THE CHANGING LANDSCAPE OF GLOBAL SOVEREIGN RISK

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I. INTRODUCTION

In the past, conventional wisdom has dictated that the debt of large, advanced economies such as the US, Japan, Germany and the UK should be seen as carrying very low risk, while debt issued by Asian borrowers was seen as volatile and risky. Lately, however, profound structural shifts in the global economic landscape are giving investors reason to revisit such assumptions and examine to what extent they still hold true.

In their search for yield and diversification, investors are beginning to look behind sovereign-debt ratings to better understand their fundamentals and see how they compare in the trade-off between risk and return. Their findings may then lead to a review of their global fixed-income allocations, both in terms of relative exposure across countries and the methodology used to formulate optimal weightings.

II. SOVEREIGN DEBT: WEIGHING QUALITATIVE AND QUANTITATIVE FACTORS

When analyzing the credit quality of a country’s sovereign debt, a number of variables must be considered. Measuring a country’s ability and willingness to pay back its debt, the two primary components of creditworthiness, requires weighing both qualitative and quantitative factors.

III. COMPONENTS OF CREDITWORTHINESS

Qualitative factors include such things as the stability of a country’s political system, the perceived effectiveness of its central bank and the country’s ability to adapt to structural shifts in the global economy.

Quantitative factors may include such measures as the size and the growth rate of a country’s Gross Domestic Product (GDP), total debt as a percentage of GDP and the current fiscal deficit as a percentage of GDP. Let’s take a closer look at the G-7 versus both newly industrialized and developing Asia and see how they stack up in terms of such quantitative factors:

Chart 1 graphically shows that trend growth in both newly industrialized and developing Asian economies is significantly higher than that in the G-7 economies throughout the full economic cycle. Moreover, much of the global growth expected in the coming years will be driven by Asia, with a big boost from China.

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The aftermath of the global financial crisis caused the G-7 countries to register negative growth rates for 2009. However, after posting more moderate declines, newly industrialized Asia, which includes South Korea, Taiwan, Hong Kong and Singapore, bounced back rather quickly.

On the other hand, developing Asian countries still posted positive growth rates in 2009 led by China, as well as the ASEAN-5 (Indonesia, Philippines, Malaysia, Thailand and Vietnam). These expansions resulted from having a larger share of their economies being driven by domestic consumption and prudent pro-growth policies to counter the negative impact of a downturn in the economic cycle.

In the next few years, the G-7 economies are expected to post modest growth as they continue on the path of deleveraging that is necessary to move towards fiscal sustainability. Asian growth, on the other hand, is projected to be robust across newly industrialized and developing Asia, propelled along in part by China’s continuing growth. The region’s economic expansion will be buoyed by favorable demographics, strengthening domestic demand and policies that promote balanced, long-term, sustainable growth.

From a trend growth perspective, both developing and newly industrialized Asia are on growth trajectories that are favorable to their governments’ fiscal positions and consequently, to their government bond markets.

**IV. CONSIDERING A COUNTRY’S FISCAL HEALTH**

Now we will consider a key measure of a country’s fiscal health: the Fiscal Deficit-to-GDP Ratio.

The ratios shown in Chart 2 clearly contrast the deteriorating fiscal positions of some G-7 and European peripheral countries with the more manageable levels found in Asia. The
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CHART 2  FISCAL DEFICITS AS PERCENT OF GDP

Source: asiabonusline, as of the end 2009

US, Japan, Ireland and Greece, all have deficit–to-GDP ratios in excess of 10 percent, while
the rest of the Asian countries have levels that are much healthier. This ratio is not only
indicative of a country’s debt burdens and its ability to service them, but also of the fiscal
policy options available to each government in case the world slips back into recession.

Developed nations have already implemented massive fiscal stimulus measures to
spend their way towards recovery, and more recently, Europe has had to adopt fiscal discipline
through austerity measures designed to bring debt levels down to more sustainable
levels.

On the other hand, Asian governments entered the crisis with generally strong balance
sheets. This was particularly noteworthy in China, where low levels of government debt
allowed the country to aggressively pursue infrastructure spending and government sponsored
credit growth that not only boosted economic expansion within the country, but also provided
a strong positive spillover effect to its Asian neighbors. For example, while global GDP de-
clined 0.6 percent in 2009 led by severe contractions in the advanced economies, China con-
tributed 1.10 percent to global growth, the same year due to a combination of robust
fundamentals and sound policy actions.

V. CREDITWORTHINESS AND THE COST OF INSURING AGAINST DEFAULT

Now let’s turn to perceived creditworthiness by looking at the cost of insuring
against default in several select government bond markets. In Charts 3 and 4, we have shown
the historical credit default swap (CDS) spreads across quite similarly rated Asian and Euro-
pean countries.

Chart 3 highlights the lower cost of protection against default for Asian borrowers,
even where the Asian borrowers are rated similarly or even lower than their European coun-
terparts. It is also readily observable that the variability of spread movements is greater among
the selected European countries. This seems to indicate that investors consider select Euro-
pean government debt riskier than even lower rated, Asian debt.
Among the below-investment grade countries in Asia and Europe, we find a similar story. The Philippines and Indonesia have the same credit rating as Greece: BB+. However, as shown in Chart 4 depicting the comparative historical CDS spreads of the three countries, investors are clearly a lot more worried about the creditworthiness of Greece than the Philippines and Indonesia. The reason the cost of protecting Greece against default is so much higher is not hard to find. The two Asian countries have fiscal deficit-to-GDP ratios that are significantly lower than Greece’s which has reached an alarming 14 percent.

VI. A LOOK AT POTENTIAL QUALITATIVE RISKS

So far, we have limited our analysis of sovereign debt risk to quantitative factors. Now we’ll look at some of the potential qualitative risks. The emerging Asian economies are still subject to the risks generally associated with emerging markets: government, political and social instability, regulatory risks, lack of transparency and others.

There have been pockets of political unrest in the region such as in Thailand and the Philippines. But they have largely played themselves out, and the recent strength in their respective equity markets demonstrates this. While currency crises have also been traditionally associated with emerging markets, Asia’s massive build-up of reserves has greatly mitigated this risk.

Finally, Asian governments implemented the necessary structural reforms post the 1997 Asian crisis so that they were well positioned to weather the storm of the credit crisis in 2008. Such regimes have pursued sustainable growth rates through structural policy changes and pro-growth cyclical policies that have helped build credible track records.
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CHART 4 COMPARATIVE HISTORICAL CDS SPREADS – BELOW INVESTMENT GRADE COUNTRIES (BPS)

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<th>Date</th>
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Source: asiabonusline, as of the end 2009

VII. WHY THERE IS POWERFUL SUPPORT FOR EMERGING ASIAN SOVEREIGN BOND MARKETS?

To summarize our perspective, we believe that both newly industrialized and emerging Asian sovereign bond markets will be supported by two very powerful secular forces.

First, the underlying macro-economic and credit fundamentals of newly industrialized and developing Asian markets are vastly superior to those of the developed world. Low debt levels, significant growth in domestic demand, favorable demographics, increasing productivity and a rising middle class have led Asian economies to grow two-to-three times faster than developed economies over the last ten years. Added to these positive, pro-growth factors is the big boost these Asian countries get from dealing with economic powerhouse, China. Given the huge debt burdens borne by advanced economies and their moves toward fiscal consolidation, there is little reason to expect this pattern to change any time soon. However, Asia does face the prospect of weaker external demand given the developed countries’ current slow growth prospects, and therefore, policymakers need to continually affect a durable rebalancing toward domestic sources of growth.

Second, Asian government fiscal positions are generally healthy, with sovereign balance sheets that are significantly stronger than most of the G-7 countries. The slump in economic activity and, to a much lesser extent, stimulus measures pushed fiscal deficits in advanced economies to more than 9 percent of GDP in 2009. Debt-to-GDP ratios in these economies are expected to exceed 100 percent in 2014 based on current policies, some 35 percentage points of GDP higher than before the crisis. In contrast, Asian Debt-to-GDP ratios are, for the most part, less than 50 percent of GDP and average fiscal deficits are at 3 percent of GDP. Third, given the much faster growth trajectory of Asian economies and their lower fiscal deficits, these ratios are more likely to improve over the next few years.
 VIII. AN ALTERNATIVE APPROACH: HOW TO INVEST IN ASIA’S FIXED-INCOME MARKETS

Having made the case for diversifying from advanced industrialized economies into Asia’s local fixed-income markets how is an investor to approach investing in this diverse and fragmented region? The changing landscape of sovereign risk has challenged the ability of traditional investment approaches to generate sustainable returns while also effectively managing risks. Current conditions have exposed the inherent structural bias to overweight countries with high levels of debt associated with the traditional market capitalization approach. As concerns about sovereign creditworthiness become increasingly important to asset allocation, there is an urgency to seek alternatives to this traditional, market capitalization approach. One such alternative was developed by iBoxx in the form of a methodology to construct a Pan-Asia bond index. This approach comprises four factors in determining index weightings across Asian government borrowers, both newly industrialized and developing. The index was developed in connection with the Asian Bond Fund 2 initiative and is known as the iBoxx ABF Pan-Asia Bond Index.

The four factors include: the size of the country’s bond market, its overall liquidity, the country’s sovereign debt rating and market functionality – which measures the degree to which offshore investors can buy and sell bonds in that market without encountering impediments such as capital controls and withholding taxes. This index methodology works well for developing markets since it takes into consideration characteristics that are more pronounced and relevant for emerging economies.

Chart 5 compares the index allocations of a traditional market weighted index with the iBoxx ABF Pan-Asia Bond Index. From this comparison, we can see that using market weights alone to determine country weightings would result in an index that has 82 percent invested in China and Korea, which many investors would consider too highly concentrated in
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terms of risk. On the other hand, taking liquidity, credit ratings and invest-ability into consideration produces index allocations that are more balanced, diversified and investable as shown in the iBoxx weightings in Chart 5.

IX. CONCLUSION

The global economy is undergoing profound structural shifts that are causing global investors to re-examine more traditionally held views of investing. This may involve re-evaluating the risks associated with investing in advanced versus developing sovereign-bond markets or challenging the market-weighted approach’s structural bias to overweigh even countries that pile on higher amounts of debt. Moreover, the explosion of debt among many advanced economies, coupled with the risk of a significant slowdown in growth, has intensified the search for diversification across developed and emerging bond portfolios.

We anticipate Asia’s greater economic dynamism will lead to more attractive investment opportunities and greater fund flows from the G-7 and other industrialized countries. Institutional investors that have traditionally limited their fixed-income options to domestic markets will be driven to invest beyond their own borders, and we expect Asian assets, including Asian bonds, to be a strong beneficiary of these flows.