



Sovereign Debt Shadows

The current international debt crisis has revived fears that governments in some advanced economies may default on their sovereign debt and unleash a global financial tsunami. After September 2008 the perceived risk of default on national debts by many peripheral European Union (EU) countries (Ireland, Portugal, Spain, Italy, and Greece) increased, spiking to levels not seen since the introduction of the euro in 1999.¹ Financial markets demanded higher yields to keep buying the securities of seemingly different countries. This disparate treatment suggests two related questions: First, what determines the growth of national debts? And second, why are investors so worried about these countries?

The answers to these questions are related to a country's overall fiscal soundness and debt sustainability. The primary fiscal surplus of a country is the difference between tax receipts and government outlays on current expenditures (excluding interest on past debt; a negative surplus is a deficit). Both long-term structural spending (such as changes in military expenditures) and cyclical components (such as unemployment benefits) contribute to fiscal deficits.² The primary surplus (or deficit) less interest payments on outstanding debt is the fiscal surplus (or deficit, if negative). Therefore, the year-to-year change in nominal government debt is the sum of two factors: the interest paid on existing outstanding debt plus the primary deficit. Higher interest rates and outlays and declines in tax receipts tend to increase a country's debt.

Government debt is typically indicated as a percentage of gross domestic product (GDP); this allows meaningful comparisons over time or across countries with respect to ability to service the debt. Faster GDP growth relative to debt permits governments to keep the debt-to-GDP ratio under control. In contrast, meager economic growth and/or little fiscal discipline can balloon the debt-to-GDP ratio until the government develops fiscal discipline or defaults on its debt.

The recent global recession has increased deficits and debt-to-GDP ratios in many countries. Interest rates are now favorably low but will likely increase as the global economy strengthens, further increasing deficits and perhaps making debts unsustainable.

Rising debt-to-GDP ratios of the five peripheral EU countries particularly concern investors, but fiscal pressures are not unique to this group. The chart plots the debt-to-GDP and deficit-to-GDP ratios for selected advanced economies for 2007 and 2009; the average GDP growth rate over 2003-07 is listed in parentheses.

All five peripheral EU countries (white dots on the chart) face burdensome public debt and budget deficits, but the causes

for uncertainty in each country's situation differ. Italy has a large initial stock of debt and poor expected growth. Ireland and Spain had lower debt coming into 2007 but experienced huge deficit increases. Portugal had moderate debt but sizable deficit increases coupled with slow projected growth. Greece had both large pre-crisis debt and a ballooning deficit.

In all countries but Ireland common elements contribute to fiscal concerns, including a high share of government expenditure as a percentage of GDP, low fertility rates (with fewer future workers to reduce the debt), and a large informal economy. In addition, four countries (Ireland is again an exception) currently spend or are projected to spend in the future a larger share of their GDP to pay for public pensions, relative to other advanced economies. A final common element among these countries is membership in the euro area, which presumably prevents the members of this group from inflating away their debt.

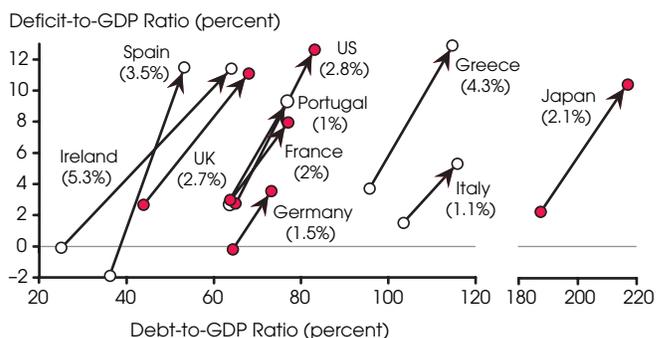
Others countries might may soon face similar fiscal pressures as the need for sizable pruning actions looms on the horizon.

—Silvio Contessi

¹ Measured by the rates on credit default swaps; see Neely, Christopher J. "Markets Worry More about Sovereign Debt." Federal Reserve Bank of St. Louis *International Economic Trends*, February 2009; <http://research.stlouisfed.org/publications/iet/20090201/cover.pdf>.

² See Neely, Christopher J. "Global Factors in Budget Deficits." Federal Reserve Bank of St. Louis *International Economic Trends*, November 2003; <http://research.stlouisfed.org/publications/iet/20031101/cover.pdf>.

Debt-to-GDP Ratios and Deficits-to-GDP in Selected Advanced Economies (2007 and 2009)



SOURCE: Data from various sources.