From NYU Stern’s blog for the forthcoming book “Regulating Wall Street”:

**Passing the Buck? - Ten Interesting Facts about Sovereign Credit Risk**

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As Greece gets ready to default or restructure its debt, and several other Eurozone countries deal with their rating downgrades, it is useful to keep things in perspective. Here are ten interesting facts based on reports from IMF, Morgan Stanley, Citigroup and my ongoing research with colleagues Itamar Drechsler and Philipp Schnabl (“A Pyrrhic Victory? The Ultimate Cost of Bank Bailouts”):

1. Sovereign credit default swap and bond spreads started rising in the Fall of 2008, especially following the collapse of the global financial system (failures of Lehman Brothers and A.I.G.).

2. In most cases, the widening of sovereign spreads was initiated by announcement of massive rescue packages for the financial sector and in some cases equally large fiscal stimulus packages. For instance, the immediate cost of UK's rescue package was in excess of 20% of its GDP.

3. As sovereign spreads widened with announcement of rescue and stimulus packages, in the short run bank and financial firm spreads in fact fell. But within a few weeks of the announcement, both sovereign and financial sector spreads started moving in tandem. There was effectively a "merger", a transfer of the "bad bank" assets of the financial sector into the government. Or you could say, we passed on the buck to the governments!

4. But it is not all about the additional debt and risks taken on by governments through the rescue packages. Countries that have experienced the greatest widening of their spreads are those that have also had high levels of debt relative to GDP and relatively low levels of labor productivity and global competitiveness.

5. Most developed countries are now running debt to GDP levels in the range of 50-120%. Typical emerging market defaults on external debt have in fact been at lower debt to GDP levels of 40-80%. The financial crisis of 2007-09 is metamorphosing as a potential sovereign crisis of 2010.

6. The US debt to GDP level is now at the same level as that after World War II. That should help put in perspective the crisis we have just witnessed (and the fiscal imprudence in the period leading up to it).

7. With all this credit deterioration of sovereigns, the interest in their credit default swaps (CDS) - a way of buying protection against default on sovereign's debt - has increased dramatically. While there were hardly any trades happening in sovereign CDS prior to the crisis (and in fact, until Summer of 2008), these are among the most widely traded CDS now.
8. The financial sectors of various countries are buying massive protections against sovereign credit risk. Net dealer exposures to Western countries has been rising dramatically since the Fall of 2008. Gross exposures in SovX, the Eurozone CDS index, now exceed exposures to financial CDS.

9. Since November 2009, the rapid widening of Eurozone sovereign CDS has been accompanied with little widening, if any, of global, investment grade corporations and financials of these countries. Now, it is the "bad countries" of the world that are partially getting merged with safer countries' balance-sheets (Think of Greece and Germany!).

10. The ratio of CDS traded to debt for sovereigns is the highest for Eurozone countries at the current moment, reflecting both their credit risk problems as well as their monetary inflexibility given the currency union. In contrast, CDS to debt ratios for the UK and the US are tiny.

Moral of the story: At least two.

1. Bailing out banks or countries does not mean the credit risk of their bad assets just vanishes in thin air. It simply gets transferred to (other) sovereign balance-sheets. But these sovereign balance-sheets, like corporations, also have limited debt capacity.

2. It may be time for most countries, including the United States, to exercise fiscal restraint and devise a clear strategy to reduce government debt over next 3-5 years. Those who do not act now put at risk any economic recovery witnessed since the Fall of 2008. Sometimes, less is more!