

Global Financial Systems

Chapter 19

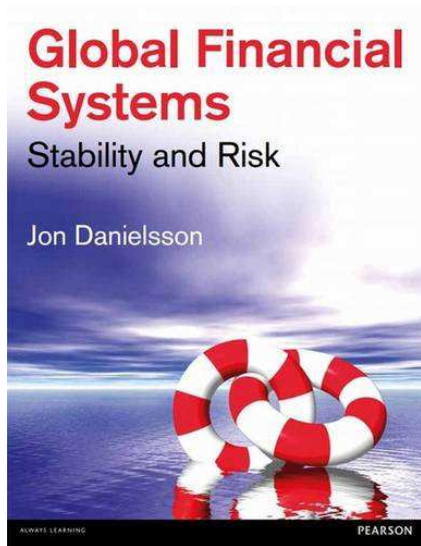
Sovereign Debt Crises

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To accompany
Global Financial Systems: Stability and Risk
www.globalfinancialsystems.org/
Published by Pearson 2013

Version 12.0, August 2025

Book and slides



- Updated versions of the slides can be downloaded from the book web page www.globalfinancialsystems.org

Chapter 19 and 20

- These slides contain the first part of Chapter 19

Sovereign Debt

Sovereign debt

- Sovereign debt is money owed by a *sovereign authority*
 - e.g. the central government or the central bank
 - not municipal governments or state-owned enterprises
 - *unless* they have an explicit central government guarantee
- Two types
 1. domestic debt
 2. external debt
- The failure of government to pay back its debt in full is called a *sovereign default*
- But keep in mind it is not the same as a private default (discussed below)

Why governments issue debt

- Finance fiscal deficits when expenditure exceeds revenue
- Smooth spending across economic cycles
- Fund infrastructure and development projects
- Manage liquidity and monetary policy operations

External debt

- Debt owed to *non-residents*; often issued under *foreign law* and/or in *foreign currency*, but not necessarily
- Typically issued in international *capital markets* or borrowed from foreign *commercial banks*

Domestic debt

- Domestic debt has always been a major part of a country's debt stock, averaging almost *two-thirds* of total public debt in the 20th century
- Advanced economies issue mainly domestic debt because they can borrow in their *own* currency with lower risk premia
- Domestic debt gives governments more options to default *indirectly* on their debt
- By creating *inflation*, governments can lower the real value of their debt stock
 - As the US did after WWII via inflation and financial repression
 - QE alone is not equivalent to this; the key channel is sustained negative real interest rates

Sovereign default

- Inherently *different* from the bankruptcy of a company
- *Countries are not liquidated under bankruptcy law*
- A default is the result of a *cost–benefit calculation* of the government involving economic, financial, political and social aspects
- Most country defaults happen long before a nation really runs out of resources
- No *legal framework* exists for sovereign defaults, no clearly drawn up *rights* for creditors, no *supranational institutions*
- Repayment depends therefore not only on the *ability* of the government but also on its *willingness* to do so

What about European sovereign debt?

- Issued in euros; member states do not have monetary sovereignty over the euro
- In some countries mostly held by foreigners, in others by domestic agents
- Much pre-2012 Greek debt was under Greek domestic law; in 2012 Greece retrofitted collective action clauses (CACs) to restructure these bonds
 - Greece used retroactive CACs in the 2012 PSI, rather than redenominating
 - Greek-law bonds were restructured; many foreign-law bonds were excluded or settled separately
- Distinction depends on context

History

- Sovereign defaults have been *common*
- France defaulted multiple times between the 16th and 18th centuries
- Spain defaulted repeatedly from the 16th through the 19th century
- Today's developed countries almost exclusively experienced external defaults when they were developing
- Only after WWII did developed countries stop being serial defaulters
- Key changes: deeper domestic capital markets, ability to borrow in own currency, stronger institutions and more diversified economies
- With newly gained *independence*, developing countries started to default frequently
- In the 20th century, several emerging economies (e.g., India, Indonesia, Brazil) experienced multiple defaults; counts vary by source and definition

Defaults, restructuring, rescheduling

- *Default is usually restructuring*
- Often involves swapping a high interest rate for a lower interest rate and occasionally even a reduction of principal
- Restructuring mechanisms:
 - Maturity extension — pushing repayment dates further out
 - Coupon reduction — lowering interest payments
 - Principal haircut — reducing face value of debt
 - Currency redenomination — changing payment currency
- Preferred to outright default because:
 - Maintains some creditor recovery
 - Preserves market access possibilities
 - Avoids complete breakdown in creditor relations

External defaults

- An external default is strongly correlated with *global economic factors*, especially commodity prices, interest rates and capital flows because sovereign borrowing is *procyclical*
- Procyclical borrowing: countries borrow more when times are good (high commodity prices, low global rates) precisely when they need it least
- When capital inflows suddenly *reverse*, developing countries frequently slip into default
- Countries tend to *overborrow* in good times, leaving them vulnerable when conditions worsen

Why repay sovereign debt

- Reputation risk — default can close future access to international capital markets
- Trade disruption — including trade finance and claim enforcement in friendly jurisdictions
- Discouragement of FDI — defaults erode perceptions of property rights and firm security
- Reputation costs significant but often conditional on regime and policy change
- In Venezuela's case, partial servicing was used to protect oil revenues and Citgo assets before eventual comprehensive default

Debt tolerance

- How can some countries function with 240% debt to GDP (Japan, see below)
- While others default at 40%?
- Debt tolerance: the level of debt a country can sustain without triggering a crisis
- Debt/GDP is not the most relevant metric — ability to service debt depends more on variables like debt/foreign income

Debt intolerance

- *Weak institutional structures* and a *problematic political system* make external borrowing a tempting device for governments to employ to *avoid* tough decisions
- Safe debt thresholds depend heavily on a country's record of default and inflation
- A country's debt intolerance can be determined by its *repayment history*, *indebtedness level* and *history of macroeconomic stability*

Japan

- Japan borrows in yen; long-term debt is largely held domestically and carried $\approx 0\%$ interest for decades until very recently, hence tolerates debt around 240% of GDP
 - However, higher inflation that lifts interest rates would raise fiscal costs significantly; this concern has contributed to Japan's deflationary bias
 - Outright default risk remains low given domestic holdings and central bank support
 - Limits policy options

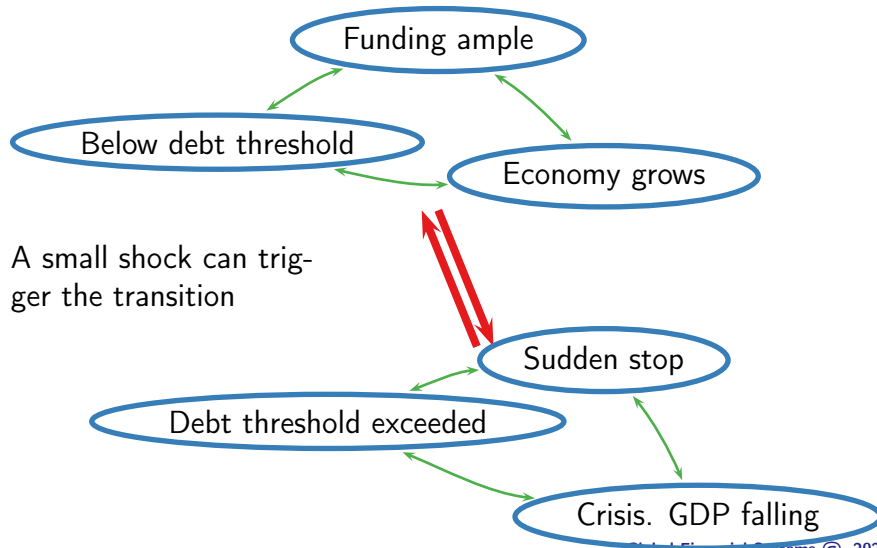
Contrasting debt tolerance

- While other countries borrow in foreign currency, at short maturities, held by skittish investors
- Mexico defaulted in 1982 at 47%
- Argentina in 2001 at 50%
- Historically, only a minority of defaults occurred with debt/GDP above 100%
- Many occurred below 60% and a non-trivial share below 40%
- Threshold is dependent on the history of the country
- A serial defaulter, with weak institutions, persistent inflation, citizens accustomed to crises has a low threshold
- Endogeneity problem: weak institutions lead to defaults, which further weaken institutions and lower future debt tolerance
- These low-tolerance countries share common vulnerabilities that increase default risk

Vulnerabilities

- Many countries tend to satisfy their funding needs by *borrowing short-term*, issuing debt with maturities between one to three years, which carries a *lower interest rate*
- This introduces *roll-over risk* and makes a country vulnerable to a *liquidity crisis*
- Many emerging markets issue mainly *external* sovereign debt
- This introduces *exchange-rate risk* and makes a *devaluation* more costly

Vulnerabilities: The transition dynamic



Enforcement

Domestic and foreign issues

- Debt issued at home under domestic law
- Terms governed by domestic law can be changed by legislation (an Act of Parliament), subject to constitutional and property rights constraints
 - Greece's 2012 retrofitting of CACs to domestic-law bonds
- Foreigners usually insist on foreign courts (New York or London)
 - Think Argentina

Institutions

- There are no international courts for enforcing sovereign debt
- Some institutions exist (next slide)
- But generally requires different approaches from corporate debt
- The IMF proposed an international legal mechanism for sovereign debt (SDRM) in 2002–03, but it was not adopted

Historical enforcement mechanisms

- Before WWII, sovereign debt enforcement often relied on military force
- Creditor nations would use gunboat diplomacy or direct occupation
- This approach ended with the post-war international order
- Modern enforcement relies on economic and legal mechanisms instead

Military enforcement (historical)

- Egypt's fiscal crisis led to European financial control; the UK occupied Egypt in 1882 (protectorate declared in 1914)
- The Ottoman Empire defaulted in 1875; in 1881 European creditors created the Ottoman Public Debt Administration to control key revenues
- European naval blockade of Venezuela in 1902–03 to enforce creditor claims; the US occupied Haiti in 1915, partly over financial control
- Haiti was forced to buy its slaves to free them from France, borrowing from French banks to service these obligations
- The amounts were so large that it was paying for them far into the 20th century
<https://www.nytimes.com/2022/05/20/world/americas/haiti-history-colonized-fra>
- The US occupation involved control of customs and finances; motives included strategic and creditor interests

Newfoundland

- Only liquidation of a country for debt reasons
- Was a British dominion with self-governing status before the crisis
- By 1933, its public debt was about three times its GDP, and the industry collapsed
- Government asked UK for help who responded “No part of the British Empire has ever yet defaulted on its loan obligations” ... “Bankruptcy is at best an ugly word and carries a stigma which a nation even more than an individual would do well to avoid.”
- Newfoundland temporarily gave up responsible government to a UK-appointed Commission of Government
- Two referenda in 1948 on whether to join Canada or regain independence
- Joined Canada in 1949 following the referenda even if it voted for independence

Modern enforcement mechanisms

- Today's enforcement relies on market mechanisms and legal action
- No military intervention, but significant economic consequences
- Key enforcement tools:
 - Loss of market access — inability to issue new bonds
 - Credit rating downgrades — increasing borrowing costs
 - Asset attachment — seizing foreign assets (ships, planes, accounts)
 - Trade finance disruption — difficulty financing imports/exports
 - Legal harassment — continuous litigation in multiple jurisdictions
- These create strong incentives to negotiate rather than default outright

Paris Club

- An informal group of official bilateral creditors (currently 22 members)
- Meet in Paris
- Specialised financial services like restructuring, relief and cancellation
- Primarily restructures sovereign debts owed to official bilateral creditors, across income levels
- Recent examples: Nigeria, Liberia, Democratic Republic of Congo
- China is not a member; it has occasionally participated as an ad hoc creditor (see discussion later)

Extreme legal steps and vulture funds

- Modern enforcement relies on legal action rather than military force
- Sovereign debt can live for years, even centuries (e.g., Haiti and Russia)
- May attract vulture funds

“billionaire Paul Singer, who in 1996 paid \$11m for discounted Peruvian debt and then threatened to bankrupt the country unless they paid him \$58m ... In order to keep a good standing in international financial markets, Peru paid. Singer and his New York-based investment fund, Elliott Associates, have since sued the Republic of Congo (Congo Brazzaville) for \$400m for a debt bought at \$10m.”
Guardian newspaper 2007

- Argentina and Elliott 2012

Carrots and sticks

- Creditors can stretch out maturities and raise interest rates to offset the cost of haircuts, sometimes offering credit enhancements
- May raise issues regarding existing covenants and pari passu clauses (equal treatment of creditors)
- Sovereigns can threaten default, and in many recent cases have suspended or threatened payments to bring creditors to the table

Encouraging lenders to agree

- Holdout problem: minority creditors can block restructuring and demand full payment while others accept haircuts
- *Exit consents*, bondholders that agree to restructuring give the sovereign a proxy vote that may strip away valuable features of old bonds, making them less attractive to holdouts. This often only requires a simple majority of bondholders
- *Collective action clauses* (CAC), that permit the majority, or supermajority, of creditors to modify key features of the terms of bonds, including principal and interest payments

Enforcement effectiveness

- Despite limited legal tools, sovereign debt enforcement has moderate success
- Evidence of effectiveness:
 - Most sovereign defaults since 1990 ended in restructuring, not outright repudiation
 - Typical creditor recoveries average roughly 50–70% of face value, with wide variation
 - Many countries return to markets within a few years, conditional on policy credibility
- Notable failures:
 - Argentina's 15-year legal battle with holdouts
 - Venezuela's ongoing default despite foreign assets
 - Russia's 1918 repudiation still unresolved
- Overall: imperfect but functional system

History lessons

Lee C. Buchheit

- Don't let a sovereign debt problem become a banking crisis
- Don't delay recognising that debt levels are unsustainable
- Keep track of government obligations (especially local government, Argentina, Spain, China)
- Ask for enough relief (avoid repeats, Latin America, Greece)
- Be ruthlessly efficient. Sovereign debt crisis comes along with other problems that need addressing
- Be evenhanded and treat all creditors the same (except perhaps trade credit). Resist geopolitics and long-term promises

Countries in serious difficulty with sovereign debt today

BoC–BoE (Bank of Canada–Bank of England) Sovereign Default Database
www.bankofcanada.ca/2024/07/staff-analytical-note-2024-19/

- This list is not comprehensive and classifications can differ
- Defaults since 2020 include Mali, Sri Lanka, Belarus, Ukraine, Ghana, Lebanon, Zambia, Ecuador and Suriname
- 19 defaults across 13 different countries between 2000 and 2019.
- Debt trades at distressed levels — about \$200 billion (as of 2024) — Lebanon, Ukraine, Sri Lanka, Tunisia, Pakistan, Ghana, Belarus, Ethiopia, Argentina, Suriname, Ecuador, Egypt, El Salvador, Maldives, Bolivia, Kenya, Tajikistan
- This widespread distress requires understanding how sovereign debt crises are typically resolved

How debt is traditionally dealt with

- Private creditor claims are often governed by New York or English law
- A separate resolution track exists for official bilateral loans, and debt forgiveness is now standard practice for low-income countries (e.g., HIPC/MDRI)
- IMF often called to provide emergency help
- The IMF will demand measures for macroeconomic stability — which can be very controversial in the countries and abroad
- Over the past half a century, the general mechanism for dealing with countries in distress is fairly well understood
- *Debt forgiveness has become a priority for state lending*
- However, the creditor landscape has shifted — non-Paris Club creditors now hold the majority of debt in many distressed countries

The role of China

- China has now become a very large creditor — Chinese state, state-owned companies and private creditors
- Often mixed with the Belt and Road Initiative
- Half the 38 countries that are in or near default have China as the biggest state creditor
- China prefers bilateral resolution and has not fully participated in multilateral forums such as the Paris Club
- In particular, it typically resists nominal haircuts, preferring maturity extensions and interest rate reductions
- Many contracts include confidentiality clauses, so terms and conditions are not publicly disclosed

Reasons

- China is not set up for restructuring, which needs permission from the State Council. A write-down may mean that bureaucrats made a mistake
- In advanced economies, official and commercial lending are institutionally separate, with established debt relief policies for official loans
- In China, multiple state-linked lenders operate with mixed mandates; many loans are treated as commercial, and traditional official-sector relief practices are often contested
- China tends to negotiate bilaterally rather than within existing creditor coalitions

Result

- Restructurings have become more protracted and harder to conclude successfully
- Non-Chinese creditors are concerned that any debt relief could indirectly finance repayments to Chinese lenders
- There are similar concerns about emergency financing being used to service Chinese claims
- The G20 Common Framework has aimed to bring China into multilateral workouts, but progress has been slow

Case study: Zambia

- Defaulted in 2020, the first African country to default during COVID-19
- China holds about one-third of Zambia's external debt
- Applied for Common Framework treatment in early 2021
- Restructuring took nearly 3 years due to:
 - Disagreements between Chinese and Western creditors
 - China's insistence on comparability of treatment — seeking similar losses from private bondholders, and raising questions about the role of multilateral development banks (MDBs)
 - Disputes over what constitutes commercial vs official debt
- Final deal reached in 2023 (with further adjustments in 2024), but implementation remains challenging
- Illustrates how creditor coordination failures delay recovery

Other contemporary challenges

- China is not the only complication in modern debt resolution
- Private creditor coordination has become more difficult with diverse bondholders
- IMF resources strained by multiple simultaneous crises
- Geopolitical tensions beyond China (Russia, Middle East) affect willingness to co-operate
- Climate-related debt (disaster clauses, green bonds) adds new complexity
- Result: debt resolution taking longer and becoming more contentious