↓		↓					↓
Luxembourg	AAA/Stable								
Malta	A/Stable								
Netherlands	AAA/Stable								
Portugal	BBB-/Negative		↓				↓	↓	↓ ↓
Spain	AA-/Negative	↑					↓	↓	↓
Slovakia	A+/Positive		↑			↑			
Slovenia	AA-/Stable			↑					↓

Arrows indicate a rating action, green indicates a positive end-of-year outlook and pink indicates a negative end-of-year outlook. Source: Standard & Poor's Sovereign Rating And Country T&C Assessment Histories, on RatingsDirect, Nov. 1, 2011.
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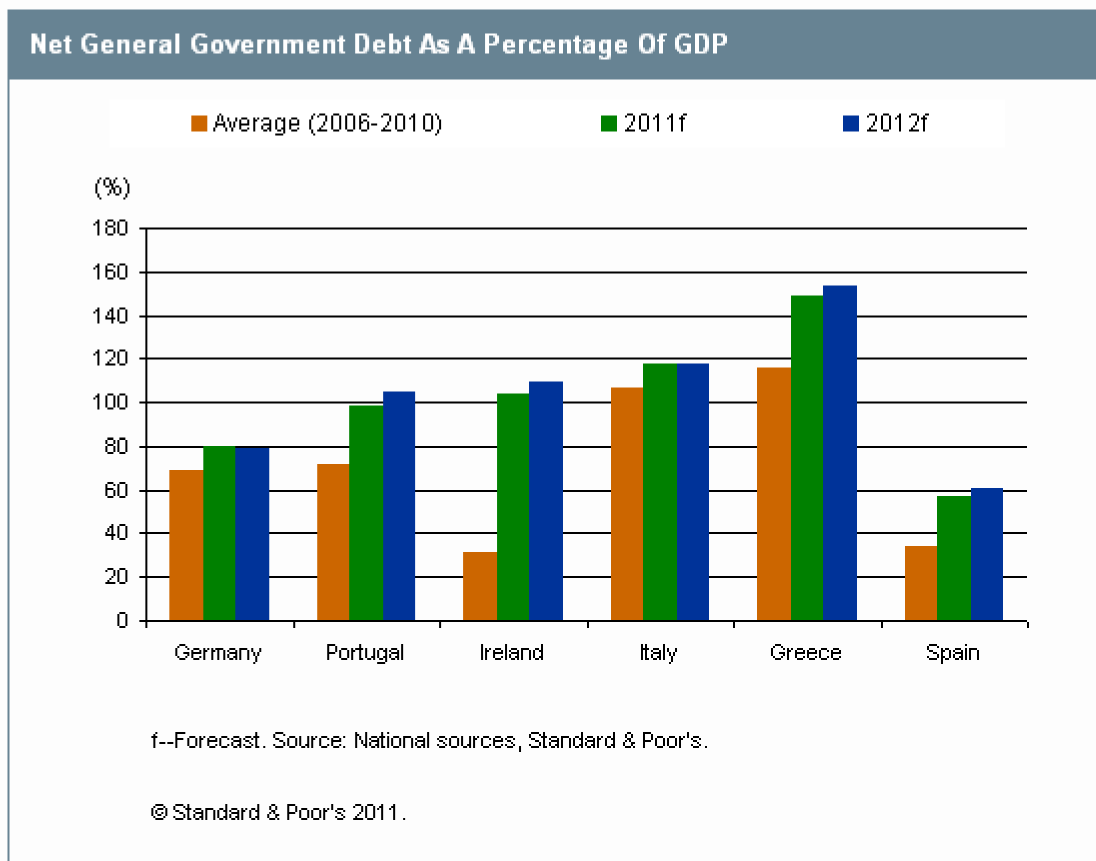
The current account deficits had to be financed, raising debt and non-debt financing from the rest of the world. Much of the debt came from banks. Macro prudential rules played an incentivizing role(4) for financing sovereigns in that banks were not required to hold much if any capital against their government securities portfolios. If the securities were held in the "hold to maturity" portfolio, they didn't have to be marked to market. They were eligible collateral for repurchase operations and thus were cheaply funded. Monetary policy focused on the eurozone as a whole, and it was difficult to see systemic risks building in financial sectors. This combination allowed serious credit-financed real estate bubbles to build in Ireland, Spain, and elsewhere.

The Great Recession of 2008 changed creditors' views on the interrelated issues of systemic risk emanating from

financial sectors, from sovereign credit risk, and from persistent external imbalances. But the growing disparity in competitiveness in eurozone members received few headlines. Nor did any of our euro area rating actions. These included our downgrade of both Greece and Italy in 2004, our 2005 downgrade of Portugal, and our second downgrade of Italy in 2006. The market disagreed with our negative euro area rating actions and continued to fund these sovereigns nearly flat to Germany.

Apart from Greece and Italy, much of the debt incurred in the run-up to the 2008 Great Recession financed private sector investment and consumption. Thus, the origin of the imbalances was not in most cases fiscally driven. But the fiscal impulse may have been too accommodative in some of euro area sovereigns (see chart 5). When the externally financed investment returns fell below expectations, the conditions were set for what Guillermo Calvo first called a sudden stop(5) in external financing. Only the European Central Bank was able to fill the breach.

Chart 5



Carmen Reinhart and Kenneth Rogoff, among others, have pointed out the different channels in which sovereign risk can exacerbate banking systemic risk and banking risks can amplify sovereign risks(6). Sovereigns are usually assumed to stand behind systemically important banks because significant bank failures can create large dislocations in an economy and weaken confidence in the financial system more broadly. Banks can thus become contingent fiscal risks to the sovereign(7). When banks hold high levels of government securities in relation to shareholders' equity, sovereign risks become an important factor in assessing bank solvency(8).

You can see how a negative feedback loop is created. This can be exacerbated by the disconnect between the

European Central Bank's shared ownership structure and the capital market's standard assumption that most national central banks will find a way to provide a price floor for the local currency debt of their shareholder governments.

Let's take a look at some characteristics of the eurozone: It had many systemically important banks, many banks with high holdings of government securities, and a single monetary authority for 17 distinct economies operating disparate budgetary and wage-setting policies. We believe these characteristics increased the vulnerability of euro area sovereigns when faced with the external shock that emanated from the fall in U.S. housing prices and related losses in subprime mortgage-backed securities(9).

Although recapitalization costs to governments to date have not exceeded 15% of GDP, except for Ireland(10), the broader costs have been substantial. As economic conditions weakened and their own costs of funding increased, banks tightened credit conditions to staunch any deterioration in their credit portfolios and preserve their capital ratios. In doing so, they contributed to depressing economic activity with the associated loss in tax revenues(11) (see charts 6-7). The impact of the 2008 Great Recession on some governments' fiscal debt position in part accounts for the higher-risk premiums demanded by investors to finance their borrowing requirements. In turn, this engendered valuation losses on the banks' government securities holdings.

Chart 6

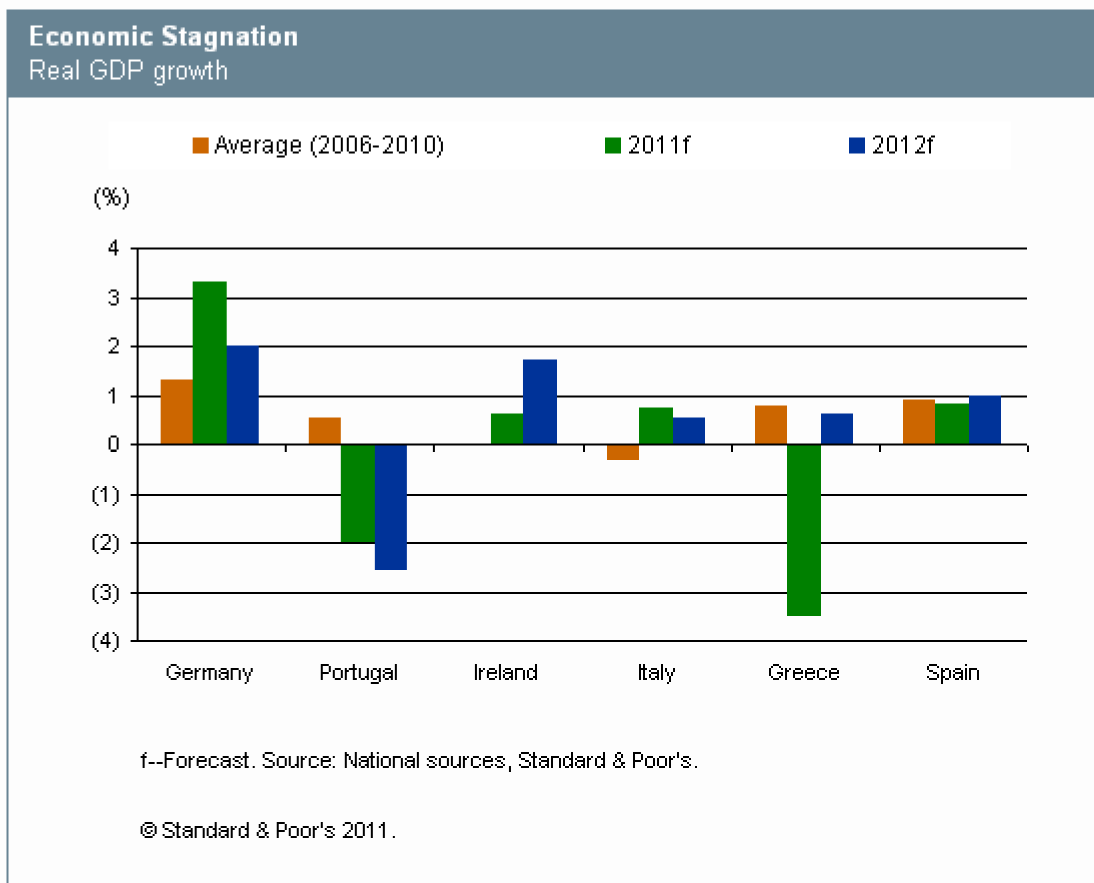


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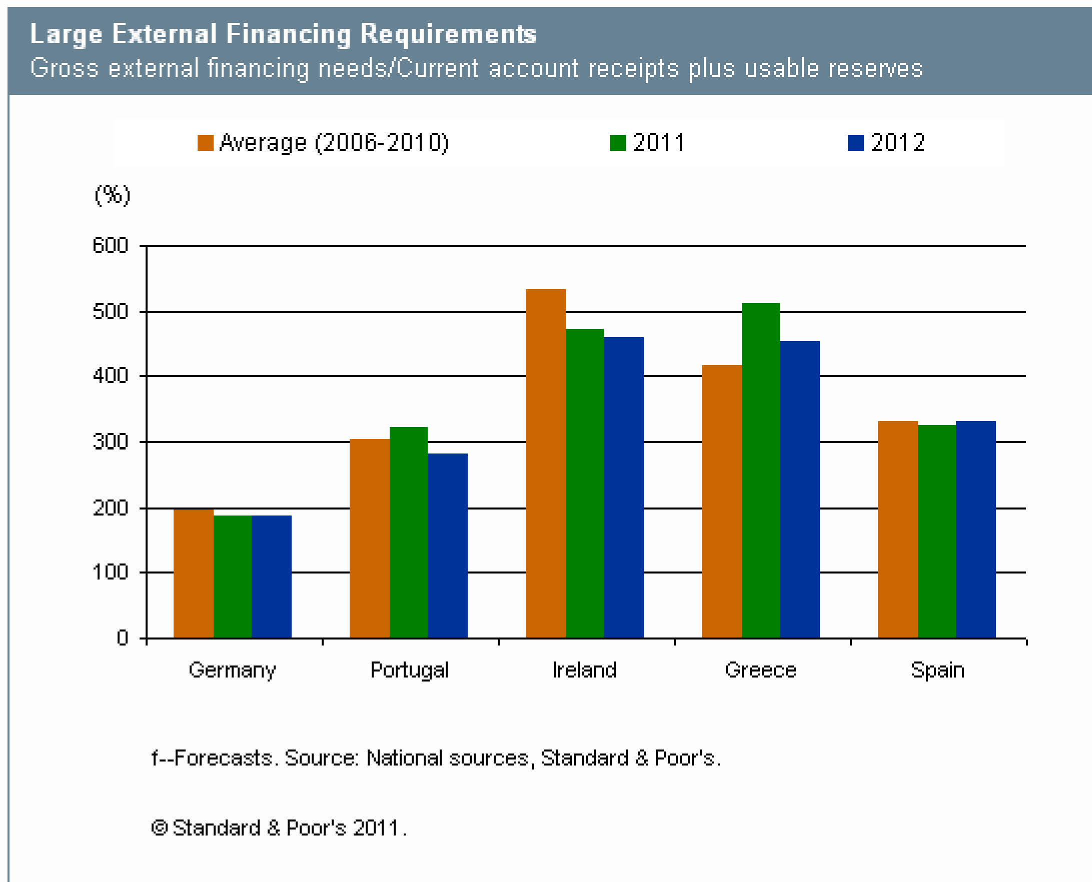
Chart 7



Not all governments were affected equally. The governments' fiscal position before the Great Recession, in retrospect, does not appear to be the main explanatory variable, in our view. Countries with large external liability positions or large external financing requirements were hurt more than countries with external asset positions and smaller financing needs. This insight brings me back to the point I made earlier about current account deficits financed by bank borrowing. Although a monetary union (so long as it holds) eliminates foreign exchange risks within the zone, it does not eliminate other balance-of-payment risks. Most importantly, it doesn't eliminate the risk of sharp increases in the cost of external financing.

Short-term external bank funding, on the other hand, tends to be more vulnerable to contraction than domestic bank funding, which is heavily influenced by the central bank's monetary stance and moral suasion. In the case of the eurozone, the higher costs and lesser availability of bank financing and portfolio investment were partly replaced by the central bank's refinancing operations and direct secondary market purchases of member government debt.

If the destabilizing imbalances are as much external as fiscal, then a prolonged period of fiscal austerity must be supplemented by measures to check and reverse external imbalances. This could come about through a more unified fiscal arrangement within the euro area, for example. It would likely increase cross-border fiscal transfers in order to smooth the impact on GDP from the necessary deleveraging of private households and corporations.

Another possibility could be to take measures to promote wage flexibility or worker mobility in order to help restore

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lost competitiveness. Surplus countries within the union could enact measures to raise productivity in the non-tradable sector while deficit countries could help promote exports. Bringing production and consumption more into line would help foster sustainable growth, which in turn would improve a government's debt dynamics, all else being equal. We believe these kind of steps could help address fundamental disequilibria, whereas debates on the amount and conditions of extraordinary official assistance center on the symptoms of the problems. These steps of course will entail policy coordination and commitment at the euro group and E.U. level. What is not possible is a realignment of exchange rates within the euro area itself. Instead, nominal wages are likely to continue to fall, as they have already done substantially in those pressured economies that are already adjusting, such as Ireland, where unit labor costs have declined by 15% since end-2008.

The Implications Of The Eurozone Travails For The Rest Of The World

How are problems in Europe a microcosm of and perhaps an augury for the rest of the world? Although the current account deficits of the U.S. have moderated, the country still absorbs 40% of global cross-border flows(12). Non-resident holdings of federal government debt are nearly 50%. We believe that, in part, this reflects the status of the dollar as the key reserve currency and the willingness of non-resident creditors and U.S. debtors to accommodate each other(13). But two important segments of the U.S. economy are carrying almost unprecedented amounts of indebtedness: the government sector and households. Net general government debt to GDP reached 72% at the end of the 2011 fiscal year, and we currently expect it to rise to 80% by 2015(14). This debt trajectory contributed to our decision to lower the rating on the U.S. government by one notch to 'AA+' on Aug. 5 of this year(15). Similarly, household debt is currently 87% of GDP. It's declined modestly, in part due to foreclosure, but is still at high levels.

The corporate sector is in much better financial health in our view--the larger corporations have strong cash flows and can finance themselves internally. But small to medium-size enterprises rely on bank credit and are feeling the effect of tighter credit conditions. We believe the U.S. economy would likely strengthen if it was reoriented away from consumption and toward nonresidential investment and exports.(16) In our view, the U.S. needs to raise its savings level over the medium term, especially public sector savings. Failure to do so might raise the vulnerabilities to shifting non-resident investor sentiment. This could lead to sharp hikes in interest rates and discontinuous movements in foreign exchange markets if non-residents decide not to add to their dollar positions or even reduce them(17). But the U.S. is a large country. It will not be able to raise the share of exports in its GDP in a material manner without the acquiescence if not cooperation of its trading partners.

When faced with a debt overhang, a debtor has only a limited number of options. For external debt, it can raise savings or lower investment. For fiscal debt, it can raise the primary balance or let inflation rise (while controlling tightly the financial system). For either, it can also default. Our ratings speak directly to default risk. Within the eurozone, Standard & Poor's rates the Hellenic Republic 'CC'(18). A 'CC' rating indicates our opinion that a default, as defined under our criteria, is likely and may be imminent(19). For the other 16 members of the eurozone, the ratings span the investment-grade categories, from 'AAA' for Germany(20) (among others) to 'BBB-' for Portugal(21). We believe that the eurozone investment-grade sovereigns will likely undertake sufficient budgetary and structural measures to service their debt on time, although the economic fundamentals supporting this view are weaker for lower-rated sovereigns than the higher-rated ones.

For the world as a whole, our 126 ratings span the entire rating spectrum from 'AAA' to 'CC' (see chart 8). Our default rate experience speaks for itself: the higher the rating, the lower the default rate (see table). We believe

sovereign default rates are likely to rise for speculative-grade sovereigns(22), and we've downgraded some governments of large economies this year, such as Japan(23) and the U.S. But we don't expect any of our investment-grade sovereigns to fail to service their debt. This is not to say that global economic conditions may not deteriorate and stay depressed for some time. This risk underscores all the more the importance of global resolve to promote trade and foreign direct investment through international coordination and cooperation.

Thank you very much.

Chart 8

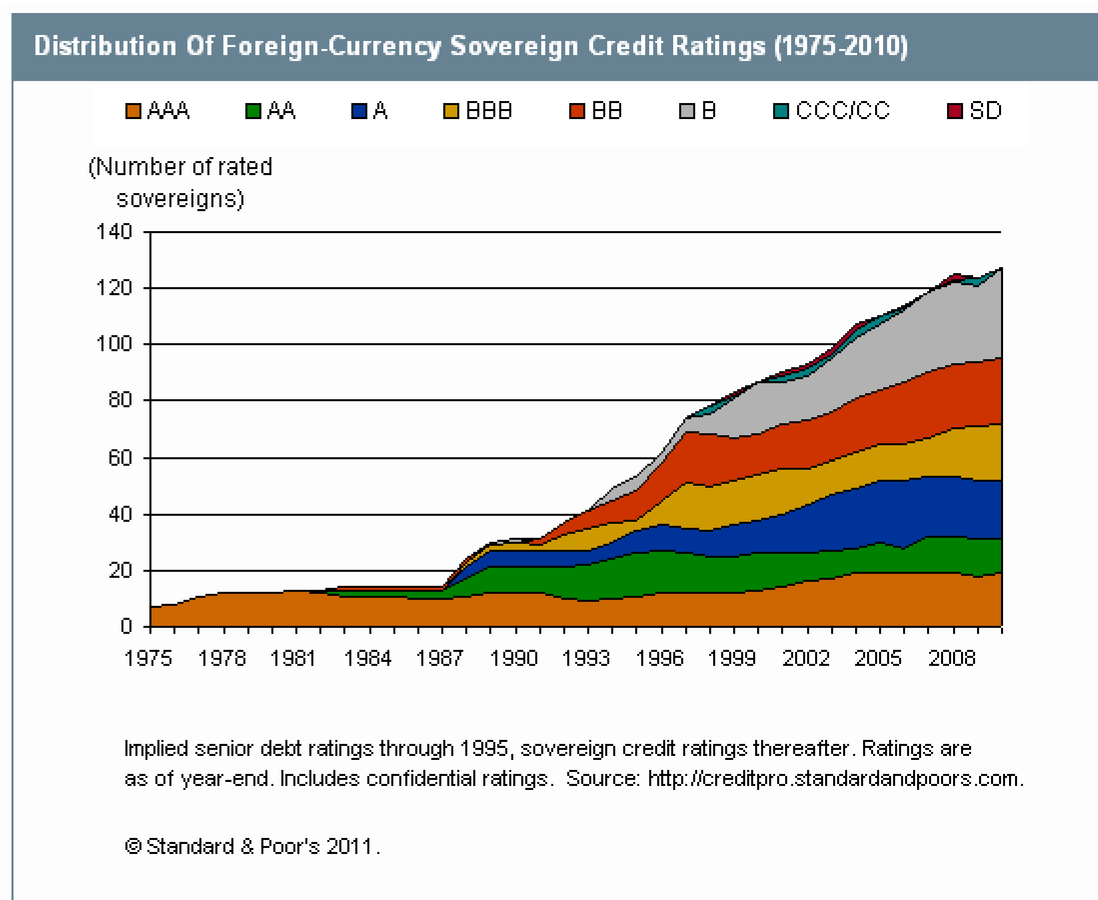

Table 1

Sovereign Foreign-Currency Cumulative Average Default Rate Without Rating Modifiers (1975-2010)*

(%)	--Time horizon (years)--													
Rating	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**15**
AAA	0	0	0	0	0	0	0	0	0	0	0	0	0	0
AA	0	0	0	0	0	0	0	0	0	0	0	0	0	0
A	0	0	0	0	0	0	0	0	0	0	0	0	0	0
BBB	0	0.46	1.45	2.53	3.68	4.93	5.61	5.61	5.61	5.61	5.61	5.61	5.61	5.61
BB	0.68	2.16	3.38	4.28	5.79	7.46	9.35	11.47	12.28	12.28	12.28	13.55	15.21	17.50
B	1.89	4.85	6.79	9.58	12.18	14.51	17.30	21.83	24.57	28.08	33.22	33.22	33.22	42.76
CCC/CC	36.36	46.97	58.75	64.65	70.54	77.90	88.95	88.95	N/A	N/A	N/A	N/A	N/A	N/A

Table 1

Sovereign Foreign-Currency Cumulative Average Default Rate Without Rating Modifiers (1975-2010)* (cont.)														
Investment grade	0.00	0.09	0.27	0.46	0.67	0.90	1.02	1.02	1.02	1.02	1.02	1.02	1.02	1.02
Speculative grade	2.59	5.06	6.98	8.89	11.06	13.23	15.75	18.67	20.14	21.29	22.71	23.62	24.83	28.63
All rated	0.83	1.66	2.36	3.05	3.81	4.54	5.26	5.95	6.27	6.51	6.77	6.92	7.09	7.48

N/A--Not applicable; there are no observations for this horizon. *Default rates conditional on survival. Implied senior debt ratings through 1995; sovereign credit ratings thereafter. Source: http://creditpro.standardandpoors.com.

Footnotes

(1)Four assumptions are embedded in the topic. One, that some person, polity, or institution can be marshaled into service. Two, that there is a crisis. Three, that this crisis is engendered by debt. Four, that this person, polity, or institution can solve the crisis.

(2)"A Short History Of Sovereign Rating Trends Among Southern Members Of The European Monetary Union," published on RatingsDirect on the GlobalCreditPortal on Feb. 9, 2010, and "EU Membership and Real Convergence--Lessons From Past Enlargements," published on RatingsDirect on April 14, 2004.

(3)"Sovereign Rating And Country T&C Assessment Histories," published on RatingsDirect on Oct. 4, 2011.

(4)See "The Essentials Of Basel II," published on RatingsDirect on Oct. 21, 2004.

(5)Calvo, Guillermo, "Capital Flows and Capital-Market Crises. The Simple Economics of Sudden Stops", Journal of Applied Economics, vol. 1, no. 1, Nov. 1998.

(6)Reinhard, Carmen and Kenneth Rogoff, "This Time Is Different," Princeton University Press, 2009.

(7)These risks are reflected in sovereign ratings. See "Sovereign Government Rating Methodology and Assumptions," published RatingsDirect on June 30, 2011.

(8)See "Bank Capital Methodology And Assumptions," published on RatingsDirect on Dec. 6, 2010.

(9)For the political economy that exacerbated imbalances in the U.S. housing market, see Rajan, Raghuram G. "Fault Lines: How Hidden Fractures Still Threaten the World Economy," Princeton University Press, 2010.

(10)See "Fiscal Monitor: Addressing Fiscal Challenges to Reduce Economic Risks," International Monetary Fund, Sept. 2011, "Explaining Standard & Poor's Adjustments To Ireland's Public Debt Data," published on RatingsDirect on Aug. 24, 2010, and "Republic of Ireland," published on RatingsDirect on June 30, 2011.

(11)See Minsky, Hyman P. "The Financial Instability Hypothesis," The Jerome Levy Economics Institute, WP No. 74, May 1992.

(12)"Global Financial Stability Report: Grappling with Crisis Legacies," International Monetary Fund, September 2011.

(13)See "Après Le Déluge, The U.S. Dollar Remains The Key International Currency," published on RatingsDirect on March 10, 2010.

(14)See "The Emerging U.S.-'AAA' G-5 Credit Gap And What Could Stabilize Or Widen It," published on RatingsDirect on Sept. 14, 2011.

(15)See "United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative," published on RatingsDirect on Aug. 5, 2011.

(16)The U.S. federal government is fully aware of the need to reorient the economy. See "Economic Report of the President, 2011," Council of Economic Advisors.

(17)Obstfeld, Maurice and Kenneth Rogoff, "The Unsustainable U.S. Current Account Position Revisited," NBER Working Paper no. 10869, Nov. 2004.

(18)See "Long-Term Sovereign Rating On Greece Cut To 'CC' On Likely Default; Outlook Negative," published on RatingsDirect on July 27, 2011.

(19)See "Standard & Poor's Ratings Definitions," published on RatingsDirect on April 27, 2011 and "The Time Dimension Of Standard & Poor's Credit Ratings," published on RatingsDirect on Sept. 22, 2010.

(20)See "Germany (Federal Republic of)," published on RatingsDirect on May 18, 2011.

(21)"Ratings On Republic of Portugal Affirmed At 'BBB-/A-3' On Strong Commitment To Reform; Outlook Negative," published on RatingsDirect on Oct. 4, 2011.

(22)"Sovereign Defaults and Rating Transition Data, 2010 Update," published on RatingsDirect on Feb. 23, 2011.

(23)See "Ratings On Japan Lowered To 'AA-'; Outlook Stable," published on RatingsDirect on Jan. 27, 2011 and "Japan" published on RatingsDirect on Oct. 12, 2011.

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