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

I. What Is Default? Why Does It Matter?
II. Definition Challenge
III. Determinants of Default
IV. Costs of Default
V. 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*

* Denotes additional information or categories.
II. Proposed Fix

Contract Terms

Technical Default:
e.g., minor covenant default

Contractual Default:
e.g., nonpayment for 30+ days

Consequential Third Party Criteria

Substantive Default:
e.g., distressed restructuring with haircuts
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III. Determinants of Default – Domestic, External, Other?

1. “Mismanagement” / **domestic** 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” / **external** 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

Newer:
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

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

- Maintain non-Fund exposure (e.g., reprofiling or official financing) to improve debt sustainability and enhance safeguards for Fund resources.