

DBRS Canada Newsletter

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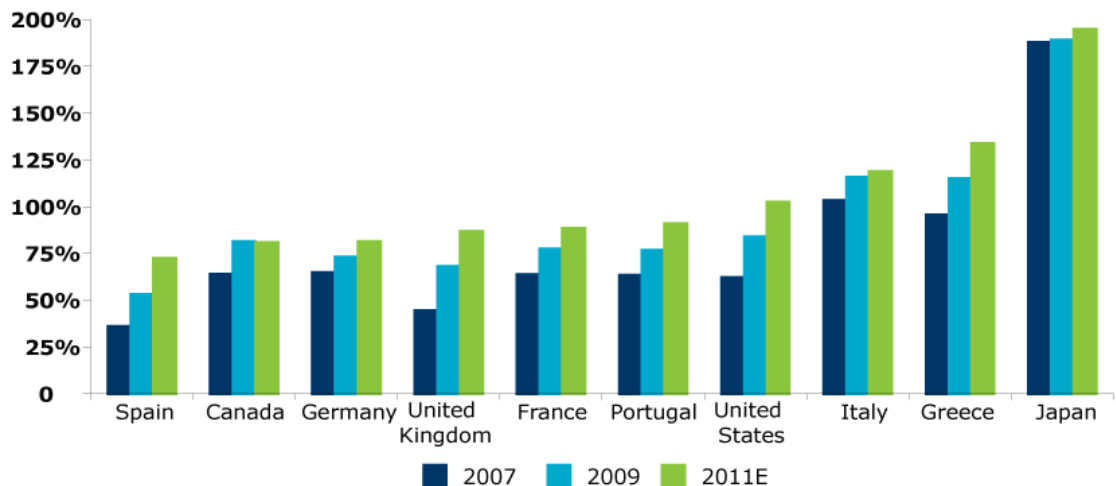
GATHERING CLOUDS: IF THE SOVEREIGNS BAILED OUT THE BANKS, WHO WILL BAIL OUT THE SOVEREIGNS?

It was not long ago that governments around the world stepped in and bailed out a number of financial institutions (and manufacturing companies) deemed too big to fail. In the United States, the list included Fannie Mae, Freddie Mac, Citibank, AIG and GM. In Europe, Northern Rock, Royal Bank of Scotland, Hypo Real Estate, Dexia and Fortis were bailed out by their respective governments. Extraordinary measures were required and resulted in the expansion of sovereign balance sheets. In addition, fiscal stimulus and automatic stabilizers, coupled with lower tax revenues, led G20 deficits to increase, with return to fiscal balance years away, if at all. **If GDP targets are not met, we could be headed for a decade of limited growth, low interest rates and more deflation than inflation.** Should sovereigns start to run into liquidity problems, however, who or what will bail them out?

History has shown us that governments can and do go into default. Not only do countries often default on their external debt, they do so with alarming frequency. If we go back far enough, we can see that some notable European countries weren't always dependable borrowers.

One problem many countries face today is the absolute size of their debt burden. Public debt has risen significantly over the last two years for developed economies, with advanced economies not expected to crest until the middle of the decade. In fact, a number of advanced economies aren't expected to come into balance for a decade, including the United States. Developing economies have a much lower debt burden either because their debt was already restructured (such as Russia's in 1998) or because their economies have been growing much faster than their public debt (such as China's).

General Government Gross Debt (% of GDP)



Source: Eurostat, International Monetary Fund and DBRS.

Another problem for sovereigns is an aging population, particularly in developed economies, with health care expenses the fastest rising costs. In addition, low fertility rates and insufficient immigration will put additional pressure on taxpayers to fund pension and health care costs for an aging population. Household debt, which is at historic highs relative to household income, particularly in countries such as the United Kingdom, Spain, Canada and the United States, is another concern. Simply put, a country, just like a family, cannot live beyond its means in perpetuity.

In the past, sovereigns have used various tools to reduce leverage and, for some, avoid default. Historically, inflation has been one of the most common tools used. In addition to inflation, however, the tool kit has included currency devaluation, debasement, seigniorage and fiscal policy. Time will tell what will work this time around: the International Monetary Fund (IMF), currency devaluation, inflation, increased real GDP, taxes, public spending cuts, lower interest rates?

In most of the sovereigns DBRS rates or its sovereign benchmarks, three common themes are apparent:

(1) Fiscal deficits, especially among the advanced economies, are high and will need to be reduced. This will require forceful and well-communicated policies that reduce spending and in some cases raise taxation.

(2) Higher deficits, combined with growing contingent liabilities, as governments stepped in to support corporations and financial institutions during the crisis, have driven up public debt. Stabilizing these ratios requires not only deficit cutting, but also structural reforms in the financial sector and labour markets (to regain competitiveness) and measures to address growing health care and pension liabilities.

(3) Starting points are important. For those countries with flexible exchange rates, independent monetary policies, well-regulated banking systems, flexible labour markets and diversified product markets, fiscal adjustment will be less painful. For all countries, achieving debt sustainability and returning to healthy growth rates will take time.

A full-length DBRS commentary on this topic, *Gathering Clouds: If the Sovereigns Bailed out the Banks, Who Will Bail out the Sovereigns?*, is available by contacting us at info@dbrs.com.

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