

Economics focus | Default settings

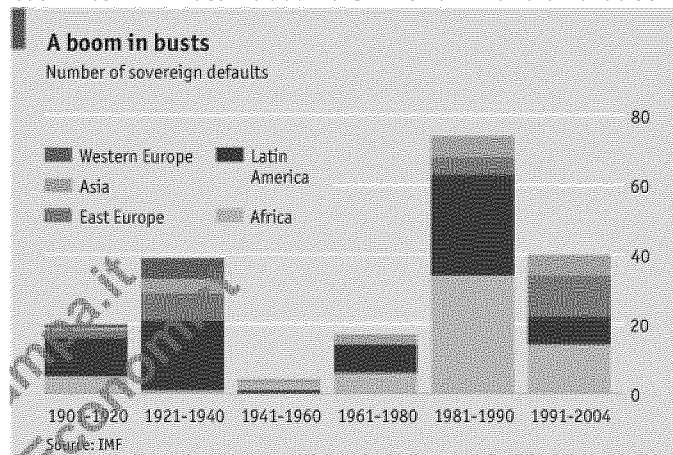
Sovereign defaults do not typically lead to economic catastrophe. How much comfort should that give?

IN DECEMBER 2001 Argentina defaulted on \$81.8 billion of sovereign debt, after months of turmoil in the country's banking system. That led to the abandonment of its exchange-rate regime and a sharp devaluation of the peso. Argentina's GDP plummeted by 10.9% that year. It has been locked out of international capital markets ever since. In Greece such tales now have a worrying resonance. Despite raising \$6.7 billion on bond markets on March 29th, the scale of the country's financing needs means that an eventual default cannot be ruled out. Both Greece's 2009 budget deficit, at 12.7% of GDP, and its debt-to-GDP ratio of 113.4% are higher than the corresponding figures for any sovereign defaulter between 1998 and 2001. If the worst were to happen, how much pain might it suffer as a result?

In theory, default should be costly. The damage it causes is the main incentive for debtor countries to honour their promises. Yet there are clearly lots of occasions when governments judge that the benefits of defaulting outweigh the costs. An IMF study by Eduardo Borensztein and Ugo Panizza counts as many as 257 sovereign defaults between 1824 and 2004. Between 1981 and 1990 alone, there were 74 defaults (see chart).

In fact, the evidence suggests that the penalties for default are often less severe than those meted out to Argentina. Its experience of being shunned by international capital markets is not typical, for example. At least in recent years defaulters have been able to re-enter markets once debt restructuring is complete. Argentina's woes stem partly from the fact that it is only now, more than eight years since it defaulted, nearing a final deal with its creditors (see page 38).

Defaulting does affect the cost of funds to a country. A study in 2006 by a trio of economists at the Bank of England found that countries which defaulted between 1970 and 2000 had both a higher bond spread and a lower credit rating in 2003-05 than countries with the same debt-to-GDP ratio which did not default.



In their study Messrs Borensztein and Panizza show that having defaulted is associated with a credit-rating downgrade of nearly two notches. Using data for 1972-2000, they also find sizeable jumps in bond spreads after a default. In the first year spreads widen on average by four percentage points. This additional cost declines to 2.5 percentage points the year after. These figures may understate the pain, however: as the Greek case shows, worries about default are enough in themselves to lead to an extended period of high spreads.

That said, markets appear to have short memories. Only the most recent defaults matter and the effects on spreads are short-lived. Messrs Borensztein and Panizza find that credit ratings between 1999 and 2002 were affected only by defaults since 1995. They find that defaults have no significant effect on bond spreads after the second year. This tallies with earlier research by Barry Eichengreen and Richard Portes. Studying bonds issued in the 1920s, they also found that recent defaults resulted in higher spreads but more distant ones had no effect.

Attempts to measure the broader economic costs of default reach a similar conclusion. Messrs Borensztein and Panizza find that a defaulting country grows by 1.2 percentage points less per year while its debt is being restructured compared with a similar country that is not in default. This effect, too, is concentrated in the first year after default. Once again, measuring from the point of default will somewhat understate the damage: defaults tend to occur during recessions, so GDP is already depressed when a country reneges.

Countries whose debt is not restructured bear a higher and more persistent penalty. The Bank of England study found that output losses were more than three times as large for countries which had failed to reach a deal with creditors than for defaulters whose debt had been restructured. The details of restructuring also matter. Bond spreads were typically larger in countries, such as Ecuador, whose creditors were forced to accept a large loss of principal, than those, such as Pakistan or Ukraine, where "haircuts" were less severe.

Sovereign defaults do not just affect the governments of countries that fail to honour their promises. Another IMF study finds that defaults lead to a 40% decline in external credit to private companies in the defaulting country. Even countries that do not default are sometimes affected by the fallout. In the aftermath of the 1980s debt crisis, for instance, credit to developing countries as a whole (including non-defaulters) dried up. Other rich countries with strained public finances may also have lots to worry about if Greece defaults.

This time really could be different

Greece cannot afford to be sanguine. The Argentine example shows that the averages mask considerable variation. And there are several reasons to think that Greece's experience in the event of a default would be worse than the norm. The academic research focuses on emerging markets because that is where all recent defaults have been. The impact of a Greek default, which would be the first by a rich country since the second world war, may be greater. If Greece defaulted, it would do so when the global economy is still weak, credit is scarce and other sovereign borrowers are raising lots of money. So markets may be less welcoming than other recent defaulters have found them. Greece's use of the euro also means that it cannot devalue: that implies it would have to impose fairly high haircuts on creditors and might face a higher-than-average increase in its cost of borrowing.

Another element to the costs of default may also alarm Greek policymakers. Messrs Borensztein and Panizza find that political leadership changed in the year of default or the year after in half of the 22 cases they study. That is twice the usual probability of such change. These political costs, at least, are unlikely to vary. ■