

SOVEREIGN DEFAULTS AND DEBT RESTRUCTURINGS – LESSONS FROM THE PAST

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RESEARCH

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EMPIRICAL FINDINGS & LESSONS TO BE LEARNED



- occurrence and duration of public debt crises
- costs of different types of financial crises
- major causes of fiscal vulnerability and fragility
- major triggers of sovereign default
- early warnings of fiscal distress
- adjustment policies and fiscal consolidation
- sovereign debt restructurings
- contagion

OCCURRENCE & DURATION OF PUBLIC DEBT CRISES

- In comparison to other types of financial crises sovereign debt crises are a rather rare event and since the default of post-war Germany in 1948 have never again occurred in a mature economy.
- The average length of pure banking crises (4-5 years) and pure currency crises (1-3 years) is rather short in comparison to public debt crises (8-9 years).
- Very often sovereign defaults have huge negative effects on the banking sector, the stock market, the bond market, and the foreign exchange rate (and the balance of payments) of the debtor country. So, they often occur in combination with other types of financial crises and not as a “pure” public debt crisis.
- Hence, the average length of the few “pure” sovereign debt crises (3 years) is much shorter than the average duration of “mixed” public debt crises (5-8 years) and the average length of the many “triple” crises (10 years).
- Under exceptional circumstances and for different reasons several sovereign debt crises in the past have even lasted for 2 or 3 decades.

COSTS OF DIFFERENT TYPES OF FINANCIAL CRISES



- Economic costs can be measured in terms of direct fiscal and quasi-fiscal costs of financial crises, or alternatively, in terms of losses of economic output or real economic growth.
- The direct or indirect economic costs of public debt crises are much higher than costs of banking, currency, and asset market crises, respectively.
- Economic costs are particularly high under “triple crises”, when banking sector problems, currency depreciations, and sovereign debt problems come together almost at the same time.
- Quite often sovereign debt crises even result in social and political unrest, military coups, or a complete collapse of regimes.

MAJOR CAUSES OF FISCAL VULNERABILITY

- a high share of short-term public debt which puts the sovereign under permanent pressure to roll-over significant parts of outstanding debts
- a high share of external public debt increasing the dependence of governments on external resources for financing redemptions of outstanding sovereign debt and net borrowing requirements of the current state budget
- a high share of public debt denominated in foreign currencies subjected to the permanent risk of major changes of foreign exchange rates
- a significant role of the shadow economy, black markets, widespread corruption, tax evasion, and capital flight to foreign countries
- weak growth of government revenues due to an inefficient tax system
- high rates of inflation and nominal wage growth which tend to push government expenditure upwards while government revenues tend to increase only with a substantial time lag
- high dependence of government revenues on customs duties or quasi-tax receipts from a few strategic export products

MAJOR TRIGGERS OF SOVEREIGN DEFAULT

- exogenous interest rate shocks such as sharp increases of interest rates in the US economy or the euro area, quite often triggered by central banks
- a breakdown of confidence of foreign investors triggering substantial capital outflows, a sharp depreciation of the domestic currency and/or a surge of external bond spreads
- a surge of government expenditure following the outbreak of a banking crisis, a deep recession, armed conflicts with other nations, internal civil unrest, military coups and/or some natural catastrophe
- a sharp decline of real exports of goods and services and/or a sudden decline of export prices, especially in countries which heavily rely on the export of a few strategic goods, such as commodities, financial services, construction or tourism which play an important role for collecting government revenues

- Most early warning signals of an outbreak of sovereign debt crises are ineffective, flawed, and sometimes even misleading, especially under conditions where the foreign exchange rate of the debtor country is fixed at an unrealistic level or the debtor country's economy has been dollarized or euro-ized.
- Deficit to GDP ratios, debt to GDP ratios or debt to exports ratios have almost nothing to do with the actual ability and/or willingness of sovereigns to meet their current obligations to pay interest and principal on their outstanding domestic and foreign debt.
- Commercial ratings of sovereigns' liquidity or solvency often lag behind the dynamics of fiscal stress in times of turmoil and financial panic.
- All in all, spreads and implied probabilities of default as calculated on the basis of effective yields to maturity for sovereign bonds seem to be the best predictors of sovereign debt problems, despite the many technical problems of properly assessing the soundness of public finance on the basis of market data which is heavily distorted by central bank interventions and speculative attacks by private investors on FX markets and sovereign bond markets, respectively.

- Since the 1970s stabilization programs under the supervision of the IMF tend to follow the same pattern of extreme austerity in monetary, fiscal, incomes, and foreign exchange rate policies, respectively.
- Almost none of these many programs has been successful. Instead such one-fits-for-all strategies of austerity have almost everywhere generated the same disastrous results – deep recessions, mass unemployment, social unrest, political instability and ultimate debt relief.
- Naturally, fiscal consolidation must be placed at the top of the agenda for sovereigns in trouble. But the expectation that sharp tax increases, huge wage reductions and bitter cuts in public expenditures are possible in the midst of a fully-fledged economic crisis is quite unrealistic.
- In contrast, such adjustment programs tend to jeopardize the medium-term growth prospects of highly indebted countries, harm the soundness of their financial systems, sometimes provoke inflationary pressures, and often even deteriorate their debt servicing capabilities.
- Hence, traditional strategies of fiscal consolidation must be supported and supplemented by coherent and credible policies directed towards promoting economic growth and regaining competitiveness.

- For many reasons sovereigns want to avoid defaulting and in most cases this is in full agreement with the self-interest of their creditors.
- Therefore, most reductions and restructurings of sovereign debt come too late and eventually incur much higher costs than necessary.
- Restructurings are retarded especially under conditions where some supranational organizations such as the IMF or the ECB provide financial support and hence artificially prolong the debtor's ability to pay.
- In many cases debtors, creditors, and supranational organizations such as the IMF, the ECB and the EU are too optimistic regarding the time horizon which is necessary for coping with sovereign debt problems. So, the conditions of debt restructurings (grace period, new maturities, etc.) are often not generous enough and do not adequately take into consideration that triple financial crises may last for many years.
- Typically, sovereign debt restructurings have a severe negative impact on creditor banks, especially on financial institutions in the respective country. Hence, sovereign debt restructurings must be accompanied by economic policy measures safeguarding the financial sector in the defaulting country as well as in its most important creditor countries.

- Sovereign debt crises almost always have severe contagious effects on some other countries, financial institutions and sovereigns, respectively.
- The channels of transmission reach from adverse trade, income and balance sheet effects to adverse capital flows (withdrawals of bank deposits, reducing bank credit lines, sales of stocks and bonds in other countries, etc.) following huge losses of financial investors and/or new risk assessments by financial investors for countries with a similar profile.
- Hence, restructurings of sovereign debt might indeed aggravate public and private debt problems in some other countries if such restructurings are proceeding in a disorderly manner and tend to produce results which have not been expected in the market.
- In many cases, however, the observable correlations of financial stress in different (and even neighboring) countries do not represent “true” contagion but are instead the result of some common shock.
- Hence, the potential threat of contagion cannot be accepted as a viable argument against restructurings of sovereign debt in one country where several other countries have been struck by the same common shocks and are now facing the same type of problems.

RECOMMENDED READING

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De Paoli, Bianca, Glenn Hoggarth, and Victoria Saporta (2006), "Costs of Sovereign Default", *Bank of England Financial Stability Paper*, No. 1

Economist Intelligence Unit (2011), *The Search for Growth – Opportunities and Risks for Institutional Investors*, London, New York et al. (The Economist & BNY Mellon)

Kiguel, Miguel (2011), "Argentina and Greece: More Similarities than Differences in the Initial Conditions", *VOX Research-based policy analysis and commentary*, internet publication

Leipold, Alessandro (2011), "Thinking the Unthinkable: Lessons from Past Sovereign Debt Restructurings", *The Lisbon Council E-brief*, issue 11

Manasse, Paolo, Nouriel Roubini, and Axel Schimmelpfennig (2003), "Predicting Sovereign Debt Crises", *IMF Working Paper*, No. 03/221, Washington, DC (International Monetary Fund)

Roubini, Nouriel, and Brad Setser (2003), "Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform", *Conference on Improving the Sovereign Debt Restructuring Process*, Institute for International Economics and Institut Francais des Relations Internationales, Paris, March 9

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