Lessons from global debt crises

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The global financial crisis of 2008-09 is still fresh in many investors' minds. After starting in the U.S. housing market, it quickly spread and within a few years had reached the sovereign debt market, particularly in Europe. Investors became concerned over excessive debt levels in countries such as Greece and questioned—often with good reason—the ability of governments to pay back the money they had borrowed. Looming sovereign defaults caused investors not just concern but also losses—through credit downgrades and subsequent declines in the market value of the outstanding debt and, in some cases, debt restructurings.

To some, the crisis provided a simple lesson: by reducing the weight of issuers with large outstanding debt, they can also reduce default risk (and its close relative, downgrade risk). But, as intuitive as it may seem, investors should not take this simple logic for granted. Recent history shows why a narrow focus on relative debt levels might be misleading. Debt levels can jump very quickly and don't always give a full picture of the challenges facing a country, as the financial crises in Russia and Argentina illustrate.

The Russian financial crisis of 1998

In 1997, Russia's debt-to-GDP ratio was 50% (according to the World Bank), a far cry from the debt levels plaguing even AAA-rated countries more recently, such as the United Kingdom (109.1% in 2012) or Germany (81.9% in 2012). And yet, within less than one year, Russia had plunged into a severe financial crisis: The stock market fell by more than 93% from its peak and the public deficit exploded. On August 17, 1998, Russia officially defaulted on its debt. The detailed causes of the Russian default are very complex, but here are a few factors.

- **The Asian financial crisis.** To some extent, the Asian financial crisis that started in 1997 had a chain-reaction effect in Russia, impacting both commodity prices and investor confidence in emerging markets. Increasing risk aversion led to large capital outflows from Russia in 1998.
- **A decline in commodity prices.** The Russian economy of the 1990s was heavily dependent on the exports of commodities such as timber, metals, and, in particular, gas and oil. The decline in commodity prices had a significant impact on the country's trade balance and tax receipts.
- **Political and fiscal issues.** Russian President Boris Yeltsin appointed and dismissed five heads of government in just 18 months, none of whom were able to implement coherent reforms as Russia's economic and fiscal situation deteriorated. To balance out rapidly declining tax revenues, the Russian government issued short-term notes in increasing volumes. Between 1998 and 2000, the public deficit ballooned.
- **A fixed exchange rate.** Russia had pegged the ruble to the U.S. dollar, allowing it to float only within a narrow band. The deterioration of the Russian economy and trade balance would normally have led to a depreciation of the ruble. Instead, the Russian central bank spent increasing amounts of its foreign reserves to defend the value of the currency. In August of 1998, the peg was finally lifted and the ruble depreciated heavily.
- **Confidence crisis.** The short-term debt that the government issued was mainly purchased by domestic banks. To finance their purchases, Russian banks ran up short-term debt denominated in dollars. The market for short-term government bonds eventually seized up as the capital flight gained pace, leaving Russian banks overindebted and exposed to exchange rate risk. The Russian central bank became the sole buyer of Russian government debt. Interest rates shot up to 150% in May 1998.

The Argentinian financial crisis of 2001

Throughout the 1990s, Argentina was a star performer among emerging markets. Economic reforms in the early 1990s brought inflation under control, reduced government regulation, and liberated markets. In 1991 and 1992, real GDP grew by more than 10%. But in 1998, Argentina slid into a recession that would last four years and soon turned into a full-blown depression. In late December of 2001, Argentina defaulted on large parts of its public debt. Key issues for bond investors include:

- **The Brazilian crisis.** Just like Russia, Argentina had pegged the value of its currency directly to the dollar at an exchange rate of 1:1. This was problematic in several ways. In 1999 Brazil, Argentina's largest trading partner, abandoned a similar

peg and allowed its currency to float. The Brazilian *real* quickly depreciated, making Argentinian exports uncompetitive and leading to a dry-up in foreign investments into Argentina, with a corresponding impact on tax receipts.

- **Tax policies.** The Argentinian government responded to the weakening economy and the growing budget deficit with a series of tax hikes. Their response actually deepened the crisis. Rather than raising funds, the tax increases stifled the economy and reduced confidence in the government.
- **Lack of fiscal discipline.** The currency board arrangement did not provide the fiscal discipline Argentina needed. The ongoing recession and mounting budget deficit led to even more borrowing. In the summer of 2001, Argentina was effectively caught in a debt trap. Bond yields spiked, and gross government debt went from 38% of GDP in 1998 to more than 160% in 2002.
- **Political blunders.** The Argentinean government was unable to move the economy out of recession and took a series of unfortunate decisions. It refused to lift the currency peg and adopted an interventionist policy by setting different exchange rates for different types of buyers and sellers, raising questions about the government's ability to solve the crisis.
- **Confidence crisis.** Markets started to lose confidence both in the sustainability of the currency peg and the government's ability to pay back its debt. The yield spread in U.S. Treasuries spiked, eventually making it impossible for the Argentinian government to refinance itself. This, in turn, sparked fears that the government would resort to bank deposit freezes, as it had done in the past, leading to a bank run. The currency peg only added to the pressure as people anticipated an eventual devaluation of the peso. Argentinians withdrew large volumes of pesos and converted them in dollars. On December 1, 2001, the government announced a deposit freeze and, less than a month later, Argentina defaulted on its debt.

The Argentinian and the Russian debt crises have several similarities—in both cases, the crisis initially spilled over from other hot spots. Both Russia and Argentina were heavily dependent on commodity exports and both suffered from some form of structural and political weakness. Crucially, both had established a fixed exchange rate between their own currency and the dollar and therefore had given up control over their currency. In the run-up to their defaults, both governments eventually lost investors' confidence in their ability to maintain the value of their currency and to repay their debt. Investors would not have been able to anticipate these defaults by looking at relative debt levels at the outset of the crisis. And by the time debt levels skyrocketed, it may have been too late for them to get out.

Debt-to-GDP isn't everything

In sharp contrast to the events that took place in Russia and Argentina, Japan, for example, has been able to live with high debt levels for a long period of time (238% of GDP as at 2012). Unlike Russia in 1998 and Argentina in 2001, Japan benefits from a modern and diversified economy, a free exchange rate, and relative political stability. Crucially, Japan can rely on vast internal demand for its debt, providing liquidity that enables the government to refinance itself. This is not to say excessive indebtedness doesn't matter, but rather that credit risk is more complex than just debt-to-GDP and investors shouldn't content themselves with just one indicator.

The advantage of market cap-weighted bond indexes is that they factor in any conceivable indicator the market uses to evaluate the various risks bond investors face. The market price of a bond reflects at all times the consensus price of all market participants and the criteria they draw on to determine its value. A one-sided focus on relative debt levels might eliminate one risk while over-exposing investors to other risk factors. What's more, history doesn't repeat itself. No two crises are ever quite the same, and what triggered the last default isn't necessarily what will lead to the next.

The lesson from the past may be that diversification and, by extension, exposure to a variety of different risk factors might still be the best way to manage risk.

Notes:

All investments are subject to risk, including the possible loss of the money you invest. Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. Diversification does not ensure a profit or protect against a loss.

Investments in securities issued by non-U.S. companies are subject to risks including country/regional risk and currency risk.