McCombs Knowledge To Go



January 10, 2012



Government Default: An Earthquake Experience

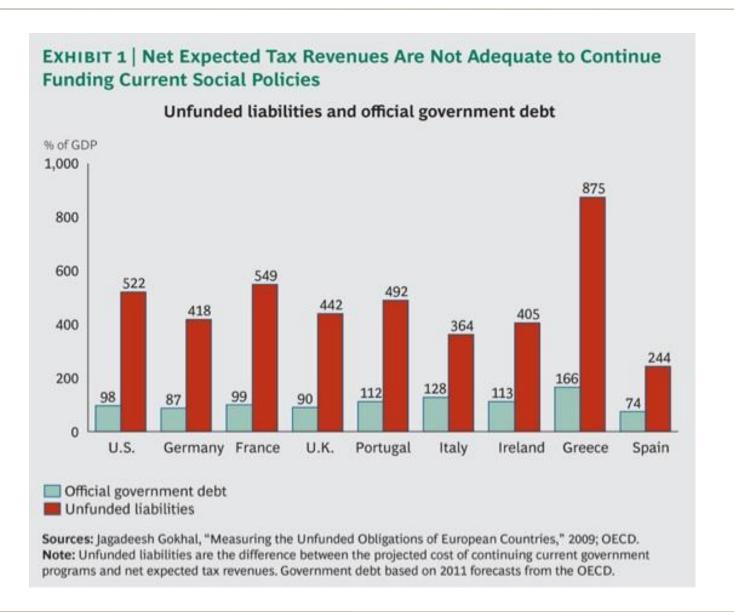


Professor Lewis Spellman www.TheSpellmanReport.com

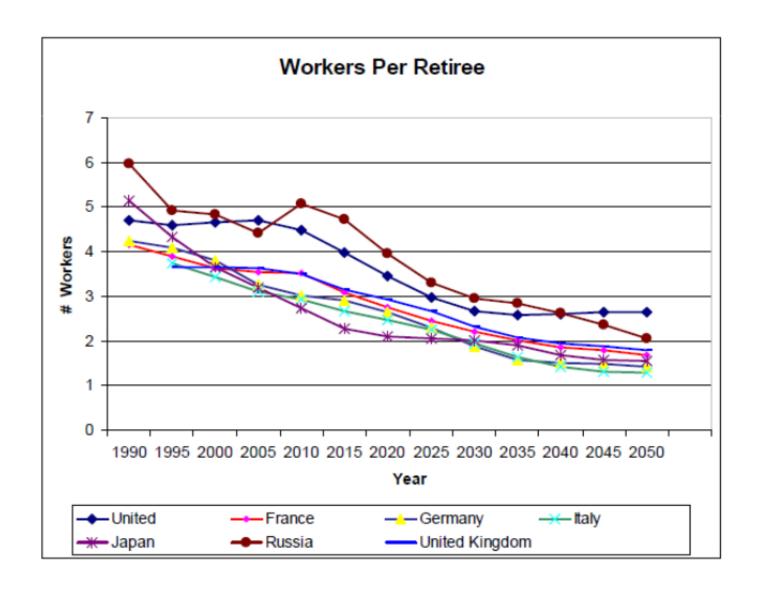
Debt and the Dynamics of Default

- Cumulative Government Deficits/GDP (Debt Satiation)
- Interest payments drain income stream if debt held by foreigners
- Past Debt is Not Past: Gets Recycled at Refinance Time and Interest Carry Rises: The European Dynamic
- Taxes meant to Carry Higher Interest Payments Slow Economic Growth which Adds to Deficits due to:
 - Unemployment expenses
 - Bank/Depositor bailouts
 - Other financial subsidies (Fannie and Freddie)
- Demographics and the Inelastic Supply of Medicine cause Unfunded future liabilities to be greater than current Debt
- Future Government Debt Accumulation Greater than Current Debt for the Developed World

Debt Satiation



Developed Word in Deep Trouble

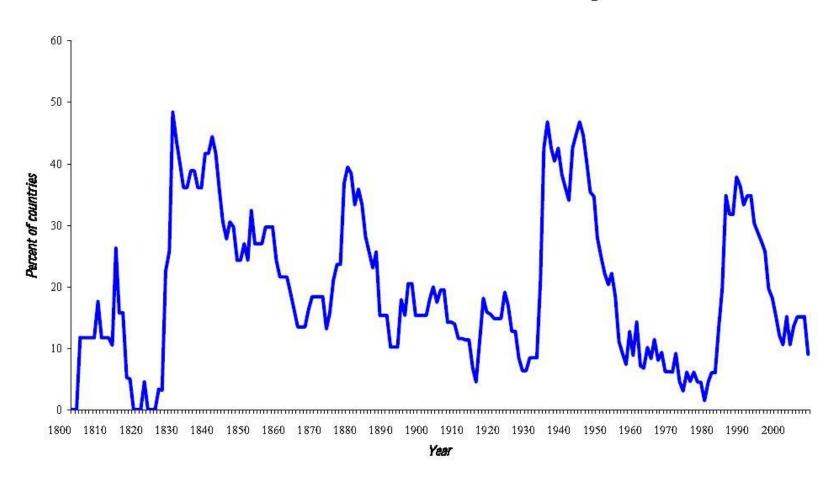


Government Default is Not a Fairy Tale

- Greece was the first country to default in 377 B.C.
- A partial list of countries that have defaulted on their debt:
 - England (3 defaults before 1600)
 - Portugal (5 times since 1800)
 - Spain no less than 7 times (and 13 times in all since 1500)
 - France (8 times between 1558 and 1788)
 - China (1929 and 1939)
 - Nigeria (5 times since 1960)
 - Asian Contagion (1997)
 - Russia (1998)
 - Argentina (2002)

Contagion

Sovereign External Debt: 1800-2006 Percent of Countries in Default or Restructuring



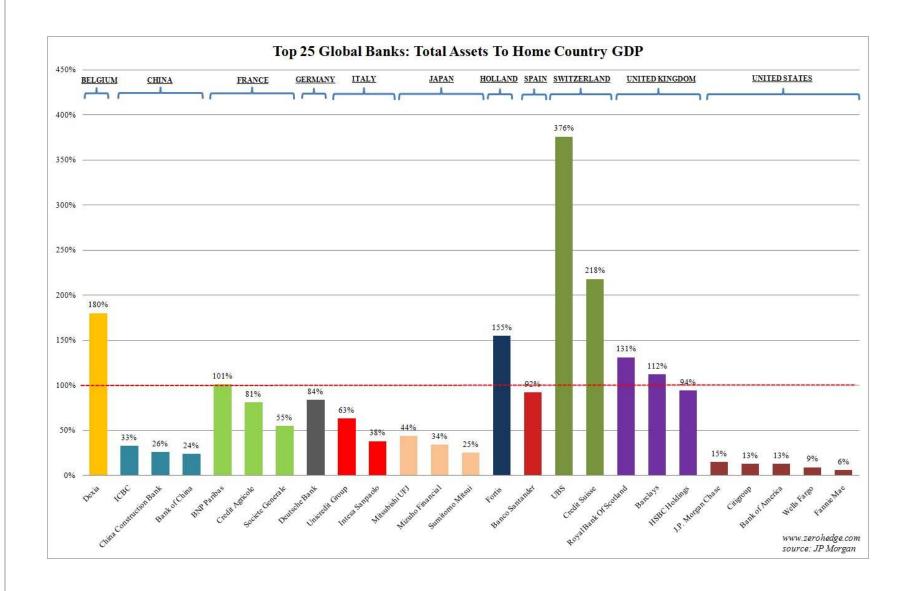
Attempts to Mitigate

- Budget Balance But Fails if private economic growth doesn't overwhelm the restrictive fiscal policy (Note: the U.S. government net contribution to total spending is close to 10% of total spending.)
- Every private growth lever is necessary to generate investment, new products and new employers to overcome fiscal shrinkage
 - Taxes incentive effects
 - Regulation impediments and costs
 - Education and other infra-structure needs
 - Functioning lenders
 - International competitiveness
 - Unit Labor Costs (wages and productivity mix)
 - Currency devaluation (doesn't likely work)

Further Complications

- Capital flees the country so asset prices crater
- Foreign currency becomes more expensive and it creates import inflation
- Banks and Financial Intermediaries hold the government debt so they in turn fail
 - Creates more government debt as government guarantees bank deposits
- Country de-coupling rarely occurs so economic woe spreads
- Central Bank called on to purchase government debt and refinance the banking system (Europe: In full banking system refinance mode)
- See TheSpellmanReport.com/Will the Dam Hold
- Central Bank in turn becomes insolvent

More on the cost of saving banks





Private Implications of a Government Default

- Depressed economy and financial resources for extended years (half to full decade)
- Wages decline with unemployment
- Private Wealth evaporation
 - Bank deposits, pensions, insurance claims etc. evaporate with mass financial institution failure because the banks hold the government debt
 - Stocks decline
 - Bonds suffer rating downgrades, low debt coverage ratios etc.

Business Finance Implications

- Rating Downgrade of sovereign debt in turn causes rating downgrade of private debt
- Business access to foreign capital is cutoff and business can't refinance existing debt
- Cost of debt denominated in foreign currency is vastly more expensive even from domestic sources
- Refinancing costs surge as bank lending stops
- Cumulative loss of financing channels so businesses tend to fail if they have debt on their balance sheet

Depressed Economy but with Inflation or Deflation?

Pressures for both in a grand tug of war

- Deflation pressures from a lack of income, wealth and spending
- Inflationary pressure from more expensive foreign currency and goods (import inflation) and fewer surviving domestic suppliers
- Will the government print, pay government expenses and distribute a la the Weimar Republic? (helicopter money as opposed to balance sheet money below)
- Note: In opposition to the logic of monetarism, monetary expansion by a central bank doesn't necessarily cause inflation
 - Example: Fed balance sheet increased 200% since 2008 but inflation is in the low single digits
- Domestic goods cheap, if still available and imports expensive
- The outcome flavored by foreign goods and capital dependency
- The Engagement of the printing press for financial support
- Also, depends on whether a single nation or a large block of similar countries in which contagion effects occur



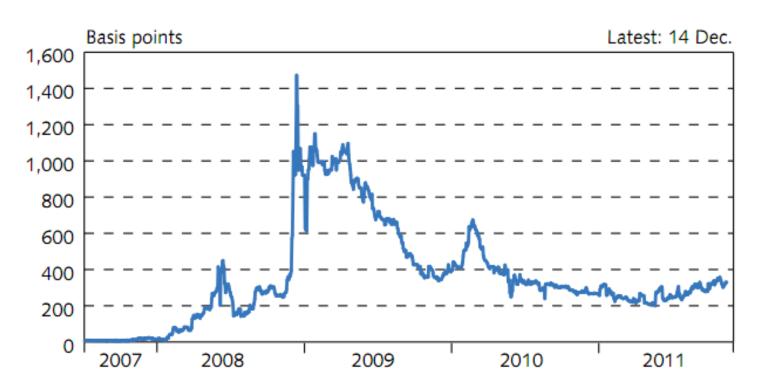
Do Defaulting Sovereigns Settle?

- Debt Resolution: Cooperative to Confrontational: Unilateral moratoria to pre-emptive and voluntary restructuring
- Main pressure on governments to settle is renewed access to capital markets at an affordable rate in order to continue to run deficits
- Good Reference on Sovereign Immunity: The Economics and Law of Sovereign Debt and Default, JEL, 2009
- Iceland two years later is again selling its debt

Defaulters can get back in the game

VII-32

CDS spread for Iceland



5-year EUR credit spread on the Republic of Iceland. Daily data.

Source: Central Bank of Iceland.



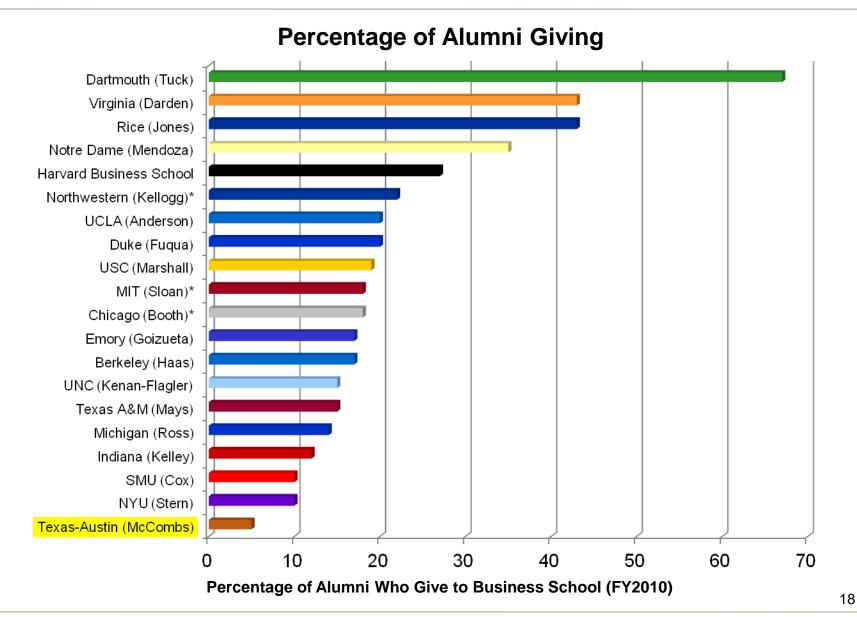
The Ending of the Default Crisis

- Many years of induced private defaults being run through scarce bankruptcy courts
- Productive facility put into the hands of new investors – usually foreign
- Private wealth has been reset to near zero but the economy becomes competitive with cheap labor and a cheap currency to export
- The reset occurs years later but from a lower level of income and wealth, if governments encourage the market rather than going socialistic

Preserving Private Wealth

- Moving capital offshore after the default is very late as capital and currency barriers are erected by a government seeking to wall in capital to hold government debt
- Positions in foreign assets impaired if global recession follows
- Foreign accounts, not enough if there is a subsequent wealth tax which usually occurs
- Protection obtained from the strongest fixed income assets or real assets?
- Duel citizenship as a hedge

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