# The Next (but not new) Frontier for Sovereign Default

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# The Next (but not new) Frontier for Sovereign Default [1]

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There is a view today that "this time it's different" for emerging markets. Governments are reducing their dependence on external debt and relying more on domestic debt financing *for the first time*! Furthermore, emerging market governments are increasingly issuing long-term domestic debt. Indeed, often this change in government debt management patterns is taken as evidence of graduation from "serial default." In this new world, debt crises in emerging markets will be a thing of the past, and the IMF is plainly out of business.[2]

## Domestic debt is not a new invention

Yet, alas, apparently unknown to most observers in financial, academic, and policy circles, domestic debt has been around for a quite a while. For that matter, so too has been default on domestic debt of one form or another. In our latest paper, Kenneth Rogoff and I unearth a vast trove of historical time series data on external and domestic public debt for 64 countries ranging back to 1914. Our key sources are publications of the now-defunct League of Nations, updates by its successor, the United Nations, and the work of many scholars and government agencies.

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[1] This article is based on Carmen M. Reinhart and Kenneth S. Rogoff's (2008) "The Forgotten History of Domestic Debt." NBER Working Paper 13946, April (2008).

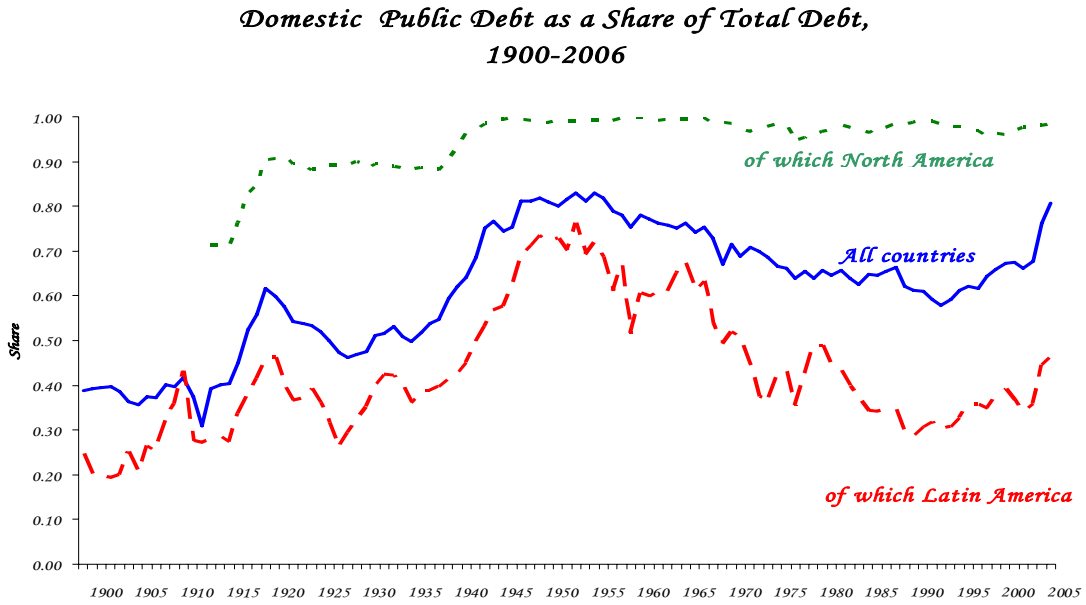
[2] Carmen M. Reinhart, Kenneth S. Rogoff, and Miguel A. Savastano (2003). "Debt Intolerance," *Brookings Papers on Economic Activity*, Spring, 1–74, document cases of "serial default," that is cases where governments have repeatedly defaulted or restructured their debts (including publicly-guaranteed debts); Venezuela with 9 defaults since independence holds the record among today's emerging markets.

Although it may come as quite a surprise to most readers that historical time series on domestic debt should be exotic for so many countries, it is. This is in contrast to *external* sovereign debt, on which there is a vast literature. We are not aware of any academic or policy study that uses similar data, certainly not one encompassing such a long time period and so many countries.

Indeed, historical data on domestic (internal) government debt has been ignored for so long that many observers have come to believe that the recent rise in domestic debt in many emerging markets is novel. This perspective is based on the belief that, historically, domestic government debt played only a minor role in the public finances of most developing countries. The new data thoroughly dispels this notion. The key findings of Reinhart and Rogoff (2008) are summarized in the remainder of this article.

***First, domestic debt is and was large***—for the 64 countries for which we have long time series, domestic debt averages almost two-thirds of total public debt; the increase in the share of domestic debt in the last few years is but an upward "blip" in the larger context. For most of the sample, ***these debts typically carried a market interest rate***, except for the era of financial repression after World War II. From 1914 through the 1960s, before inflation became a widespread phenomenon***, more than one-half of domestic debt was long term,*** even for Latin America.

Figure 1

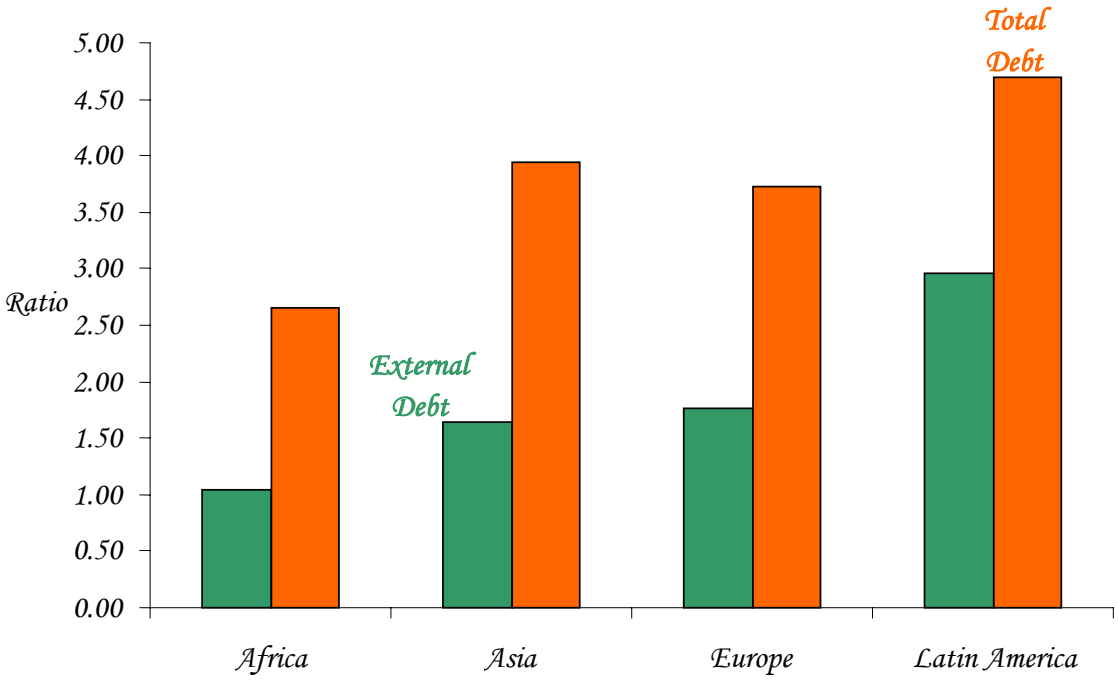



**The puzzle of "debt intolerance"**

***Recognizing the significance of domestic debt goes a long way toward explaining the puzzle of why many countries default on (or restructure) their external debts at seemingly low debt thresholds***. In fact, when heretofore ignored domestic debt obligations are taken into account (as shown in Figure 2), fiscal duress at the time of default is often revealed to be considerably more severe.[3] Specifically, debt-to-revenue ratios are about twice as high for total (domestic plus external) debt as the standard ratios that only considered external indebtedness.

[3] This puzzling "debt intolerance" is examined by Reinhart, Rogoff, and Savastano (2003).

*Figure 2. Public Debt-to-Revenue Ratios During External Default: 89 Episodes, 1827-2003*

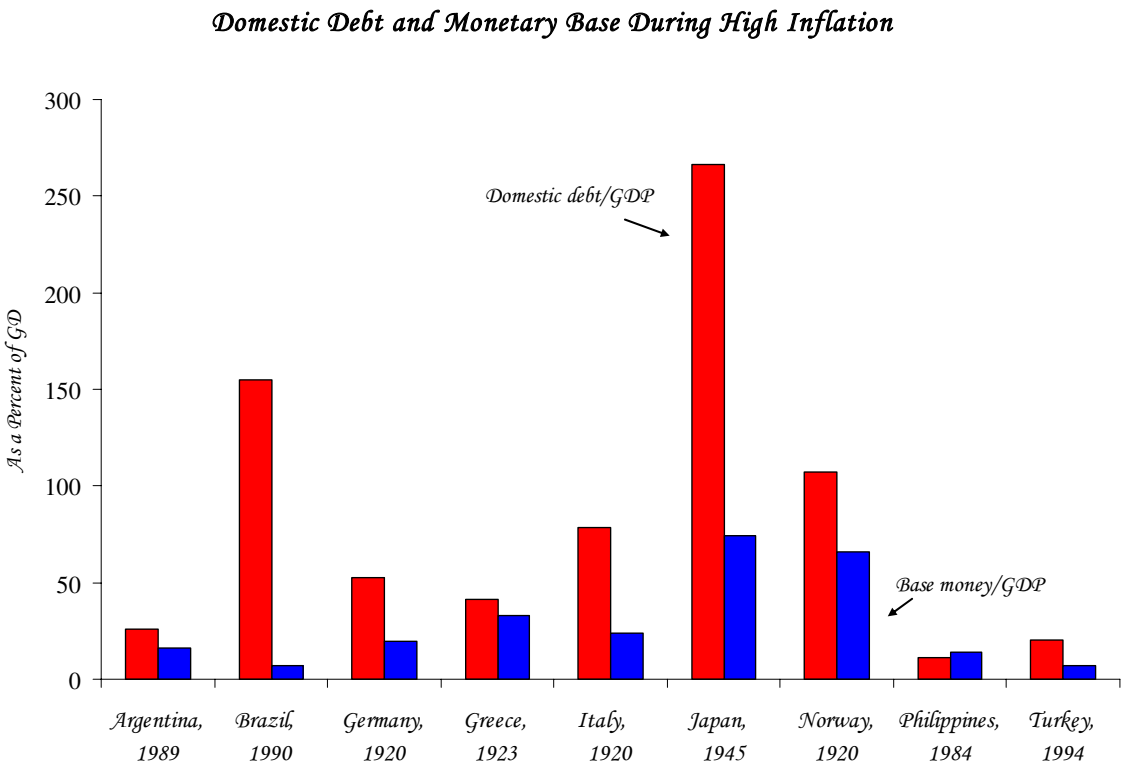



**Default through inflation**

***Domestic debt may also explain the paradox of why some governments seem to choose inflation rates far above any level that might be rationalized by seignorage revenues levered off the monetary base.*** (This was the puzzle first pointed out in Cagan's classic, 1956, article on post-war hyperinflations.)[4] Although domestic debt is largely ignored in the vast empirical literature on high and hyper-inflation, we find that there are many cases where the hidden overhang of domestic public debt was at least the same order of magnitude as base money, and more often than not, a large multiple, as shown in Figure 3.

[4] Cagan, Philip (1956). "The Money Dynamics of Hyperinflation." In Milton Friedman (ed.), *Studies in the Quantity Theory of Money*. Chicago: University of Chicago Press.

Figure 3



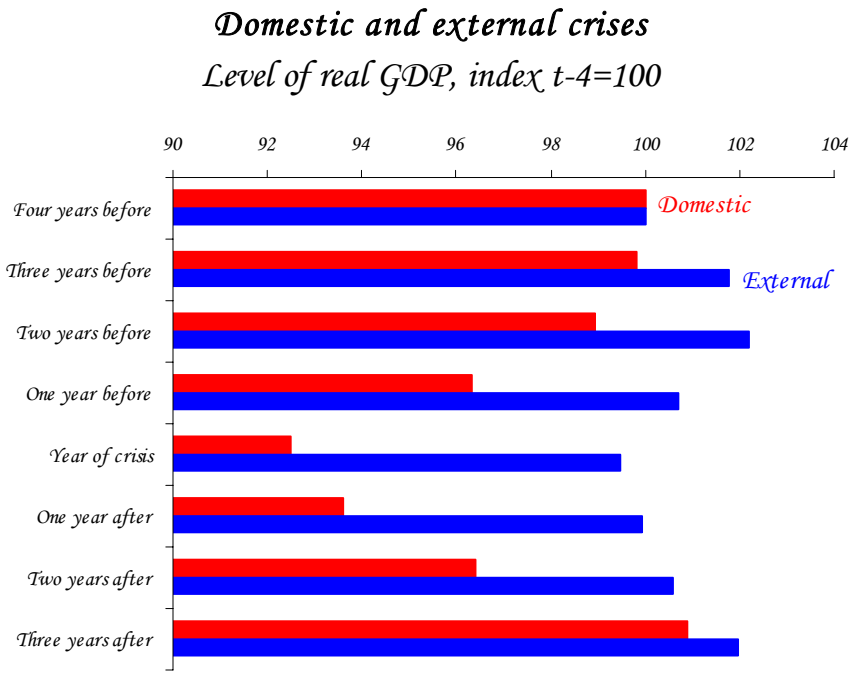

**Outright defaults on domestic debt**

***Where there are domestic debts there is also domestic default.*** Our paper offers a first attempt to catalogue episodes of outright defaults on and reschedulings of domestic public debt across more than a century. This phenomenon appears to be somewhat rarer than external default, but far too common to justify the extreme assumption that governments always honor the nominal face value of domestic debt. ***When outright default on domestic debt does occur, it appears to occur under situations of greater duress than for pure external defaults—both in terms of an implosion of output and marked escalation of inflation.*** As shown in Figure 4, in the runup to a default on

external debt, the economy is stagnant or in recession (on average, real per capita GDP edges down slightly from its level four years before the crisis); on the eve of domestic default, however, the output contraction is much deeper, as GDP registers an average decline of about 8 percent.

It is important to note that we do not here catalogue episodes of major *de facto* partial defaults, say through a sharp unexpected increase in financial repression (e.g., of the type China still imposes today).

Figure 4




**Reflections on future prospects**

Celebration about graduating from a history of serial default may be premature. This author is skeptical that proposed remedies to the syndrome of serial default, such as

contingent debt contracts (for example, see those discussed by Guimaraes) will significantly lessen the likelihood of sovereign default or restructuring. [5] One variety of a state-contingent contract is inflation-indexed debt. At the time of this writing, Argentina is engineering a partial default on its domestic debt by significantly understating the domestic inflation rate (reported at about 8 percent) to which the debt is indexed. Unofficial estimates of inflation are in the order of 25 to 30 percent.[6]

Governments that have repeatedly defaulted on their external debts, inflated away or outright defaulted their domestic debts, will, in all likelihood, not hesitate to default again.

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[5] See Bernardo Guimaraes "Emerging economies' debt contingent on world real interest rates," VoxEU October 8, 2007.

[6] For instance, see the story reported by the news agency Bloomberg on January 23, 2008. It led off, "Argentina's real inflation rate in 2007 was almost three times the official figure as a result of data manipulation, the union representing the National Statistics Institute's workers said in a report."