MarketWatch

May 14, 2010, 3:22 p.m. EDT

The second debt storm

Who will bail out the countries that bailed out the world's corporations?

By Alistair Barr, MarketWatch

SAN FRANCISCO (MarketWatch) -- The financial crisis never really went away.

The debt mountain that brought down some of the world's biggest banks and dragged the international financial system to the brink of disaster has simply shifted to governments. Now it's threatening countries around the globe -- and, if left unchecked, could rip the very fabric of Europe's economic system and wreck economic recoveries in the U.S., China and Latin America.

SPECIAL REPORT

Debt talks: Greece's Papandreou, left, with Germany's Merkel (Reuters).

The second debt storm

The financial crisis has shifted the debt burden from banks to governments, alarming investors around the globe.

- **Market Edge: Strategist Max Bublitz assesses debt and the bond markets**
- **Jon Markman: Greek bailout makes no sense in any language**
- **MarketWatch Topics: Sovereign Debt**

The impact on markets has been severe. The euro has slumped more than 12% against the dollar since the sovereign-debt crisis flared in southern Europe. Gold has marched to new highs as investors seek a safe haven and, perhaps most alarming, it is now more expensive to buy insurance against national default than it is to insure against corporate failure.

"The sovereign-debt crisis spun out of control in the past week, and we see no easy way to resolve it," said Madeline Schnapp, director of macroeconomic research at TrimTabs Investment Research.

Some investors and analysts are increasingly concerned that governments may be no more capable of repaying their debts than the banks and insurance companies they saved. And, they warn, if a major country comes close to default, it could trigger a financial meltdown that would eclipse the panic that followed the bankruptcy of Lehman Brothers in 2008.

The world has seen sovereign debt crises before. Latin America, Africa and Asia have all experienced upheavals sparked by excessive debt. These crises were all accompanied by stunted economic growth, inflation and weak stock market returns, which make it even harder to pay off debts. As investors and government officials ponder the current state of affairs, they see ominous signs that the developed world may be facing a similarly bleak future.

"The problem of the western world is that we have too much debt," said Daniel Arbess, who manages the Xerion investment strategy at Perella Weinberg Partners. "Rather than reducing our debt, we've been moving it from one balance sheet to another."

"All we're doing is shifting chairs on the deck of the Titanic," he added.

Europe's bailout

Some governments have started to respond to market pressure, with the U.K. pledging billions of pounds in spending cuts this week. Spain and Portugal also unveiled austerity measures. But the problem is so big that investors remain wary. Check out Portugal's plans.

Stock markets plunged and credit markets shuddered last week on concern Greece and other indebted European countries like Portugal and Spain might default. See the story on market impact.

"What's happened on a corporate level is now happening on a national level. The first nation to experience this is Greece, but other nations will, too," Schnapp said.

To stop Greece's debt troubles turning into a run on the euro and a global stock market rout, the European Union unveiled an unprecedented package of almost $1 trillion in emergency loans, stabilization funds and International Monetary Fund support on Sunday.

In the days that followed, the European Central Bank bought the government debt of Greece and other countries on the periphery of the region's single-currency zone, such as Portugal, Spain, Italy and Ireland, investors said. Such a drastic step has been shunned by the ECB until now. Read about the market response on Monday.

"Temporarily the crisis in terms of liquidity has been averted, but the underlying problem hasn't gone away," Schnapp added. "Giant debt and expenditures by governments are still there."

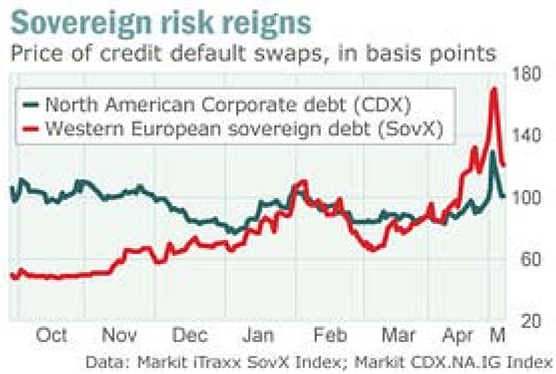
TrimTabs cut its recommendation on U.S. equities to neutral from fully bullish on Sunday, in the wake of the European bailout.

Protection

The sovereign crisis has been brewing for months.

For much of the financial crisis, investors worried about financial institutions defaulting, rather than sovereign nations. But that pattern has been upended.

In early February, the cost of insuring against a sovereign default in Western Europe exceeded the price of similar protection against default by North American investment-grade companies. That was the first time this had happened, according to data compiled by Markit from the credit derivatives market.



The move "symbolizes how credit risk has been transformed from corporate to sovereign risk, as the solution to the financial and economic crisis was government intervention," Hans Mikkelsen, credit strategist at Bank of America Merrill Lynch, wrote in a note to investors at the time.

Since then, the cost of insuring against sovereign default in Western Europe has climbed further, hitting a record of 169 basis points on May 7.

The European bailout pushed that down to 120 basis points on Tuesday. But that's still more expensive than default protection on North American corporate debt which cost 100 basis points on Tuesday. (In the credit derivatives market, 100 basis points means it costs $100,000 a year to buy default protection on $10 million of debt for five years).

'100%'

Market Edge: Debt Crisis Enters Second Phase

The global debt crisis is in its second stage as governments deal with the debt absorbed from the private sector, and record gold prices have been reflecting these worries, according to SCM Advisors strategist Max Bublitz. Laura Mandaro reports.

While much of the concern has focused on Western Europe, unsustainable government debt is a global problem. And it is developed world governments that are accumulating the biggest debts, not emerging market countries -- a big change from previous sovereign crises.

"Looking beyond the immediate crisis in Europe, I am particularly worried about the next stage involving the U.S., the U.K. and Japan," Xerion's Arbess said.

Debt to GDP ratios in the world's advanced economies will top 100% in 2014, 35 percentage points higher than where they stood before the financial crisis, the IMF estimated last month.

Three percentage points of this increase came from government bailouts of financial institutions, while 3.5 percentage points was from fiscal stimulus. Another four percentage points has been driven by higher interest on government debt and 9 points came from revenue lost from the global recession, according to the IMF.

"Public finances in the majority of advanced industrial countries are in a worse state today than at any time since the industrial revolution, except for wartime episodes and their immediate aftermath," Willem Buiter, chief economist at Citigroup Inc. (NYSE:C) and former member of the Bank of England's Monetary Policy Committee, wrote in a recent note on sovereign risk.

Even though the current epicenter of the crisis is focused on the euro zone, the overall fiscal position of the single currency area is stronger than that of the U.S., the U.K. and Japan, he noted.

"Unless there is a radical change of course by those in charge of fiscal policy in the U.S., Japan and the U.K., these countries' sovereigns too will, sooner (in the case of the U.K.) or later (in the case of Japan and the U.S.) be at risk of being tested by the markets," Buiter said.

Ultimately, these countries face the risk of being "denied access to new and roll-over funding, that is, of being faced with a 'sudden stop,'" he warned.

Economic drag

Once government debt levels approach 100% of GDP, things can get tricky.

That's because a lot of a country's income from taxes and other sources has to be spent on interest payments.

John Brynjolfsson, chief investment officer at global macro hedge fund firm Armored Wolf LLC, illustrated the point with a simple example. With debt at 100% of GDP, interest rates at 3% and real economic growth of 3%, all the extra income collected by a country would be used to pay interest on its debt.

If a lot of government debt is owned by foreigners, like the U.S., the money leaves the country rather than being invested in more productive ways. This dents economic growth.

A study published this year by economists Carmen Reinhart and Ken Rogoff found that, over the past two centuries, government debt in excess of 90% of GDP produced economic growth of 1.7% a year on average. That was less than half the growth rate of countries with debt below 30% of GDP.

"Most lenders realize that once growth disappears, there's little reason to lend more," Brynjolfsson said. "That's because new lending is just going towards paying off old debt, not investment in productive activities."

U.S.

The U.S. government has spent more than $1 trillion bailing out financial institutions like American International Group (NYSE:AIG) and rolling out fiscal stimulus programs to bolster the flagging economy.

In 2009, the government took in about $2.1 trillion in taxes and other revenue and spent more than $3 trillion, according to TrimTabs' Schnapp. The gap, or deficit, is made up by borrowing more money through sales of Treasury bonds and notes.

In coming years, U.S. government debt will exceed 100% of GDP, according to economists at Exane BNP Paribas and elsewhere.

In the next 20 years, if fiscal policies aren't changed, U.S. debt to GDP will exceed 150%, putting the country in the same league as Greece and Portugal, according to recent research led by Stephen Cecchetti, head of the Monetary and Economic Department at the Bank for International Settlements in Switzerland.

And the official data don't tell the whole story, Buiter says.

Fannie Mae (NYSE:FNM) and Freddie Mac (NYSE:FRE) have been the responsibility of the U.S. government since the mortgage giants were placed into conservatorship by the Federal Housing Finance Agency during the financial crisis in 2008, he noted.

Fannie and Freddie's liabilities at the end of last year's third quarter were almost $1.8 trillion, according to Buiter. This equals 13% of U.S. GDP and should be included in measurements of the country's general government debt, he added.

U.K.

The U.K. government committed 850 billion pounds ($1.25 trillion) to bailing out banks including Royal Bank of Scotland (LONDON:UK:RBS) and Lloyds Banking Group (LONDON:UK:LLOY) and providing guarantees and insurance to the sector, according to the country's National Audit Office.

The U.K.'s debt to GDP ratio will soon reach 100% and could top 200% in the next two decades if fiscal policies aren't changed, according to Cecchetti's research.

The country's new coalition government, which came to power this week, called for 6 billion pounds in spending cuts starting this fiscal year. Bank of England Governor Mervyn King applauded the plan.

"We are still halfway through the world's worst financial crisis ever," King warned. It's "imperative that our own fiscal problems are dealt with sooner rather than later." Read about his comments.

Japan

Japan's government debt to GDP, at over 200%, already dwarfs the U.S. and the U.K., a hangover from its own financial crisis at the end of the 1980s.

"The perfect example of sovereign risk that is contained today but could be dramatic in the future is Japan," Pierre-Olivier Beffy, chief economist at Exane BNP Paribas, wrote in a recent note to investors.

Such high debt levels aren't a problem now because Japanese people save so much and invest a lot of that money in the country's bonds. Financial institutions in the country are also big buyers.

With more than 90% of all Japanese government debt purchased domestically, interest payments get funneled back into the country, helping to support economic growth.

However, Japan's population is getting a lot older. At some point, savers may stop buying government bonds and start spending their money in retirement. If that happens, the government may be forced to pay higher interest rates when it borrows.

Rates on 10-year Japanese government bonds are below 1.4%. So, despite huge debt, interest payments aren't too cumbersome. But if rates climb, that would change with painful consequences.

"Japan, as an economy, has never admitted its mistakes. Twenty years ago they transferred the bad private assets to the public balance sheet, while nominal GDP has gone nowhere for 20 years," Kyle Bass, managing partner at global macro hedge fund firm Hayman Capital, said during an April industry roundtable run by Opalesque Ltd.

"When your biggest holders turn into sellers overnight, what do you do? You have to finance yourself at G7 rates," he added. "If they borrow where Germany borrows at a bit over 3%, they are out of business."

Bass is betting on higher Japanese interest rates, similar to positions that other hedge fund firms including David Einhorn's Greenlight Capital and John Paulson's Paulson & Co. have put on. Read about Einhorn's views.

'Final chapter'

How will all this debt be repaid? Brynjolfsson discusses the three main alternatives.

Developed nations could generate strong productivity gains, while rising exports from their pharmaceutical, technology and financial-services industries could generate better-than-expected income. Combined with "frugality, sacrifice and good fortune," there could be enough money to repay debts, he explained. This may include lower government spending and higher taxes.

Countries could also default, either because they can't pay or won't, Brynjolfsson said. In this scenario, lenders would likely agree to a reduction, or haircut, on the amount of money they're owed -- either voluntarily or after courts impose a settlement.

A third outcome may be inflation, Brynjolfsson said. Sovereign debts would be honored but would be repaid in currency that's worth a lot less than when the debt was sold.

"The sovereign debt problems encountered by most advanced industrial countries are the logical final chapter of a classic 'pass the baby' (aka 'hot potato') game of excessive sectoral debt or leverage," Buiter said.

"First excessively indebted households passed part of their debt back to their creditors - the banks. Then the banks, excessively leveraged and at risk of default, passed part of their debt to the sovereign," he explained. "Finally, the now overly indebted sovereign is passing the debt back to the households, through higher taxes, lower public spending, the risk of default or the threat of monetization and inflation."

Inflation

Brynjolfsson and other investors are in the inflation camp.

One tell-tale sign of potential inflation is that the U.S. Treasury Department is trying to extend the average maturity of its debt from about 48 months to roughly 84 months, Brynjolfsson said.

"That makes me a little uncomfortable and suspicious," he added.

With lots of short term debt, it's hard to inflate the debt away. That's because interest rates should rise quickly to adjust for higher inflation expectations and investors will charge a higher rate when it comes time to refinance the bonds.

But the longer the maturity of government debt, the easier it is for inflation to kick in before bonds need to be refinanced, Brynjolfsson explained.

Berkshire Hathaway (NYSE:BRK.A) (NYSE:BRK.B) Chairman Warren Buffett said this month that he's bearish about the ability of all currencies to hold their value over time because of massive deficits being run up by governments in the wake of the financial crisis.

The U.S. will never default on its debt because the dollar is the world's reserve currency. But the country may print more dollars to repay with devalued currency, he suggested. Check out Buffett's take on currencies and inflation.

The ECB's actions this week added to inflation concerns. The bank has been in the market buying the government debt of Greece and other indebted European countries, according to Brynjolfsson.

Some investors worry this amounts to so-called quantitative easing that could devalue the euro and produce inflation. The ECB says it plans to neutralize the effects of government bond purchases by selling other assets, limiting growth of the money supply.

Xerion's Arbess sees "a round of devaluations of a lot of different currencies."

"That will be accompanied by inflation in the price of non-renewable assets like gold, other precious metals and industrial commodities," he said. "People start to hold on to things that they think will retain value."

Gold hit a record Wednesday. Read about why gold prices rose.