THE USUAL SUSPECTS: SOVEREIGN DEFAULT IN SOUTH AMERICA, 1950-2010

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Why do South American countries tend to have higher sovereign default rates? Jack Dempsey attempts to explain this phenomenon by examining the causes and costs surrounding sovereign defaults. He addresses the 'usual suspects' of high borrowing costs, low resources and political factors and concludes these are largely to blame.

Introduction

Venezuela's recent sovereign debt woes have been well documented in the media with a general conclusion that it is not a matter of if, but when the nation will default on its sovereign debt. Argentina technically defaulted in 2014, their second default in 13 years, due to legal disagreements over the restructuring of debt from 2002. Combine these with Paraguayan and Uruguayan defaults in 2003 and a Venezuelan default in 2005 and a recurring theme begins to emerge of sovereign default among South American nations in recent times.

Building on data compiled from 70 countries from Reinhart and Rogoff's "This Time is Different" (2009), there have been 103 external defaults since 1950, giving an average of 1.47 defaults per country over this time period. The ten South American nations included in the sample account for 35 of the aforementioned defaults, an average of 3.5. Understandably, this is a somewhat biased statistic as the overall sample contains many nations that have not defaulted since 1950 and therefore dilute the overall results. However, by removing nations that have not defaulted in the stated time period, leaves an average of 2.51 defaults per nation, proving South American to default 40 per cent more than the average defaulter.

Therefore the question that must be posed, and the one this essay attempts to answer, is why do South American countries tend to have higher default rates on external sovereign debt? The answer to this question is a complex one, steeped in a vast array of economic, political and social issues. An attempt to address this issue will be made along the lines of:

i) The explicit causes of default
ii) The costs of default
iii) Why do South American nations have higher default rates?

A good place to start is with an explicit definition of sovereign default. According to the previously mentioned Reinhart and Rogoff, two of the world's most pre-eminent voices on debt, sovereign default is: "the failure to meet a principle or interest payment on the due date (or within the specified grace period). These episodes also include instances where rescheduled debt is ultimately extinguished in terms less favorable than the original obligation" (2008).

Over the stated time period, it is obvious that it is today's emerging economies that are guilty of almost all the defaults, with the 26 advanced economies included in the study having only defaulted twice among them since 1950. While South American countries are deemed to be "developing" under international guidelines, this does not go as far to help explain why they have a higher default rate, as many developing economies boast exemplary records in relation to sovereign debt. Countries like China, Malaysia and Taiwan are yet to experience a sovereign default since 1950, and do not look likely to do so any time soon.

The Cause of Default

Hatchando, Martinez and Sapriza state that sovereign default is most likely to be observed when resources available to the sovereign are low, borrowing costs are high or there is a substantial change in the political circumstances.

Resources

When resources run sufficiently low it may become optimal for a sovereign to default rather than make massive expenditure adjustments. Research from Tomz and Wright (2012) shows that 62 per cent of defaults occur when a country's output levels are trending below average. Such empirical evidence helps put weight behind the general consensus that default risk is higher when a nation's economy is performing poorly.

Resources for many countries rely on commodity prices, and if prices of such drop abruptly the sovereign can face gaping holes in the national budget. Commodity prices can fluctuate massively, leaving such dependent nations susceptible to worldwide demand for natural resources. The last great commodity price slump, which began in the late 1970s, was a drag on developing economies for almost two decades (The Economist, 2014).

Borrowing Costs

Borrowing costs are highly susceptible to change for countries due to many internal and external factors. The most important of these external factors involve changes in the exchange rate. Eichengreen, Hausmann and Panizza (2005) reported that between 93 per cent and 100 per cent of developing country debt is issued in foreign currency, mainly the dollar, euro and yen. Such debtor countries are therefore exposed to fluctuations in exchange rates, leaving them open to ballooning payments in the case of an appreciation in the debt denominated currency.

Empirical studies have also indicated that interest rates paid by developing countries tend to move in the same direction as U.S. interest rates (Lambertini, 2001). This leaves such developing nations extremely vulnerable to variations in the state of the US economy and the resulting interest rate changes. Evidence of this can be found in the massive increases in U.S. interest rates in the early 1980s, as rates hit 20 per cent, a period that coincides with the much-discussed Latin American debt crises.

Increased borrowing costs can be extremely dangerous for countries that continually roll over on short-term debt in order to service fast approaching interest payments and maturities, an activity that many nations indulge in.

Political Factors

There is a strong correlation between political risk and sovereign default, with studies by Citron and Nickelsberg (1987) showing that political instability is statistically significant as a determinant of a country's default probability. This can be seen by Syriza's rise to prominence in Greece coercing a negative reaction from worldwide bond markets. A country's willingness to pay is firmly influenced by politics via the distribution of interests and by the institutions and power structures (Von Rijckegham and Weder, 2004). Further evidence from Kohlscleen (2008) shows that the political systems in place also play a large role in whether a nation defaults or not, with parliamentary democracies experiencing lower default probability than their presidential equivalent due to the higher number of veto players. Even higher default probability is observed when a nation is under the rule of a military dictatorship or similar (Dhillon and Sjostrom, 2009).

The Cost of Sovereign Default

This is a particularly important topic as if costs to default were low or nonexistent then all countries would incessantly default on debts and international credit markets would dry up. Therefore, an important matter contingent on the terms of debt contracts is that default must be more costly than repaying the debt. Hatchondo, Martinez and Sapriza (2007) state there are two main costs creditors impose on default of sovereign debt: i) Higher borrowing costs and ii) Signaling costs.

Higher Borrowing Costs

Increased borrowing costs can be defined simply as a hike in the price of debt. Following a default, coordination is required among the holders of the defaulted debt and any potential future lenders in order for this condition to be enforced. However, such a feat is near impossible to achieve in today's extremely competitive credit markets. The only truly viable solution remaining is to block payments to other creditors via legal actions to try and exclude defaulters from capital markets, as is being currently attempted by the media-coined 'Vulture Funds' on Argentina, who refuse to take a haircut on defaulted debt from 2002.

Empirical evidence from Eichengreen and Portes (2000) finds no evidence of higher borrowing costs or capital market exclusion following a sovereign default, this is indicative that signaling costs are the only true cost to sovereign default. Although it must be mentioned that, unlike a private company, a country cannot enter bankruptcy and, as such, most default episodes are followed by settlement with creditors, an outcome not worthy of capital market expulsion.

Signaling Costs

The true costs of default come as a result of the information it conveys to capital markets and economic actors. A number of issues are immediately raised following such an explicit default. Is the government not willing to respect property rights? Are economic conditions so bad in the country it cannot afford to service its debt? Is the country still safe to do trade with? All of these combine to essentially discredit a nation's economy and central bank, making it very difficult to raise funds at attractive rates in future credit markets.

In addition to the above, Tomz and Wright (2012) put forward a theory that a country only repays debt in order to retain access to future credit markets. Such a theory is very plausible as most governments need to borrow in order to finance capital expenditure among other things and the drying up of their only source of borrowing would leave the nation's finances reliant on increased taxes or decreased expenditure, neither popular approaches with the voting population.

South American Default Rates

This section will attempt to unearth the reasons behind South America's elevated default rates since 1950. This will be attempted, firstly, via Hatchondo, Martinez and Sapriza's (2007) format of the causes behind sovereign default and, secondly, via other methods the author believes allow for a more direct approach.

Low Resources

An over-reliance on natural resources leaves South American countries extremely susceptible to boom and bust cycles, as can be seen with Venezuela's current predicament,

where a near 50 per cent fall in the oil price has had a detrimental effect on budget revenue, of which oil accounts for 48 per cent of, as well as for 96 per cent of export earnings (Kwan Puk, 2014). This has been a recurring theme in many South American nations over the years, where economies are heavily biased towards commodity exports and a slump in prices can make such nations very vulnerable to default due to the drying up of government revenues.

This failure to diversify is still prevalent today in South American economies, nations like Chile, Peru and Argentina remain heavily reliant on Chinese demand for copper, non-ferrous metals and soybeans respectively. This "sinodependency", a term coined by The Economist magazine, is a worrying aspect going forward considering the recent slow-down in the Chinese economy (BBVA Research, 2013).

High Borrowing Costs

As the risk of default becomes higher, the cost of borrowing naturally rises as creditors look to be compensated for the elevated level of risk they are undertaking. Such is the case for South American nations who suffer from historically high borrowing costs that come hand in hand with an elevated risk of default. This raises Reinhart and Rogoff's issue of serial defaulters (2004), where previous default increases the chance of future default via knock-on effects in relation to the difficulty such countries have in borrowing at attractive rates. This affects future economic development that could contribute towards paying any outstanding debts. The serial defaulters theory essentially embodies a self-reinforcing feedback loop in relation to sovereign default.

The pro-cyclical nature of capital markets (Reinhart, Rogoff and Savastano, 2003) means that cheap and easy credit comes periodically for South American nations. Used to having a high cost of borrowing, these surges of credit make certain nations liable to overindulge on debt (The Economist, 2015). This results in higher than normal debt/GDP ratios, which, working as the aforementioned vicious circle, result in higher costs of borrowing due to increased risk that comes conjointly with higher levels of government debt.

Political Factors

All South American nations have fallen under the rule of a non-democratic political regime during some time of the last 65 years, a significant factor in determining the probability of default (Xinrui Yu, 2012). By observing the political regimes of countries around their time of default, it becomes clear to the observer that there is a correlation between non-democratic regimes and default. Handpicking one country, Colombia, it can be seen that it had the shortest rule under a dictatorship (4 years) out of the South American nations and also no sovereign defaults since 1950, perhaps a coincidence but again, perhaps not. Furthermore, the political standpoint of the ruling party has a large role to play in regards to default. Some regimes prefer to default on external debt rather than see its people suf-

fer, while others, such as Venezuela currently do the opposite, paying creditors while massive shortages of imported goods engulf the nation.

Crisis Factors

Reinhart and Rogoff (2009) developed default indicators of currency crises, inflation crises, stock market crashes and banking crises. When considering these it becomes clear that in the case of South American nations, defaults are generally accompanied by an elevated number of the aforementioned crises factors in the year or preceding year of their default.

While a slightly arbitrary measure, it is a revealing one that helps to control for countries that have not defaulted in the stated time period. Using this metric, the average defaulter experienced 1.612 such crises per default while South American nations were 53 per cent higher at 2.47 crises. Reading further into the data highlights a more profound problem among South American nations. Of the 166 crises experienced via the 103 defaults, 66.3 per cent were related to currency or inflation crises but of the South American cases the figure was a relatively higher 75 per cent, indicating possible inefficiencies in monetary and fiscal policies among such nations. This also works to highlight tendencies to deal with debt via the printing press, resulting in massive inflation and huge depreciations against the US dollar and other currencies.

It must be noted that a large number of South American defaults fell during the Latin American debt crises period, when an alarming build-up of foreign debt meant that Latin American nations would no longer be able to service their borrowings. The 1980s, the general period of these crises, accounts for 38.24 per cent of the overall defaults since 1950 for these nations. This is a significant figure when considering that the 1980s only accounts for 16.67 per cent of the observed time period. This highlights the possibility that South American nations' higher default rates are a result of an outlier event.

A further dive into trying to explain the higher rate of default can possibly be unearthed via the low credibility that the nation's central bank currently maintain. Is the credibility of South American central banks already so tarnished that losing credibility is almost no longer an issue to consider? The main obstacle to default, for advanced economies, tends to move along the lines of maintaining the integrity and credibility of the country's central bank and government. However, in the case of many of the South American nations, central bank credibility is already substantially low and so the loss of more credibility is not as devastating as it would be for many other nations.

Conclusion

Reinhart, Rogoff and Savastano (2003) observe that certain countries suffer from debt intolerance, in the same manner that a coeliac is gluten intolerant. These countries tend to have fragile fiscal structures, weak financial systems and almost always fall under the "emerging" banner. They are known to enter debt spirals as they borrow when at their greatest risk of default. This theory works well when trying to comprehend why South American nations have the highest sovereign default rates over the past 60 years, with their weak institutions failing to prevent problematic economic factors from ballooning into full scale crises.

Based on the above, in my opinion it seems that South American nations have expereinced higher default rates over the period 1950 to 2010 due to the worse than normal outcomes that result from the three already discussed reasons behind default. The politically unstable environment that many of the countries exist under make them a somewhat undesirable place to lend to, resulting in high borrowing costs that can be made even worse by fluctuating macroeconomic factors. Loose fiscal and monetary policy, and a strong tendency to start-up the printing press to repay debt, contributes further to their debt woes as government spending becomes unsustainable and the currency weakens, worsening the burden of foreign denominated debt. Finally, the issue of low availability of resources to the government is well documented in the above.

Overall, however, I believe that the main reason behind the high rate of sovereign default shown by South American nations is weak political systems. Such regimes allow for corruption, unsustainable social spending and an over-reliance on natural resources. These characteristics leave South American nations highly exposed to macroeconomic factors that can be highly beneficial or highly detrimental to their economy. Fluctuating exchange rates, commodity prices, and the pro-cyclical nature of credit markets that allow for easy credit in times of high global savings, all contribute greatly to the expansion and contraction of South American nations.

To avoid exposure to these extremely influential external factors, nations must begin to diversify away from the industries that they have become over-reliant on, in order to protect themselves from the ups and downs that come with such an economic system. Attempts of such have already been made by the likes of Colombia and Peru who have used the high commodity prices of the past decade to build foreign-exchange reserves and to pursue greater economic reforms in order to insulate themselves to slowdowns in the worldwide demand for commodities (The Economist, 2014).

Many of the issues involving sovereign default raised in this essay unearth problems that delve deep into eco-political and cultural mindsets, which are somewhat beyond the realms of this essay. However, time will bring forth more evidence of the reasons behind South American defaults and will determine whether the usual suspects will remain as so. An expected interest rate hike from the Federal Reserve combined with an increasingly strong dollar could produce problems for many South American nations, with the effects of such to be followed with great interest by this author.

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