Introduction

International sovereign debt is a cornerstone of fixed-income investing, offering a range of opportunities for investors seeking yield, total return and diversification benefits. As an asset class, local currency sovereign debt (including U.S. issuance) has exploded over the past decade. In 2001, there was $11 trillion worth of global government bonds outstanding. By 2011, there was more than $31 trillion. This includes the government debt of closed economies, such as China and India, which is not considered freely tradable by foreigners, and it excludes the external government debt issued by countries in non-domestic currencies (such as when a country issues U.S.-dollar-denominated debt).

While sovereign debt is often considered to be “risk-free,” its credit quality, like that of any fixed-income sector, can vary. That has been made clear in recent years, as sovereign debt levels have risen amid deteriorating economic and fiscal conditions in some European Union nations.

Recent developments in various nations’ sovereign debt underscore the increasing uncertainty of investments in this asset class. In March 2012, Greece restructured €152 billion worth of its sovereign debt—the largest such restructuring in history.

The United States also faces a rising sovereign debt burden, though investors still view U.S. debt as the world’s lowest-risk asset. Meanwhile, Japan maintains the highest gross sovereign debt level of any advanced country in the world, and the market price for insuring the country’s debt rose more than 70% from July 2011 to January 2012, reflecting heightened fears of possible default.

These conditions highlight the changes surrounding developed market sovereign debt. Traditionally, investors in this debt had focused on analyzing interest rates and paid little or no attention to credit risk. By contrast, emerging market sovereign debt investors have had to focus on credit concerns along with interest rate dynamics. Today, many developed markets are being assessed for their credit risk, while the relatively lower debt levels found across emerging markets have mitigated their credit risk.

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For investors, this unprecedented upheaval in developed markets’ sovereign debt stability poses a challenge, particularly given the prominent place such debt has occupied in low-risk portfolios. Potentially adding to the upheaval is the increased issuance of sovereign debt, given the risk that the market will be unable to absorb it.

As a result, some investors may consider reducing their exposure to developed-market sovereign debt holdings. Others may believe that fears about developed-market sovereign debt are exaggerated and see the current climate as an occasion to add this debt to their portfolio. As investors examine their sovereign debt strategies, they will need to take into account both rising levels of debt by the developed market economies, which are affecting governments and markets around the world, and the improved fiscal conditions of emerging markets, which could make their sovereign debt attractive for some investors.

Record debt drives up risk

Sovereign debt levels throughout the developed world are higher than at any point in the past 100 years. The only other period when public debt levels approximated those of today was during World War II and its aftermath. One other striking feature is the speed with which debt levels have increased since the onset of the financial crisis. In recent years, the sovereign debt of advanced economies rose from 75.4% of GDP in 2006 to almost 104% of GDP in 2011 (see Exhibit 1). Among advanced economies, the European Union, the U.S., and Japan have been major drivers of the debt increases in recent years.

The European Union

The creation of the European Union, and its ongoing expansion, has led to an increasingly larger common market that has contributed to lower transportation, customs, financial and administrative costs. The introduction of the euro in 1999 helped to drive down interest rates across the region, which led to a surge in borrowing by governments, banks, and households in many countries. Smaller countries initially benefited from increased liquidity and expanded access to credit from other members of the eurozone. However, in the absence of a floatable currency, many of the southern eurozone countries have seen their wage competitiveness deteriorate. Coupled with labor market rigidities, the competitiveness of these countries declined even more when Germany implemented labor and structural reforms. The failure to standardize banking regulation throughout the eurozone further intensified the region’s debt crisis, as lax regulation in some countries, such as Spain and Ireland, contributed to excessive real estate lending by many banks or savings institutions.

Without spending cuts to offset the decline in tax revenue, the deficits of these countries have risen (see Exhibit 2). The economic slowdown that followed the 2008 financial crisis added to the deficits, as did the need for significant outlays to help stabilize the financial system. In November 2009, Greece disclosed that it had manipulated its budgeting to obscure the impact of the financial crisis. In Spain and Ireland, the federal governments intervened to prop up the banking system, adding significantly to the debt load of both countries. Spain’s budget went from a surplus of 1.9% of GDP in 2006 to almost 104% of GDP in 2011. 

Exhibit 1: Sovereign debt levels have increased rapidly since the financial crisis

Exhibit 2: Lower tax revenues and continued spending drive deficits in Europe

Source: International Monetary Fund

Source: Eurostat
GDP in 2007 to a deficit of 9.2% in 2010; Ireland’s budget went from a surplus of 0.1% of GDP in 2007 to a deficit of 32.4% of GDP in 2010. These developments played out against a rising tide of health care and pension costs in Europe, further squeezing federal budgets.

The United States
Gross federal debt in the U.S. rose dramatically from 2000–2011, from 57.3% of GDP to 98.7% of GDP (see Exhibit 3). A mix of factors drove the debt surge, but among the most important were continued growth in federal spending on Medicare and Medicaid (they account for about 24% of federal outlays) and Social Security (20%). The Congressional Budget Office noted in its January 2012 outlook, “Because of the aging of the population and rising costs for health care, the set of budget policies that were in effect in the past cannot be maintained in the future.” Also adding to the rising debt levels over this period were tax breaks approved in 2001 and 2003, military campaigns in Afghanistan and Iraq, the recession from December 2007–June 2009, and the sluggish economic growth that followed, which led to rising expenditures for the unemployed.

Japan
The high level of sovereign debt in Japan (see Exhibit 4) stems from a mix of weak economic growth, deflation and an aging population. Distinguishing Japan from other nations is the fact that the vast majority of the debt is held domestically, so the country is less vulnerable than other countries to panicked selling by foreigners. Because the country also has a globally competitive export sector and a very healthy trade and current account surplus, balance of payments is less of a concern. In addition, the country has ample foreign exchange reserves and high levels of household savings, which has allowed it to withstand a long period of economic stagnation.

While the absolute debt levels of all countries (regardless of income level) are important, also important is the trajectory. If debt levels are high, but the government is implementing reforms that will gradually reduce the debt, investors will be more forgiving and sovereign borrowing costs will be lower. A country’s credit history is also important—a history of paying debts (or not paying debts) will have an impact on investor confidence in said markets.

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**Exhibit 3: Host of factors driving U.S. gross federal debt surge**

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<th>U.S. federal debt at the end of year: 2000–2011</th>
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Source: White House Office of Management and Budget

**Exhibit 4: Weak economic growth and an aging population fuel steady rise in Japan’s debt**

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<th>Japan total government net debt (% of GDP)</th>
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Source: International Monetary Fund
Emerging market debt stabilizes

The fiscal conditions in a number of emerging market countries over the past decade have been in striking contrast to the sovereign debt challenges facing some developed markets. In 2011, gross public-sector debt levels in emerging economies were just 37.8% of GDP (see Exhibit 5) compared to 104% for advanced economies. The improved fiscal discipline in emerging markets has been part of a larger story that has enabled these countries to achieve higher levels of economic growth, higher living standards, and a larger slice of the global economic pie. Today they generate about half of the world’s economic activity—up from 30% in 1980.7

Why sovereign debt matters

The favorable sovereign debt outlook in emerging markets has insulated many of those countries from the troubles facing more developed markets. But regardless of a country’s income level, if it is not disciplined about managing its sovereign debt, its economy (and the economies connected to it through trade and finance) can be affected in a number of inter-related ways:

- higher borrowing costs for households, banks and corporations
- lower economic growth
- financial repression
- credit rating downgrades
- weakening of banking systems

Higher borrowing costs

Unsustainably high levels of sovereign debt, exceeding a country’s real growth rate over the long run, often result in governments facing higher borrowing costs, as buyers of bonds demand higher yields. In the case of the European peripheral countries, the growing inventories of debt heightened investors’ concerns that the debt inventories of these countries were growing at an unsustainable level. In late 2011, the yield on the Italian government’s 10-year bonds reached 7.56%,9 while the yield on the Spanish government’s 10-year bonds exceeded 6.7%.10 The differential between Italian and German bonds, which have yielded about 2%, has led to great uncertainty about the stability and viability of the eurozone.

The higher borrowing costs for developed market sovereigns translate to significant sums. The U.S. devotes 6% of its annual federal spending to meeting its debt obligations. A rise in interest rates of one percentage point above the current baseline would result in an additional $1 trillion of debt service over 10 years, according to Kevin Warsh, a former Federal Reserve governor.11

The fiscal climate in emerging market countries has triggered a significant reduction in their borrowing costs. In January 2012, the Philippines issued a dollar-denominated 25-year bond, with a yield of just 5% (at a spread of 221 basis points to the interpolated U.S. Treasury curve). Indonesia sold 30-year dollar-denominated bonds at a yield of 5.375%. By contrast, Italy’s 30-year bond yielded 7% at the time, and Spain’s yield was 6.1%.8 Even more noteworthy is that many emerging market countries, such as the Philippines and Indonesia, can fund themselves locally with maturities exceeding 20 years, which is in stark contrast to a decade ago.

With emerging markets realizing greater macroeconomic stability, corporations domiciled in these countries are better able to access both local and international capital markets on more favorable terms—facilitating expansion that is helping to lift the economic growth rate in these countries.

High sovereign debt levels can trigger a downgrade of the country’s debt by credit rating agencies. Downgrades typically result in higher borrowing costs for the country, but there can be many other spillover effects.
These higher borrowing costs force governments to make difficult decisions. Will they reduce spending? Or will they maintain spending levels, allow their debt to continue growing, and accept the resulting higher tax rates, higher interest rates, and reduced economic growth at some point in the future?

**Lower economic growth**

High sovereign debt can also depress a country’s economic growth. In their book, *This Time is Different: Eight Centuries of Financial Folly*, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University (and formerly chief economist at the International Monetary Fund) show that when a country’s public debt-to-GDP ratio exceeds 90%, median economic growth declines 1% and average growth falls even more. The reason, say the authors, is that as debt levels rise towards historical limits, risk premia begin to rise sharply, facing highly indebted governments with difficult tradeoffs. Even countries that are committed to fully repaying their debts are forced to dramatically tighten fiscal policy in order to appear credible to investors and thereby reduce risk premia.12

Similarly, because high sovereign debt levels tend to drive up yields on government debt, investors will be drawn to this debt and away from corporate debt—particularly because sovereign debt’s perceived safety relieves investors of the need to engage in comprehensive due diligence. But when investors buy high levels of sovereign debt, the result is a “crowding out” of private investment, which can also depress economic growth. The higher interest rates that accompany high sovereign debt levels can also increase savings and reduce consumption—another factor contributing to lower growth.

**Financial repression**

A country’s sovereign debt level will also influence the economic policies it pursues, with highly indebted governments often seeking to control their rising interest expenses through containing nominal rates, thereby generating “negative” real interest rates (i.e., below the inflation rate). In the period from 1945–1980, many advanced countries used these policies to help reduce debts created during World War II.13 Sometimes referred to as “financial repression,” these policies can penalize bondholders and savers. And by transmitting distorted signals to the markets, these policies can also curtail private sector investment and credit growth, give a misleading picture of a country’s debt burden, and contribute to delays in the implementation of needed structural reforms.

But faced with challenging market and economic environments, central banks can use negative real rates as a policy tool to stabilize markets. The Federal Reserve’s so-called “quantitative easing,” which involved the purchase of hundreds of billions of dollars worth of financial assets between 2008 and 2011, is credited with helping to calm U.S. markets following the financial crisis.

**Credit rating downgrades**

High sovereign debt levels can trigger a downgrade of the country’s debt by credit rating agencies. Downgrades typically result in higher borrowing costs for the country, but there can be many other spillover effects. When Greece’s sovereign debt was marked down in 2010, the International Monetary Fund found that all eurozone countries were affected, in the form of higher costs to insure sovereign debt against default and stock market declines.14 With banks often holding the sovereign debt of other countries, their stability can be jeopardized if investors believe exposure to this debt is significant.

**Weakening of the banking system**

Banking systems are intrinsically linked with the finances of sovereign nations. They are regulated by regulatory bodies within the country or countries in which they operate and typically invest in their home country’s sovereign debt. Thus when sovereign debt levels rise, banks can also face funding challenges. During Europe’s sovereign debt crisis, banks in Greece, Portugal and Ireland found it more difficult to raise wholesale debt and deposits, and became more dependent on the European Central Bank for liquidity.

The Bank for International Settlements has identified four ways in which higher sovereign debt (and a rise in sovereign risk) adversely impacts banks:

- “First, losses on holdings of government debt weaken banks’ balance sheets, increasing their riskiness and making funding more costly and difficult to obtain.”
- “Second, higher sovereign risk reduces the value of the collateral banks can use to raise wholesale funding and central bank liquidity.”
- “Third, sovereign downgrades generally flow through to lower ratings for domestic banks, increasing their wholesale funding costs, and potentially impairing their market access.”
- “Fourth, a weakening of the sovereign reduces the funding benefits that banks derive from implicit and explicit government guarantees.”15
For banks with large holdings of a troubled country’s sovereign debt, a default (or threat of one) can unleash turmoil throughout the banking sector and freeze the interbank lending market on which banks depend for liquidity. While central banks can provide funding, that only feeds the perception of the sector’s turmoil—raising borrowing costs and injecting friction into the financial system.

Because many financial loan products are priced off of a local sovereign risk free rate, with a “credit premium” added, banks’ balance sheets can become very sensitive to a degradation of the underlying pricing instrument. If the sovereign debt was underpriced, then the other financial loans may have been underpriced, thus the need for greater capitalization to ensure the solvency of the bank.

Given the web of networks that link financial institutions together, a sovereign debt crisis in one country can have a widespread ripple effect. Signs of weakness are likely to push investors to reduce risk. Amid the uncertainty over Europe’s economic and financial stability in 2011, the retreat from risk contributed to market declines in the U.S. and raised corporate borrowing costs.

Ben Bernanke, Chairman of the Federal Reserve, has spoken about how a sovereign debt crisis in Europe could affect the U.S. In a speech delivered in March 2012, he said that, “were the situation in Europe to take a severe turn for the worse, the U.S. financial sector likely would have to contend not only with problems stemming from its direct European exposures, but also with an array of broader market movements, including declines in global equity prices, increased credit costs, and reduced availability of funding.”

How investors should think about sovereign debt

Investors have traditionally treated the sovereign debt of advanced countries as risk-free, or close to it. That calculus has now changed. The restructuring of Greece’s sovereign debt underscores the change, but it is far from an isolated example. The U.S. threatened a debt default in August 2011 due to political wrangling over whether to raise the country’s debt ceiling. In addition, the sovereign debt levels of numerous eurozone countries subject them to high borrowing costs and continued economic challenges. In April 2012, the yield on Spain’s 10-year bonds exceeded 6%—underscoring the continued market uncertainty.

Like any investment scenario, opportunities emerge when prices are low. At TIAA-CREF, we continuously explore value opportunities, judging the risks and potential rewards, and examining the worst-case scenarios.

With respect to sovereign debt, we are closely monitoring developments throughout the world. We continue to have concerns regarding the ability of Greece and other highly indebted nations in the European Union to meet their debt obligations and stabilize their economies. But we are cautiously optimistic that eurozone nations will be able to address their debt and fiscal issues, and we are encouraged by progress toward financial integration, debt sustainability and bank recapitalization. We continue to believe the euro is a viable currency that benefits the 17 nations that use it, and we are encouraged by the European Central Bank’s lending to European banks at a low interest rate through the Long Term Refinancing Operations in late 2011 and early 2012. This move to inject liquidity into the financial system helped to stabilize the financial sector and has given European leaders time to develop more permanent solutions.

But there are still major economic and fiscal challenges facing Europe, including the eurozone’s economic slowdown (the IMF projects a contraction of 0.3% in 2012) and high unemployment (10.9% as of March 2012). The very high jobless rate in some countries, such as Spain, could also spark social instability, which would further stifle economic growth. Other challenges include the possibility (while admittedly low) of a breakup of the eurozone or an exit from the euro by one or more members.

One of the fundamental questions facing all highly indebted countries is how they will succeed in reducing their debt in an orderly fashion. Higher levels of economic growth are critical, but history shows that additional measures are usually needed, including spending reductions. However, these reductions often work against economic growth, thus reinforcing the challenge facing these nations.

Investors have traditionally treated the sovereign debt of advanced countries as risk-free, or close to it. That calculus has now changed.
Conclusion

Sovereign debt is used as a benchmark for financial assets and lending rates throughout an economy. As a result, when sovereign debt levels are moderate and sustainable, governments, banks, corporations, and households tend to benefit from lower borrowing costs and a more stable economic environment. By contrast, high sovereign debt (and a corresponding perception of increased sovereign risk) tends to drive up bond yields and impose additional fiscal burdens on government budgets, while also undermining economic growth and depressing confidence in equity markets. In many cases, the rising costs of sovereign debt will affect the borrowing costs for local corporations and banks. Given the continued uncertainty, and the long tail risks that stem from sovereign defaults, we believe investors should use caution when investing in sovereign debt, monitor portfolio exposures to countries, and pay careful attention to sovereign credit issues.

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The changing nature of sovereign debt

Notes

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