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When Do Countries Borrow? When Do They Default? Theory and Reality

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD

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Background

- U. Panizza, F. Sturzenegger, and J. Zettelmeyer (2009) "The Economics and Law of Sovereign Debt and Sovereign Default" *Journal of Economic Literature*,
- E. Borensztein, and U. Panizza (forthcoming) "The Costs of Sovereign Default" *IMF Staff Papers*
- E. Borensztein, and U. Panizza (2009) "Do Sovereign Defaults Hurt Exporters?" *Open Economies Review*,
- E. Levy Yeyati and U. Panizza "The Elusive Cost of Sovereign Default," IDB, Research Department Working Papers (2006)
- E. Borensztein, E. Levy Yeyati, and U. Panizza (2006) *Living with Debt*, Harvard University Press and IDB

Outline

- The economic theory of sovereign debt
- What do the data say?
- Policy implications

The Economic Theory of Sovereign Debt

- The literature started with (and it's still tied to) an influential theoretical paper by Eaton and Gersovitz (*Review of Economic Studies,* 1981)
- The story of the paper was:
  - Countries borrow in bad times (low economic growth) and repay in good times (high economic growth)
  - Since there are no repayments in bad times, there cannot be defaults either
  - As a consequence, defaults can only happen in good times
  - Defaults are thus strategic (countries can pay but they decide not to pay)
  - The only reason that prevents countries from defaulting is that defaults are costly

The Economic Theory of Sovereign Debt

- So, what are the costs of default?
  - This is an important question because creditor rights are not as well defined for sovereign debt as is the case for private debts. If a private firm becomes insolvent, creditors have a claim on the company's assets. In the case of a sovereign debt, in contrast, the legal recourse available to creditors has limited applicability and uncertain effectiveness.
- The traditional economic literature has emphasized
  - Reputational costs
    - Countries that default will no longer be able to access the international capital market
  - Trade costs
    - Default will lead to sanctions which, in turn, will have a negative effect on trade

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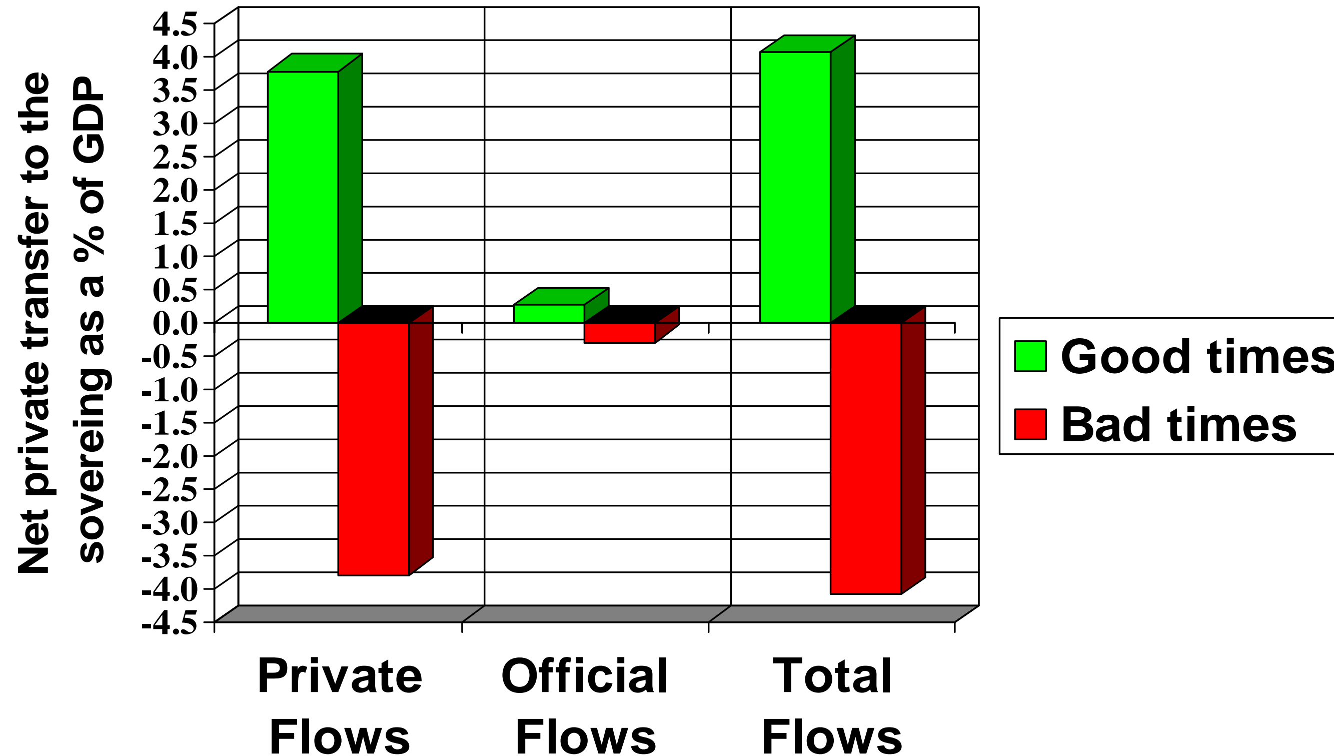
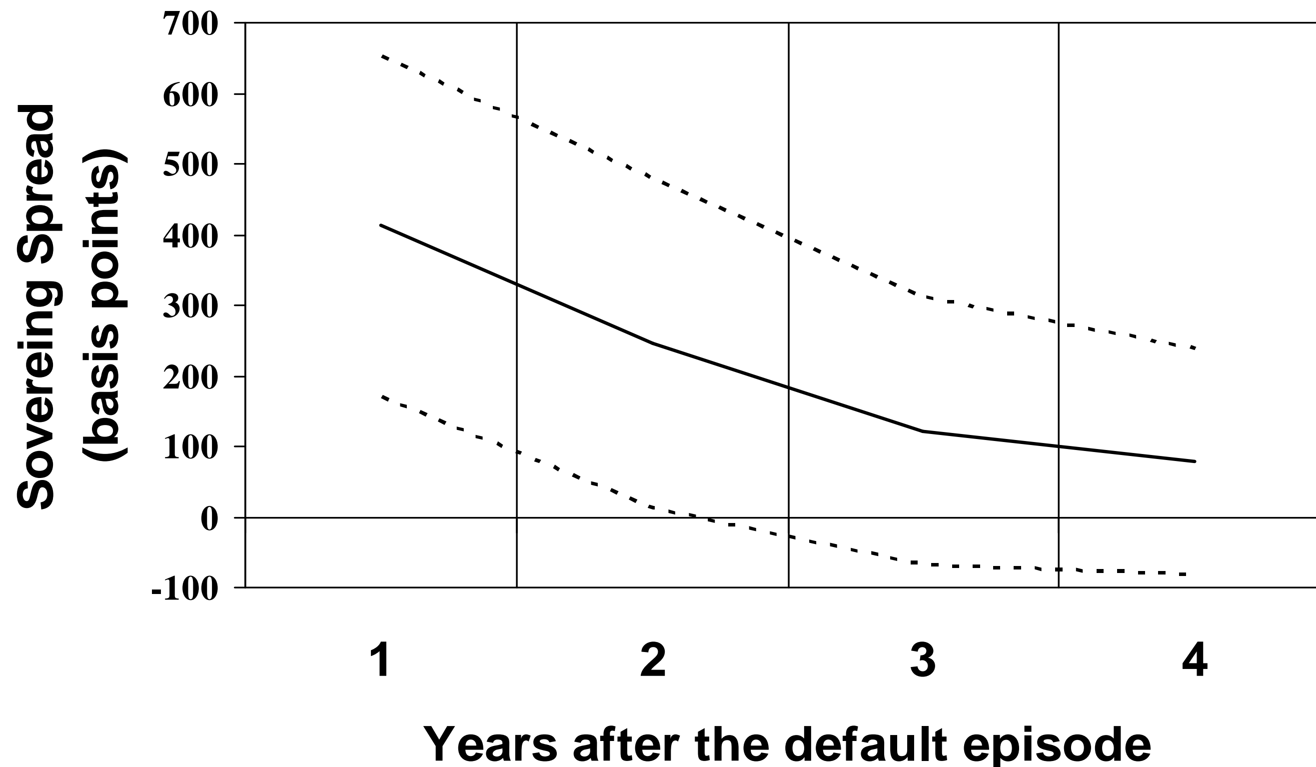
What do the data say?



- Government external borrowing is procyclical and not countercyclical (probably because countries borrow when they can)
- This confirms the idea that the seeds of debt crises are planted during good times

What do the data say?



- 3 years after the resolution of a default episode, there is no statistically significant difference between the spreads paid by defaulters and non defaulters
- We find similar results if we look at access
- Global factors (risk aversion and US interest rate) appear to be more important than default history

What do the data say?

- There is some evidence that defaults have a negative effect on trade
- But this is still controversial and the channel is not clear
  - No evidence that defaults have a direct impact on trade credit
  - No evidence (at least in recent years) of explicit sanctions

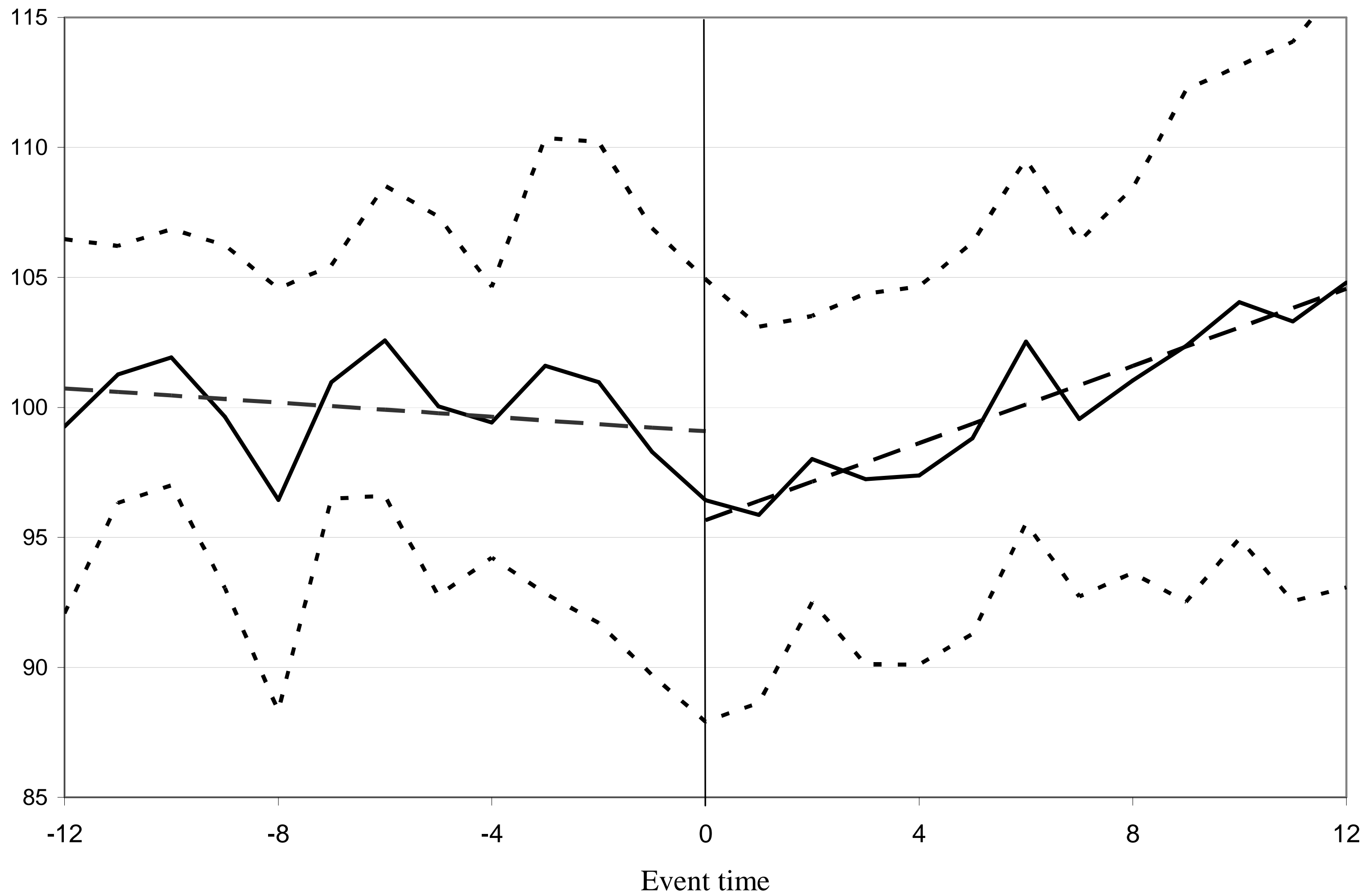
What do the data say?

- Anyway, who cares?
  - We do know that defaults are bad because they lead to deep recessions
    - Econometric estimates found that, on average, default episodes are associated with a 2 percentage points drop in GDP growth
- But do we really know what we think we know?
  - Are default episodes bad for growth or is it low growth that causes default?
  - That is, do defaults happen in bad times?

What do the data say?

- Causality is always very hard to assess
- But, if we look at high frequency data, we find that:
  - Growth collapses anticipate defaults
  - Default episodes are often followed by a rapid rebound of the economy

What do the data say?



Summing up: Theory *versus* Reality

- Theory
  - Countries borrow in bad times
  - If ever, countries default in good times (strategic defaults)
    - So, if anything, they default too much
  - Defaults are very bad for the economy, with long lasting negative consequences
- Reality
  - Countries borrow in good times
  - Countries default in bad times (justified defaults)
    - And sometimes too late
  - Defaults do not seem to have long lasting negative consequences

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Policy implications

- Let me start by saying that I am not (I repeat **NOT**) suggesting that countries should default more often
- But I want to ask, why is there this disconnect between theory and reality?
- My hunch is that this is the consequence of a lousy international financial architecture

Policy implications

- In a well working system, countries should be able to borrow when they need funds (i.e., in bad times)
  - But during bad times, the international capital markets are not willing to provide credit at a reasonable interest rate
  - Therefore, countries borrow in good times because this is when they have access to credit
    - Same reason why Willie Sutton robbed banks
  - Unfortunately, sometimes they borrow too much in good times and this behavior sows the seeds of future crises

Policy implications

- Most of the defaults we observe are justified (or unavoidable, at least ex-post) episodes
- Strategic defaults are very very very rare
  - So, we cannot use econometric methods to assess the cost of these very rare events
  - What we are actually assessing is the cost of non-strategic defaults
- It is possible that strategic defaults are rare because policymakers believe that this type of default would indeed be very costly

Policy implications

- The idea is that the international community and financial markets implicitly forgive countries that default out of necessity but would impose a harsh punishment on countries that default strategically (Grossman and van Huyk, AER 1988)
- If this is the case, policymakers need to signal that the default is indeed unavoidable and not strategic
- A way of doing this is to go through considerable pain in order to delay the default as long as possible
- This is clearly a second best solution
- The first best could be achieved with the creation of a body with the ability to assess whether a default was indeed unavoidable
  - A bankruptcy court for sovereigns

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