Foreword

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This volume presents and summarises the proceedings of a one-and-a-half day seminar on sovereign risk hosted by the BIS in January 2013. The event brought together senior central bankers, sovereign ratings analysts, fund managers, sovereign legal specialists and risk managers at financial institutions.

I personally came away with an even stronger impression of the potentially dire implications for financial markets if sovereign borrowers cannot put their finances back on a stable medium-term footing. The macroeconomic arguments for fiscal consolidation are compelling: with populations growing older and the challenge of making good on open-ended promises of health and pension support, this is no time to be running up debts to risky levels.

Ominous too are the financial stability implications of sovereigns losing their all but risk-free status. As they do so, foreign investors unload their sovereign bond holdings onto domestic investors. The resulting rise in funding costs for the sovereign means increased borrowing costs for banks, which pass these on to corporate and household borrowers. In the bond market, investors make even multinational firms headquartered in the country pay up. Meanwhile, the sovereign's backing for the banking system loses its credibility in the marketplace, so that the banks' sovereign debt holdings become a source of weakness instead of strength.

Strictly speaking, sovereign bonds never were entirely risk-free in the sense of posing no credit risk. And this is to say nothing of the duration and inflation risks that were always present in sovereign paper, as well as the currency exposure for foreign investors. But market participants used to be willing to regard the credit risk element as if it were negligible. Yet it takes only a slight uptick in default probabilities for the market dynamics to change radically, as outlined above.

That said, the discussions at the BIS seminar suggested that financial markets and investors are still only at the early stages of adapting to higher perceived sovereign risk. It is too early to say exactly where these adaptations will take us but, on present trends, the destination will be unattractive. Hence, the success or otherwise of sovereigns' efforts to earn back their practically risk-free status is as much a financial stability issue as a macroeconomic one.

If sovereigns fail to restore their credit standing, what then? Some of the responses could even be benign. For instance, some fixed income investors are re-weighting sovereigns by GDP rather than by debt market capitalisation. Or they are adding emerging market sovereign bonds to their core holdings. Such moves would make sense even in the absence of higher overall sovereign risks.

Unfortunately, most of the reaction to increased sovereign risk will lead us in less benign directions. Oddly enough, even the best-rated sovereigns could suffer. As the supply of undoubted sovereign debt shrinks, these issuers will be able to raise long-term funds at negative real yields. This will be a boon to interest-sensitive

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sectors such as real estate. But, for countries with their own currencies, the combination of cheap money and strong exchange rates could pose the dual threat of rapid private credit growth, along with attendant risk of financial instability, and hollowing out of their manufacturing sectors – a form of Triple-A Dutch disease, indeed.

Another outcome is that risk managers at banks and insurance companies are starting to attach non-zero probabilities of default to even the most creditworthy of sovereigns. Contrary to much commentary, Basel II's internal ratings approach never assigned a zero weighting to prime or home sovereigns. Now risk managers are allocating credit risk charges to an ever-wider range of sovereign exposures.

It remains to be seen how higher perceived risk in sovereign exposures will affect risk-taking elsewhere in the portfolio. In the stock market, investors are already penalising banks and other financial firms that are highly exposed to sovereigns – and this includes firms with long investment horizons matched to their long-duration liabilities.

Nor will risk managers and investors stop there. Experienced risk professionals are well aware of the limitations of their risk models. Sooner or later, they will decide that their firm must be able to survive a surprise default by any sovereign, regardless of its rating.

This is where things could get complicated. Instead of just adjusting their portfolios in line with changing risk-return profiles, financial firms could become increasingly reluctant to use sovereign debt to achieve the duration and liquidity they need. And, if good substitutes for sovereign paper are lacking, it is far from clear how the financial system will continue to function smoothly.

- Insurers, for example, customarily rely on government bonds for the long-duration assets that match their long-term liabilities. From a credit point of view, it would be possible to diversify into corporate bonds, but corporate bond markets would need to develop in an unprecedented manner to provide the very long-dated paper required.
- Similarly, banks look to government paper for their secondary liquidity reserves and to post as collateral. Again, corporate paper will have to become much more liquid before it can provide a useful substitute for government debt in bank liquidity management.

In summary, when one considers:

- how demand for an ever-shrinking pool of top-quality sovereign debt could make trouble even for its issuers;
- the technical challenges involved in estimating reliable default probabilities for sovereigns, as well as the unpredictable nature of related portfolio responses; and
- the hurdles facing insurers and banks as they seek the duration and liquidity they need while keeping their sovereign exposure in check,

then it is very hard to avoid the conclusion that few questions of the moment are as important as whether – or not – sovereign debtors can retain or regain their risk-free status.