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Knowledge To Go

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Government Default: An Earthquake Experience

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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

EXHIBIT 1 | Net Expected Tax Revenues Are Not Adequate to Continue Funding Current Social Policies

Unfunded liabilities and official government debt

% of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>Unfunded Liabilities</th>
<th>Official Government Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>522</td>
<td>98</td>
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<tr>
<td>Germany</td>
<td>418</td>
<td>87</td>
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<tr>
<td>France</td>
<td>549</td>
<td>99</td>
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<tr>
<td>U.K.</td>
<td>442</td>
<td>90</td>
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<tr>
<td>Portugal</td>
<td>492</td>
<td>112</td>
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<tr>
<td>Italy</td>
<td>364</td>
<td>128</td>
</tr>
<tr>
<td>Ireland</td>
<td>405</td>
<td>113</td>
</tr>
<tr>
<td>Greece</td>
<td>875</td>
<td>166</td>
</tr>
<tr>
<td>Spain</td>
<td>244</td>
<td>74</td>
</tr>
</tbody>
</table>

Sources: Jagadeesh Gokhal, “Measuring the Unfunded Obligations of European Countries,” 2009; OECD.
Note: Unfunded liabilities are the difference between the projected cost of continuing current government programs and net expected tax revenues. Government debt based on 2011 forecasts from the OECD.
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

Top 25 Global Banks: Total Assets To Home Country GDP

BELGIUM  CHINA  FRANCE  GERMANY  ITALY  JAPAN  HOLLAND  SPAIN  SWITZERLAND  UNITED KINGDOM  UNITED STATES

0%  50%  100%  150%  200%  250%  300%  350%  400%  450%

Banks and Their Total Assets to Home Country GDP Ratios

Source: JP Morgan

www.zerohedge.com
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

Basis points


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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- Dartmouth (Tuck)
- Virginia (Darden)
- Rice (Jones)
- Notre Dame (Mendoza)
- Harvard Business School
- Northwestern (Kellogg)*
- UCLA (Anderson)
- Duke (Fuqua)
- USC (Marshall)
- MIT (Sloan)*
- Chicago (Booth)*
- Emory (Goizueta)
- Berkeley (Haas)
- UNC (Kenan-Flagler)
- Texas A&M (Mays)
- Michigan (Ross)
- Indiana (Kelley)
- SMU (Cox)
- NYU (Stern)
- Texas-Austin (McCombs)

Percentage of Alumni Who Give to Business School (FY2010)
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