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3

Sovereign debt and default:

WHY IT MATTERS FOR WORKERS

PSI BRIEFING SERIES - DEBT AND WORKERS

Sovereign debt may feel far-removed from the concerns of workers. As voters, they rarely have a say on governance of national debt. But, as was revealed by the Greek crisis, when a country is insolvent, it is the voice of the financial markets which decides economic and employment outcomes, rather than the voice of workers.[1]

Sovereign (or external) debt is issued by a national government to foreigners be they private investors, other governments or international organisations. This gives the state funds to spend in the short term, but an obligation to pay back investors (with interest) in the long term.

Sovereign debt and default

WHY IT MATTERS FOR WORKERS

Traditionally, sovereign debt is seen as risk-free for investors as governments can employ different measures to guarantee repayment, including increasing taxes or print money. But in practice, governments do default on external debt, leading to debt restructuring (often under harsh terms) and even the imposition of austerity measures by external creditors such as the IMF and World Bank.

WORKERS SUFFER WHEN DEBT IS UNSUSTAINABLE

The costs of sovereign default are profound. Countries suffer a blow to their growth: on average GDP shrinks by 3 to 5 percent for the first few years and the negative effect on growth can last up to 10 years. If a banking crisis occurs at the same time, GDP can collapse by as much as 10%.[2] Simultaneously, governments are forced into austerity as taxes drop and access to foreign financial markets either stops abruptly or becomes a lot more costly. Austerity then exacerbates these problems as public sector jobs and welfare payments such as pensions are cut, labour markets are deregulated, and infrastructure spending is cancelled or delayed supressing demand further.

Countries try to avoid default (although this is not entirely in their hands) as the default can lead to destruction of wealth, a drop in national income, and dislocation for those who cannot insure against such risks: usually workers and the poor. Orthodox solutions have traditionally visited misery on those unable to protect themselves and are least to blame. Financial speculators tend to accrue the benefits while the loses are often paid for from public budgets, especially when the debt crisis is an outcome of private credit-led speculative financial flows.[3] This means that it is the workers – tax-payers – who must tighten their belts (wage cuts or worse) until the debt is ultimately repaid or reduced.

As individuals, we have some independence over what we earn and spend. To reduce our personal debt, we can cut down on our spending – and our income is unaffected as it is dependent on a much larger economy. But for an economy as a whole, if individuals, businesses and the government cut their spending, then total income falls. At a national level, total spending and total income are equal, as whatever is earned must have been spent by someone else. Government expenditure provides income for others in the economy. Public spending includes wages and salaries, demand for the goods and services from private businesses in the economy, as well as investment into infrastructure spending like electricity, water, sanitation, roads, etc. But if the government increases saving and reduces spending then the income of businesses and individuals is compromised.

Austerity usually involves immediate and sharp cuts to government spending as part of a negotiated bailout. This often includes a consolidation period, where the country is given extra time to repay. All kinds of social spending may be cut, pensions may be reduced and there may be an off loading of state assets through fire-sale privatizations. The impact of these cuts falls hardest on those whose livelihoods depend on state expenditure: workers in the public service and those who rely on public services, particularly low paid workers and women. Since women are more likely to be employed in the public sector (in education and healthcare) and rely disproportionately on public services, austerity effects women more, increasing their financial insecurity, and exacerbating the gender employment and the wage gap.[4] Austerity often results in the unravelling of social cohesion– crowded schools and declining public services may be seized upon by right-wingers as the fault of migrants – when in reality it is budgetary cuts approved by complacent politicians that are to blame.

A recent and drastic example of imposed austerity is the ongoing crisis in Greece that began in 2010.

Debt crisis and enforced austerity have helped fuel the far right – such as the Golden Dawn in Greece seen here

CASE STUDY

NEVER TO BE REPEATED THE DISASTROUS BAILOUT OF GREEK CREDITORS

Over the last decade, Greece has experienced the worst debt and economic crisis in modern economic history. That this happened to a member of the European Union demonstrates that no country is immune and that the orthodox solutions of the west do not work. Since the beginning of the crisis, Greek GDP shrank by 27.7%. By comparison, the crises in East Asia and Argentina in the late 1990s and early 2000s shrank the GDP in those economies by 12.5% and 19.5%, respectively. However, unlike any other case during peacetime, the Greek economy has failed to show any signs of recovery a full decade after the crisis. The devastation to the economy and the severe social costs present a clear argument to never let international authorities subject any country to the same punishment.

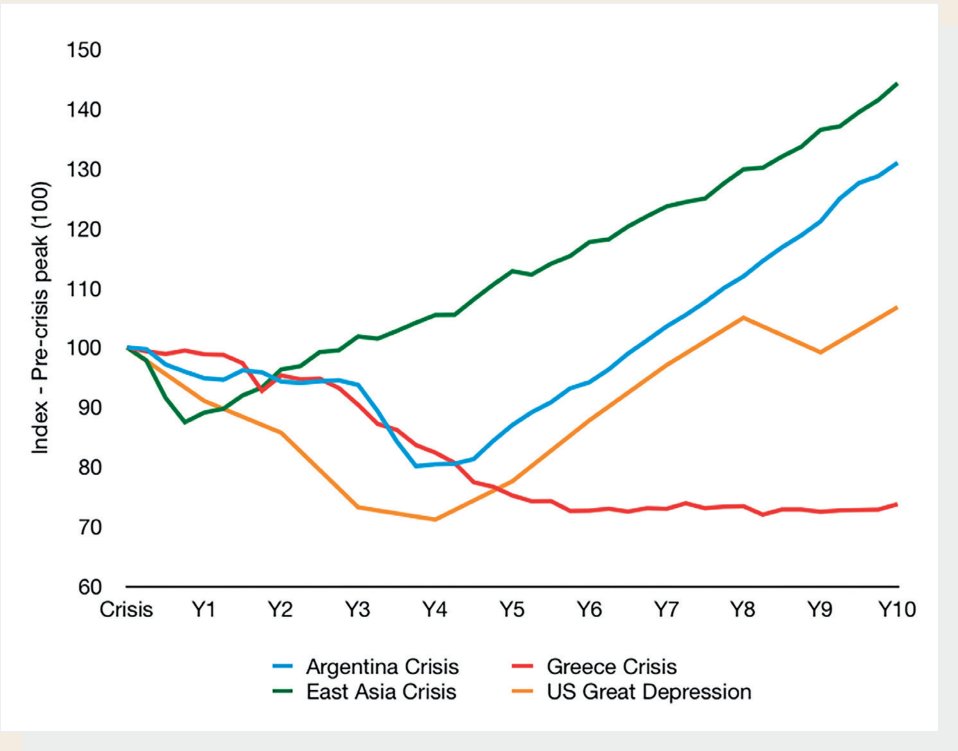
The key factor behind the depth and length of the crisis was the decision by EU authorities to fully bailout the private creditors of Greece (mostly European banks), so that the losses of the crisis were transferred from banks and other private holders of Greek public debt to public creditors such as governments and international institutions. This has meant that the debt burden of the country has continued to increase at the same time that austerity measures have been imposed in an unrelenting manner. Together, these measures caused a sharp and prolonged deterioration in the living standards of the Greek population.

EVOLUTION OF REAL GDP DURING AN ECONOMIC CRISIS

INDEX – PRE-CRISIS GDP PEAK (100)

The Greek crisis that started in 2009 stands out as the worst economic crisis in modern economic history.

Source: Thomson Reuters, Maddison GDP data set.[5] Note: Argentina crisis (Q2 1998 – Q2 2008); Greece crisis (Q2 2007-Q2 2017); East Asia crisis (average index for Thailand, Indonesia and South Korea) (Q3 1997- Q3 2007); US Great Depression (1929-1939)



A decade after their respective crises, East Asia (1997) and Argentina (2000/01), had managed to grow their economies substantially above the pre-crisis levels. Even the US after The Great Depression, where GDP collapsed by 28,8%, recovered to its pre-crisis peak faster than Greece.

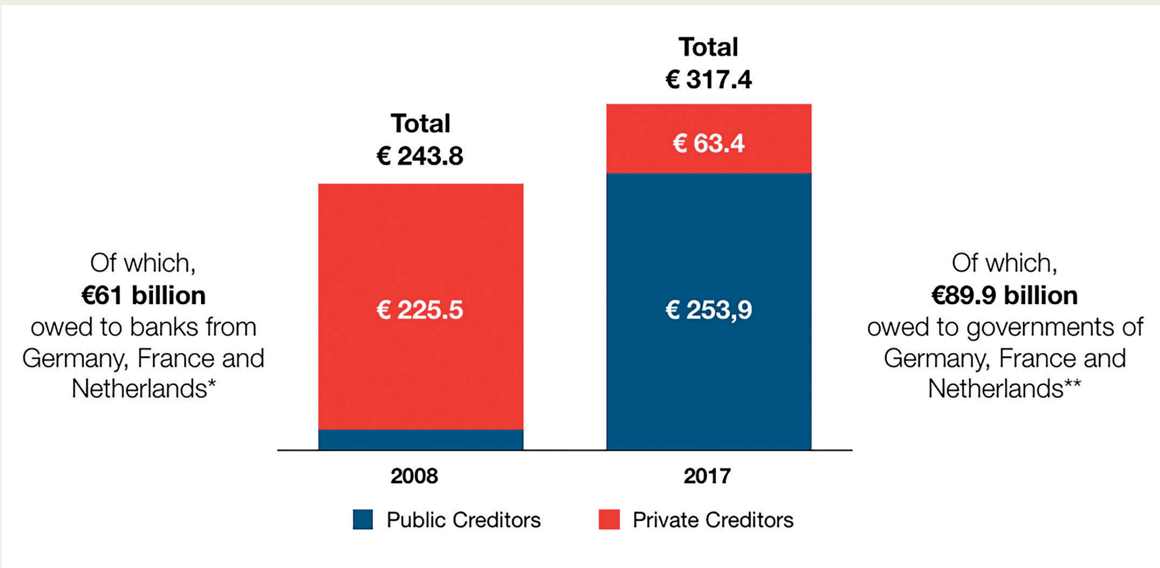
In 2008, before the crisis began, the public debt of Greece stood at €243 billion.[6] Over 90% of this public debt was held by private investors - over 70% by foreign investors. German, French and Dutch banks had an exposure of €61 billion (over a quarter of the total).

As the aftershocks of the GFC hit Europe, borrowing costs for Greece increased substantially and Greek debt became unsustainable. Faced with this situation, Greek and EU authorities could have chosen to restructure the debt of the country. In this scenario, the debt burden of the country would have been reduced by imposing some losses on private creditors (who played their part in creating the unsustainable debt). Instead, the so-called Troika of the EU Commission, the ECB and the IMF, coordinated the biggest international financial rescue for private investors in history: official creditors lent Greece a total of €288.7 billion between 2010 and 2018.[7]

GREECE, GENERAL GOVERNMENT DEBT BY CREDITOR 2008-2017

(BILLIONS OF EUROS)

The Greek bailout increased the debt of the country while it transferred the credit exposure from private banks to governments across Europe.



Source: Arslanalp, S. and Tsuda, T., (2014), BIS (2018)[8] WSJ (2018)[9] ., ECB (2018)[10]
**BIS data. Exposure to official sector of Greece by banks on an ultimate risk basis.*
*** Includes GLF, ESM and EFSF loans. National shares using ECB capital key.*

The rescue operation allowed the repayment of private creditors in full, protecting them from losses, while shifting exposure to Greek debt onto official institutions. The share of Greek public debt owned by official international creditors (composed of EU governments and institutions and the IMF) increased substantially from 7% of the total in 2008 to 80% in 2017. Private international investors took the bailout money and fled: during the same period, their share of Greek public debt fell from 70% to 7% of the total.

While private creditors cashed-in, the population of Greece suffered. As part of the austerity program imposed on Greece to free resources to pay creditors, government expenditures fell by 30% between 2008 and 2017.[11] Expenditure on health services decreased by 45%. Expenditure on education and social protection fell by 18% and 13% during the same period.

In addition, the government embarked on an aggressive program of privatizations. Since 2010, a total of 38 privatizations were completed, in many cases at fire-sale prices, raising a total of €4.7 billion.[12]

The impact of these measures on the Greek population cannot be overstated. Unemployment peaked at 27.5%, while youth unemployment reached 59.9%. The percentage of Greek people living below the poverty line increased from 16.3% in 2010 to 42.2% in 2015.[13]

During this same period, the number of homeless people quadrupled while the number of suicides doubled.[14]

While some viewed the rescue program as a success, given that private creditors came away unscathed, it was an outright failure in terms of ensuring the recovery of the Greek economy, the sustainability of its debt and the wellbeing of its people.

Instead of decreasing the country's debt, the program actually increased it by almost a third. This failure in now recognized by one its main coordinators, the IMF, who acknowledge that Greece will continue to face substantial challenges to ensure the sustainability of its public debt in the medium term. After a decade of crisis and decimation of the living conditions of the population, the IMF now argues in favour of debt relief to ensure recovery and debt sustainability for Greece.[15]

As it stands, however, there is no common approach to debt restructuring which would prevent such an outcome being repeated. What is clearly needed is international commitment to sound principles on sovereign debt restructuring, such as those adopted by the UN General Assembly in 2015, but still not made effective by nation states.

HOW DO GOVERNMENTS FUND DEFICIT SPENDING?

Governments use income (mostly tax revenue) to fund their expenditure priorities. These can range from investment in infrastructure to supporting an educated and healthy workforce and providing vital public sector workforce.

Importantly, governments also spend to maintain social cohesion and equity, providing safety nets for families, the unemployed, disabled and the elderly.

Depending on their public spending priorities and the state of the economy, public spending can exceed tax income resulting in deficit spending and accumulation of government debt.

Public debt can be held by:

- nationals of the country, which is known as domestic debt
- foreigners, in which case it is termed sovereign debt.

To fund this public budgetary shortfall, governments may increase public debt by issuing bonds (a form of debt) or seeking loans - both from domestic and foreign sources. Governments must consider all the relative costs, risks and benefits of undertaking foreign and domestic debt obligations.

While interest rates payable on foreign loans may be lower than domestic loans, foreign loans have to be repaid in a foreign currency and so if the value of the foreign currency appreciates, or the domestic currency falls, over the repayment period the benefits of a lower interest rate might be wiped out.

The value of many currencies has been depreciating against the US dollar since 2008, which raises the nominal values of sovereign bonds when issued in dollars. A frequently cited example is Ghana, whose government issued a 10-year eurobond with the nominal value of $750m in 2007 at a coupon rate of 8,5%. At the time, the Ghanaian cedi was nearly at parity (one to one) to the dollar, but the cedi value collapsed against the dollar in the 10 -year period , so that Ghana effectively repaid 4.5 times more than the face value of the original bond.

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WHEN IS SOVEREIGN DEBT UNSUSTAINABLE?

While it is relatively easy to tell when a household or corporation is solvent (by assessing whether net liabilities are greater than net assets), for countries it depends on their ability to generate budget surpluses to repay debt. Judging public debt sustainability means looking at economic activity (present and future) as well as external factors over which governments have little control – like commodity prices.

Debt sustainability is based on many judgments about the future. By the end of WWII, Britain shouldered debt of up to 250% of GDP (as it had the previous century after the Napoleonic wars): yet no threat of default loomed.[16] Japanese debt to GDP has exceeded 200% of GDP for years, but is relatively stable as 90% of it is held by domestic investors. There is no absolute level at which debt to GDP becomes unsustainable – it depends on future growth projections, productivity and external trading conditions, amongst others.

Austerity can be enforced by external creditors, but also by conservative politicians using deficit hysteria to restrict spending on public services. Today, over two-thirds of countries around the world are implementing austerity: contracting their public purses and limiting rather than expanding their fiscal space.

Many governments have been unable to service their external debt obligations and had to seek terms for debt restructuring. If investors consider a country to be high risk, they ask for a higher return on the debt

WHAT UNDERMINES GOVERNMENTS ABILITY TO SERVICE THEIR DEBT?

In an ideal world, the boost to the economy that results from deficit spending should result in higher economic activity that leads to higher tax revenues and ensures that debt incurred by the government can be serviced. But things don't always go as planned.

A state may need to service the debt before the public spending that created the debt generates revenue, or their currency could devalue relative to the currency in which they must make repayments, or commodity prices slump, or there is a natural disaster such as a drought or a hurricane.