

Government Debt Default: Past, Present and Future

Selhání vládního dluhu: včera, dnes a zítra

Tomáš Wroblowský¹

Abstract

It is frequently presented that government debt default will be lethal both for the creditors, for the country itself, and even for the world economy. However, history shows that debt crises and sovereign defaults are as old as sovereign borrowing itself. Moreover, none of debt defaults in the past was a cause of a world economy crisis or even collapse. The question is: Will the past be repeated today or in the future? Or is the situation in the world economy so different that we really face a threat of domino effect so high that default of one country can be transmitted through the financial sector to the world economy crisis?

Key words

Government debt, default, crisis, fiscal discipline

JEL Classification: N40, H63

1. Introduction

When reading lately published papers about the future of highly indebted countries, especially in Europe, it seems that many of them are facing a threat of sovereign debt default. It is frequently presented that such situation will be lethal both for the creditors, for the country itself, and even for the world economy. However, history shows that debt crises and sovereign defaults (defaults of countries, empires, city-states...) are as old as sovereign borrowing itself. Moreover, none of debt defaults in the past was a cause of a world economy crisis or even collapse. The question is: Will the past be repeated today or in the future? Or is the situation in the world economy so different that we really face a threat of domino effect so high that default of one country can be transmitted through the financial sector to the world economy crisis?

2. Historical Overview of Sovereign Defaults

Probably the first sovereign default is more than two thousand years old. In the fourth century B. C., a significant part of Attic Maritime Association defaulted on loans from Delos Temple (Winkler, 1933). Since then, hundreds of situations when countries were not able to repay their debts happened. Of course, there were several differences, both in the causes of those situations and in the way they have been resolved.

Government debt defaults frequently happened as a consequence of wars, revolutions or similar political affairs. Those events made the indebted governments unable or unwilling to repay the debt. Bulgaria or Austria – Hungary repudiated their debts to enemy creditors at the beginning of the World War I, Italy and Japan did the same at the beginning of World War II. Czechoslovakia suspended its debt to western countries after the communist takeover in 1952.

¹ Ing. Tomáš Wroblowský, Ph.D., Department of Economics, Faculty of Economics, VŠB – Technical University Ostrava. E-mail tomas.wroblowsky@vsb.cz, phone +420 59 699 2281.

Some countries, like Austria, Russia, China or Spain, defaulted as they were not able to repay their liabilities as a result of lost wars or long lasting civil wars.

According to Sturzenegger and Zettelmayer (2006), the government defaults since 1800 are bunched in temporal and mostly regional clusters. These clusters are connected with the boom – bust cycles in international capital flows. The lending booms, connected with each cluster, have different origins. An important finding is that the cycles in both economic growth and private savings are connected not only with changes in debtor countries (lending boom in 1920 as a result of the need of financing the war reparations in Germany or in 1990's as a result of the fall of communism can be mentioned as examples), but also with the situation in creditor countries. For example the 1970's huge increase of bank lending to developing countries has its origin about ten years earlier, when American banks began looking for lending alternatives abroad due their loss of a portion of their domestic business to corporate the debt markets. The situation today is almost the same case. Both the financial crisis in 2008 and the debt crisis now, connected with high risk of government debt default in Greece and other European countries, are a consequence of changes not only in debtor, but especially in creditors situation (easy monetary conditions in both USA and Europe).

If there are some lending busts in the past, which led to defaults or rescheduling government debts, we can also find some typical causes of such situations. Following Easterly (2001), Sturzenegger and Zettelmayer say that we can find four typical causes of those capital flow busts. (1) Terms of trade deterioration in debtor countries, (2) a recession in main creditor countries, (3) significant rise of international borrowing costs, usually driven by tighter monetary policy in creditor countries and (4) a crisis in a debtor country, which is transmitted worldwide through the financial sector.

2.1 Sovereign Debt Default: Is It Natural?

As mentioned above, debt default, defined as a failure on the repayment of a country's debt, is a situation that happened frequently in the past. Greece, which is probably the country with the highest probability of default, defaulted twice in the 19th century. Other countries in danger, like Portugal, have the same experience, with Spain facing the default experience five times during the last two centuries. A brief summary of selected countries' defaults is depicted in Table 1.

Table 1: Historical examples of government defaults

Country	Defaults
Greece	1824, 1893
Spain	1820, 1831, 1851, 1867, 1882
Portugal	1834, 1892
Turkey	1876, 1915, 1940, 1978
Russia	1839, 1917, 1998
Argentina	1830, 1890, 1915, 1930, 1982, 2001
Brazil	1826, 1898, 1914, 1931, 1983
Mexico	1827, 1859, 1867, 1914, 1982
Czechoslovakia	1952

Source: Standard and Poor's reports

Now it is the time to focus on the ways of resolving crises connected with government defaults. While in the past the creditors usually did not coordinate their behavior against the debtors facing the threat of default, in last two centuries it is typical, that the creditors try to cooperate both with other creditors as well as with the debtor countries.

Until the half of 19th century, there was either no negotiation between the debtor and creditors, or if it was, it usually proceeded through some ad hoc creditor committees. Lack of experience and specialization, lack of creditor's coordination and sometimes a competition between different committees made this approach not too efficient. The first institutionalized unit appeared in 1868, when the British Corporation of Foreign Bondholders Appeared (CFB). This corporation had two functions – to provide information on debtor countries and to coordinate the creditors and negotiate with the debtors. Hundred years later, the Bank Advisory Committee (BAC) appeared. This was another institution which was an intermediary between the creditors and debtors, although without any legal authority.

When speaking about the negotiations between the creditors and debtors, it is necessary to mention the role of the official sector. In the very past, the governments of creditors countries frequently used the power to force the debtor to repay its debt. When we turn back to the last two centuries, there are several changes evident. The lack of any legal framework for sovereign debt defaults forces not only the creditors (banks, pension funds, insurance companies etc), but also the governments to use several tools to protect their interests. It frequently happens that the government doesn't intervene in the situation of default and lets the private holders of foreign debt to solve the situation without its help. But because losses of such institution can heavily affect the creditor's economy, the government has to be a part of the negotiation process. This can happen either as official and public pressure of the creditor's country government on the debtor one, or (more frequently) as some "indirect pressure", such as diplomatic pressure, barriers of trade etc.

3. From the Past to Present (and Future?)

There are many questions connected with the risk of default in countries like Greece, Italy or Portugal. One of them asks if possible default would be a disastrous event for the defaulting economy and/or for the rest of the world. Let's turn our attention first to the possibly defaulting countries themselves. There were many papers in the economic literature about possible scenarios of Greek future. Possible default will probably have positive effects as well as negative. The positive can be more space for the active fiscal policy. Today – even if Greece and other affected countries were able to reach the primary surpluses, they still have to pay such huge interest that their budgets will always generate deficits. In case of debt default or re-structuring, the need for fiscal cuts (which support the decrease of aggregate demand and increase the social pressure) will be lower. The negative will be probably an exclusion of (or at least more difficult access to) financial markets. The economic literature provides very mixed results about that. Many studies in the past stated that sovereign default has only minor impact on the access of defaulting country to financial markets after that. This result can be characterized by Bulow and Rogoff statement that "debts which are forgiven will be forgotten" (Bulow and Rogoff, 1989, p. 49), which is a significant incentive for moral hazard. Probably the most recent study, published by Cruces and Trebesch (2011), however, gives different results. According to that study, sovereign defaults are the main condition determining the subsequent borrowing conditions and creditors really take into account their previous losses.

However, it is vital to mention that the debt crisis in Europe is not only economic, but a political issue as well. For the reasons discussed later on, it is probable that European institutions such as Commission or ECB, governments of countries like Germany or France, with the cooperation of IMF will probably ensure the possibly defaulting countries to have access to the financial markets in the future.

So now it is time to analyze the possible consequences of default from the debtor's point of view. If the banks, pension funds, insurance companies or any other investors will suffer

losses (there estimates about 50% haircut in the case of possible Greek default), it is probable that significant amount of them will have big problems. These problems can be transmitted through the financial sector to other “healthy” financial institutions and cause the situation similar (or even worse) than after Lehman Brothers fall. Many banks will probably need help from national government and if they are too big to fail (or better, if they are able to persuade the government that they are vital for the economy, see that moral hazard is present again), the governments will probably repeat the wave of national help to the financial sector. Thus, those who will suffer will be the taxpayers. All these events described above will certainly negatively affect the economic growth not only in debtors, but in creditor countries as well.

4. Conclusion

The sovereign default is an event which is almost as old as sovereign borrowing itself. There are several lessons from the past, which can be used for the explanation of today's situation in highly indebted countries facing the risk of default. According to some authors, the defaults are caused by the booms and busts in international capital flows. The boom of capital flows to countries like Greece, caused by easy monetary conditions and relatively high yields with low risk (illusion that all Eurozone countries bonds are almost zero-risk) was followed by the bust in recent years (crisis after Lehman Brothers, panic at financial markets). This lead some European countries to situation when the probability of default is very high. However, there are also big differences between defaults in the past and possible default today. While in history the sovereign defaults had usually only minor impact both to creditors and debtors, the risk that default of one country may cause a world-wide financial and then economic crisis is insignificantly higher today.

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Summary

Všeobecně se má za to, že selhání vládního dluhu může mít fatální důsledky pro zadluženou zemi samotnou, pro věřitele a dokonce i pro celou ekonomiku. Historie však ukazuje, že selhání suverénního dluhu je téměř tak staré jako dluh samotný. Navíc žádný z defaultů v minulosti neměl výrazné celosvětové dopady. Bude se tedy historie opakovat? Tento příspěvek se zabývá právě hledáním odpovědi na otázku, zda i v dnešní době může případné selhání vládního dluhu mít pouze lokální a časově omezené dopady, nebo zda je nevyhnutelný přenos těchto důsledků skrz finanční sektor do celého světa, což povede k celosvětové finanční a ekonomické krizi.