



9 June 2010

## When the Markets Get It Wrong: US Government Debt

When the media claim that credit default swaps are a terrifying instrument, they are completely correct, but for the wrong reason. Whereas the talking heads would have Americans fear the instruments, what the instruments tell us remains far more terrifying. Basically, a credit default swap offers a way to insure a debt (whether it be a corporate bond, a mortgage, or a government note) so that if the borrower cannot repay the loan, the creditor has limited his risk. They function as a sort of contract; the buyer pays upfront for the insurance against the risk, and if the debtor does default, the lender calls in the policy and only loses what he paid for the contract.

So, credit default swap pricing shows the raw pulse of the market: one can quantify the cost of risk on any government bond. So, today, insuring \$10 million of US government debt for 5 years costs about \$43,000 whereas insuring \$10 million of Greek debt for the same time period costs about \$730,000. CDS pricing shows clearly that the market values Greek government debt at about 17 times as risky as US debt, which sounds encouraging to Americans.

But, as 2008 showcases, sometimes the market can underestimate risk. Of the major world economies presently embroiled in a debt crisis (France, Germany, Greece, Ireland, Portugal, Spain, the UK, and the US), US sovereign debt is presently priced as the safest, closely followed by Germany. Yet when looking at the big picture, the US situation has much more in common with the Greek than the German.

In fiscal years 2008, 2009, and 2010, of the debt crisis countries, only Germany ever had a surplus (approximately \$1.4 billion in 2008) while Greece and the US had the highest and second highest debt as a percentage of GDP of the eight nations in 2008, 2009, and 2010.

Country	2008 Net borrowing/lending % of GDP	2009 Net borrowing/lending % of GDP	2010* Net borrowing/lending % of GDP
France	-3.40%	-7.87%	-8.20%
Germany	0.04%	-3.29%	-5.71%
Greece	-7.75%	-12.87%	-8.72%
Ireland	-7.16%	-11.45%	-12.16%
Portugal	-2.75%	-9.33%	-8.73%
Spain	-4.06%	-11.45%	-10.40%
UK	-4.82%	-10.89%	-11.40%
US	-6.64%	-12.50%	-10.97%

Based on International Monetary Fund *World Economic Outlook Database* (April 2010), and Joint External Debt Hub data with ATR analysis

\* Denotes an IMF estimate or a calculation based on an IMF estimate

Country	2008 gross debt as % of GDP	2009 gross debt as % of GDP	2010* gross debt as % of GDP
France	67.48%	77.44%	84.24%
Germany	65.89%	72.50%	76.70%
Greece	97.40%	113.40%	124.10%
Ireland	44.20%	63.70%	79.30%
Portugal	66.40%	75.20%	84.56%
Spain	40.70%	50.00%	61.79%
UK	51.95%	68.17%	78.19%
US	70.56%	83.21%	92.56%

Based on International Monetary Fund *World Economic Outlook Database* (April 2010), and Joint External Debt Hub data with ATR analysis

\* Denotes an IMF estimate or a calculation based on an IMF estimate

722 12<sup>th</sup> Street N.W.

Fourth Floor

Washington, D.C.

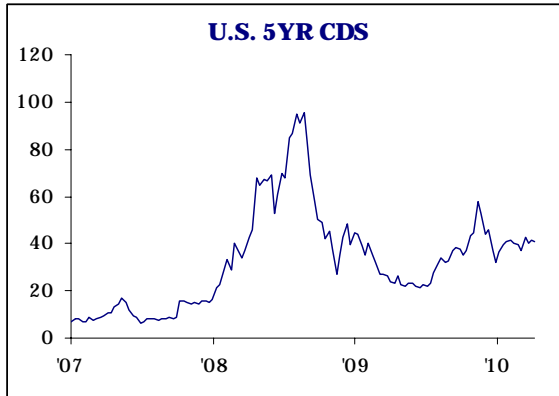
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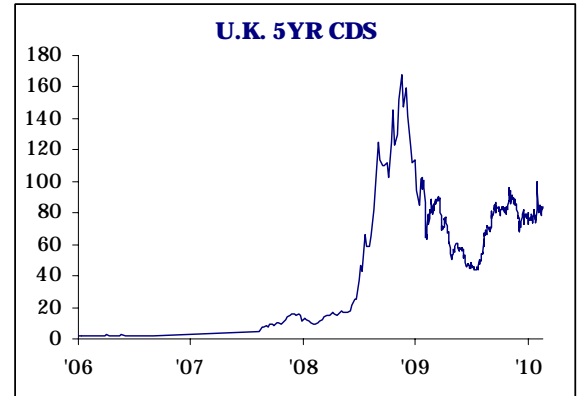
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Yet investors now worry about the solvency of countries such as the UK and France, and the market rates their debt as approximately two times as risky as US debt. Moreover, since the US financial meltdown, appraisals of US debt remain essentially unchanged from the start of 2008 while the cost to insure Western European debt doubled.



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Yet even under the most conservative calculations of debt, the US has one of the highest debt to GDP ratios, and it has the largest dollar value of debt, bar none. In fact, the US is head-and-shoulders above the rest of the debt crisis countries combined and has a deficit double or triple the other seven countries' deficits combined.

Country	2008 gross debt in million USD	2009 gross debt in million USD	2010* gross debt in million USD	2008 Net borrowing/lending in million USD	2009 Net borrowing/lending in million USD	2010* Net borrowing/lending in million USD
France	1,934,594	2,072,202	2,248,299	-97,530	-210,702	-218,921
Germany	2,420,209	2,430,738	2,556,260	1,433	-110,138	-190,136
Greece	342,797	375,105	403,442	-27,279	-42,558	-28,337
Ireland	118,271	145,096	171,373	-19,145	-26,072	-26,276
Portugal	162,643	171,347	191,072	-6,738	-21,268	-19,725
Spain	651,999	732,020	880,244	-65,104	-167,589	-148,224
UK	1,394,480	1,488,499	1,737,940	-129,299	-237,838	-253,424
US	10,189,147	11,863,217	13,698,624	-958,477	-1,781,607	-1,623,956

Based on International Monetary Fund *World Economic Outlook Database* (April 2010), and Joint External Debt Hub data with ATR analysis

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And this just stems from a conservative accounting. Including the corporate debt that the US government has guaranteed, the balance spikes by about [\\$8.3 trillion](#). Then, there are the unfunded pension obligations and depleted Social Security trust fund, which up the ante yet further. Suddenly, US debt looks much less safe, and strong evidence exists to show that the US will have no choice but to address this [within a decade](#).

Indeed, Germany, the second cheapest of these countries' sovereign debt to insure, [nearly failed to auction some of its own bonds](#) two weeks ago; if Bundesbank had not stepped in, it

would have been a failed auction. Investors have begun to lose interest in government debt; the market will only bear so much of it.

Plus, the US AAA credit rating may be under threat as the [UK rating is](#) and as the (now downgraded) [Spanish rating was](#). When such a downgrade occurs, borrowing costs much more as do existing debt obligations, which further enfeebles a nation and increases its risk.

Markets have under-appraised US risk, and when the US is forced to raise interest rates to combat inflation or has a failed auction, or risks its credit rating, the market will correct. As inexorable as this correction will be, it would behoove US leaders and citizens not to allow the situation to go that far; once the risk appraisal increases, the tightening of credit snowballs. Just look at Greece for a justification of why austerity measures imposed by draconian creditors do little social good for a country.

The US has a choice between a rock and a hard place; either it faces compulsory and harsh restructurings farther down the line or Americans choose to confront the US addiction to debt now and enact meaningful and immediate reform. Those are the two options.