Chapter 7

Sovereign Default: What Is It, So What?

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Sovereign Debt:
A Guide for Economists and Practitioners
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Overview

1. What Is Default? Why Does It Matter?
2. Definition Challenge
3. Determinants of Default
4. Costs of Default
5. Reducing Incidence, Deadweight Losses from Default: IMF Role

I. What Is Default? Why Does It Matter?

- *Insolvency* or *illiquidity* is a condition
    - *Default* is an event (cf. crisis)
        - *Restructuring* is a process
            - *Haircut* is an outcome
                - *Market exclusion* is a consequence/cost

I. What Is Default? Why Does It Matter?

- *Default* may (but need not automatically) result in particular costs
  - *Acceleration*, *collateral seizure* are contractual remedies in default
  - *Money damages*, *injunctions* are judicial remedies in default (cf. Bulow & Rogoff 1989, Schumacher et al. 2016)
  - *CDS* is market insurance against default; default triggers payout - contagion
  - *Selective Default* rating conveys information about default; triggers market and regulatory reactions—contagion
- But default* need not be all bad/avoided at all cost – e.g., if it helps achieve debt sustainability

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II. The Definition Challenge

Contract Terms

- Loan, Bond EoD—non-payment, repudiation, covenants, x-default
- Official Debt—suspension, refund, acceleration
- Domestic Debt—depends on background law

- *Excludes, e.g., restructuring w/CACs, distressed exchange, domestic law change*

Consequential Third-Party Criteria

- Default rating (CRAs)—incl. nonpayment, distressed exchange, unfavorable modification; *not arrears to Official Sector*
- CDS Credit Event (ISDA)—incl. nonpayment, restructuring
- Other possibilities: index inclusion, collateral eligibility

II. Default in Economic, Policy Literature

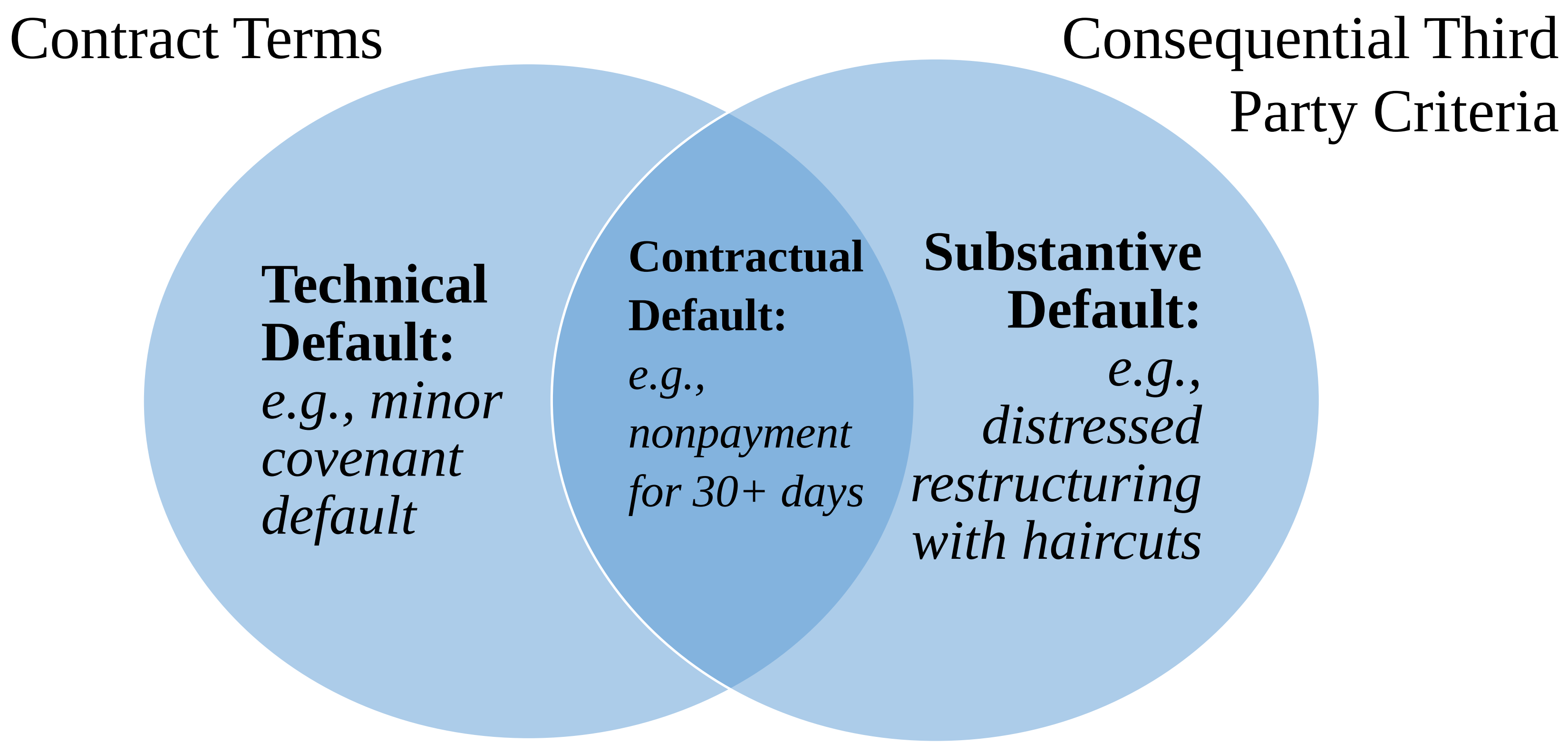
By Debtor Conduct

- Technical Default
- Repudiation
- Hard vs. Soft*
- Full vs. Partial/Selective*

By Creditor Type

- Official vs. Private
- Foreign vs. Domestic*
- Banks vs. Bondholders*

II. Proposed Fix



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III. Determinants of Default – Domestic, External, Other?

1. "Mismanagement" / **<u>domestic</u>** determinants
   - NOT public debt/GDP – *see* debt intolerance (Reinhart et al. 2003, Manasse & Roubini 2009)
   - YES external debt (Catao & Milesi-Feretti 2014)
   - YES banking crises
2. "Misfortune" / **<u>external</u>** shocks (e.g. rise in global interest rates, center country crises, commodity price swings)
   - Defaults often clustered due to external shocks (Kaminsky & Vega-Garcia 2016 , Reinhart et al. 2016)
   - Current global conditions ("triple bust") suggest more defaults to come? (Kaminsky 2017, Reinhart et al. 2018)
3. Does law matter?
   - Governing law, contracts

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IV. Costs of Default*: Reputation, Enforcement, Spillovers, Doom Loops

Traditional:

1. Loss of market access, borrowing costs→ evidence mixed
   Short-lived? (Borensztein & Panizza 2009). "Type" of default matters (Cruces & Trebesch 2013, Catao & Mano 2017)
2. Real effects on economic growth, trade, investment, credit
   Causality hard to identify. Domestic firms suffer (Arteta & Hale 2012, Hebert & Schreger 2016, Acharya et al. 2017)

Newer:

3. Spillovers to financial sector ("doom loop", Gennaioli et al. 2014, Acharya et al. 2014, Bocola 2016, Sosa-Padilla 2018)
4. Creditor lawsuits on the rise, risk of "financial embargo" as in Argentina (Buchheit et al. 2013, Schumacher et al. 2016)

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1. Country's decision to restructure ⟺ IMF lending policies
2. Experience with "too little, too late" restructurings
   - ***Too late***. Greece, others. 80 percent of restructurings had very high debt levels 3 years before the restructuring
   - ***Too little***. Many examples of repeated, small restructurings until definitive debt treatment (e.g. Poland). Two-thirds of all restructurings with private foreign creditors did not successfully establish sustainability and led to repeat restructurings
3. Incentives to blame for delayed and inadequate restructurings
   - Debtor (too late), private creditors (too little), official sector (moral hazard)
4. Criticism: If creditors expect restructuring or subordination, turning to the official sector could trigger run/default

V. Changes to IMF Lending Framework

	2002 Framework	2010 Framework	2016 Framework
Debt is unsustainable	Definitive debt restructuring/ official concessional financing	Definitive debt restructuring/ official concessional financing	Definitive debt restructuring/ official concessional financing
Debt is sustainable but not with high probability		Definitive debt restructuring/ official concessional financing OR Invoke systemic exemption	Maintain non-Fund exposure (e.g., reprofiling or official financing) to improve debt sustainability and enhance safeguards for Fund resources
Debt is sustainable with high probability	Exceptional access without debt restructuring	Exceptional access without debt restructuring	Exceptional access without debt restructuring

DEBTCON3

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