NZ Funds warns of subprime sovereign debt

Sovereign debt implications for New Zealanders are threefold according to NZ Funds, with the maths of sovereign debt and the probability of defaulting widely misunderstood.

Thursday, October 7th 2010, 7:24AM

Chief investment officer Michael Lang says firstly GDP growth will be lower for longer than exporters and investors may have anticipated.

Secondly currency markets become extremely volatile which means New Zealand exporters and investors alike need to think carefully about hedging currency exposure, accepting terms of credit or investing in the debt of sovereign nations vulnerable to default.

Lastly, he says sovereign debt troubles among the weaker members of the European Union may be the catalyst for overvalued global equity markets to take another leg downward.

He says the International Monetary Fund's latest sovereign debt projections were seen as good news for New Zealand which was found to have "more fiscal space to deal with unexpected shocks".

But unfortunately the research points toward a high probability of further shocks to the global financial system in the form of sovereign debt defaults and investors have little reason to celebrate - troubles in Greece raised investor awareness about the problem.

Lang explains that the problem is one country might go for many years with an elevated level of debt, while another defaults with only half the amount.

Japan's government bonds were first downgraded over a decade ago in 1998. Since then its debt levels have increased to 227% of GDP, yet investors continue to be repaid. By contrast, Government bonds in Greece collapsed at only 133% of GDP.

Lang warns a common mistake is to only look at a nation's level of indebtedness measured by debt as a proportion of GDP.

"This is equivalent to comparing an individual's mortgage to their annual income. If the mortgage is twice as big as their annual income they would have a debt to GDP ratio of 200%.

"But the size of the sovereign debt burden is not everything when it comes to keeping up with interest payments."

He says what also needs to be taken into account is how high interest rates are and how quickly GDP is growing.

He says if interest rates on a country's debt are 10%, then as long as the country is growing at 10% or more there should be no change in its ability to service the debt. By contrast, if the interest rate on a country's debt is 2% but its GDP growth is less than 2% then its ability to honour its government bonds comes into question.

By comparing the Debt to GDP on one axis to national interest rates and GDP growth on the other axis, the likelihood of countries entering into sovereign debt difficulties can be graphed. Sovereigns at risk of default rank high either in terms of the level of debt they have borrowed or in terms of their inability to service existing debt levels as measured by interest rates adjusted for GDP growth. For the first time in many years Japan (and to a lesser extent the United States) look vulnerable on this measure.

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