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D-DebtCon 2020 – “A Pandemic Test for the International Financial Architecture”

# Causes of sovereign defaults

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# Key Messages

**1**

**There have been 42 sovereign bond defaults since 1997, 21 of which took place since 2010**

- 36% of defaults were caused by institutional or political weaknesses, 33% by high debt burdens, 17% by chronic economic stagnation, and 14% by banking crises
- The number of banking crisis-induced defaults declined in the last decade, while those resulting from institutional weaknesses and high debt burdens increased

**2**

**ESG risks have contributed to all four default categories and have played a role in 36% of sovereign defaults since 1997**

- Hurricane damage played a significant role in rising debt levels in the Caribbean region and has directly triggered several defaults
- Governance risks have contributed to a number of defaults
- The coronavirus pandemic, a social risk under our ESG framework, triggered two defaults directly as of the end of July and will have substantial implications for public health and safety globally

**3**

**Default risk rises as debt burdens rise, but a high debt-to-GDP ratio is neither a necessary nor a sufficient condition for sovereign default**

- Debt affordability is better correlated with past default experience than debt to GDP
- Foreign-currency exposure presents a significant vulnerability
- Public enterprises' contingent liabilities can also trigger sovereign defaults

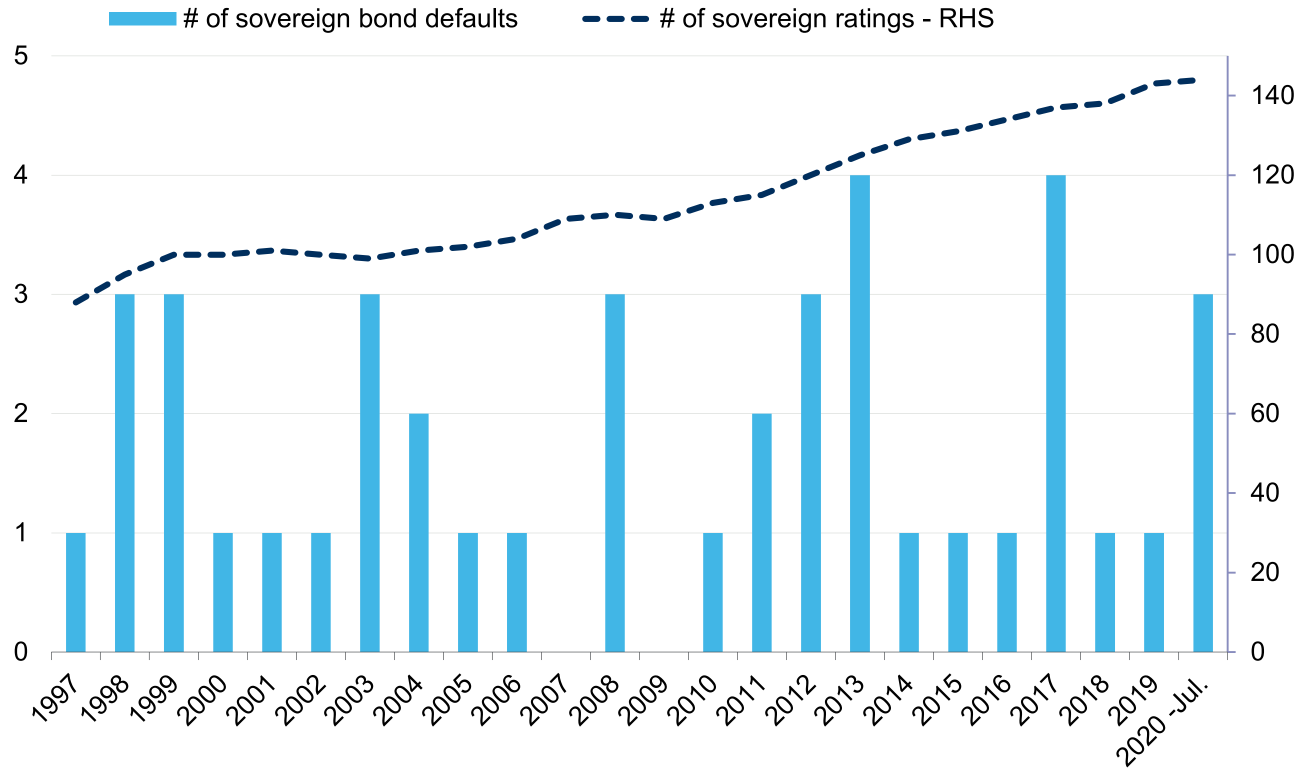
Link to the report: The causes of sovereign defaults, August 2020

# Update on the "Causes of sovereign defaults" 10 years later

## Motivated by investor questions and the coronavirus shock

- The coronavirus pandemic will lead to higher sovereign debt levels across the globe
  - On average, debt to GDP by year-end 2021 will be 20 pp higher across advanced economies and 10 pp higher across emerging markets
- We analyze the history of sovereign bond defaults since 1997 (the modern-era of bond financing for governments) to provide a perspective on:
  - **What is the role of debt levels in driving sovereign default risk?**
- Sample includes the 42 sovereign bond defaults from 1997 to July 2020

**Rated and unrated sovereign bond defaults, 1997 – July 2020**




Source: Moody's Investors Service

# The causes of sovereign defaults from 1997 to July 2020 can be grouped into four categories

### 1. Chronic economic stagnation

Chronic economic stagnation, a weak fiscal position and domestic vulnerabilities combined with large external shocks and loss of investor confidence to culminate in a default

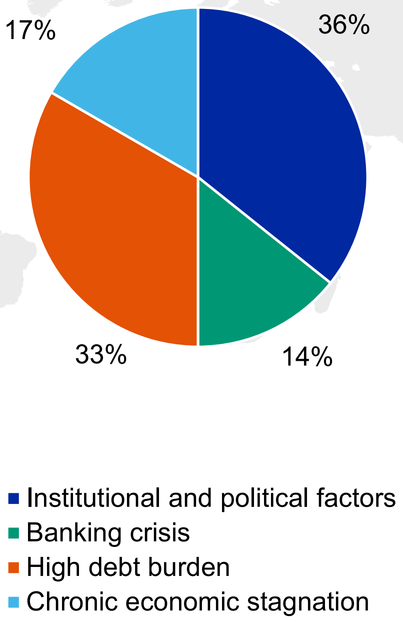
*Russia (1998), Ukraine (1998-2000), Argentina (2001), Grenada (2004, 2013), Venezuela (2017), Suriname (2020)*

### 3. High debt burden

Persistent external and fiscal imbalances built up to an unsustainably high debt burden. Slow buildup of debt and a deterioration in debt affordability eventually resulted in a default

*Pakistan (1999), Moldova (2002), Dominica (2003), Seychelles (2008), Jamaica (2010, 2013), St. Kitts and Nevis (2011), Greece (2012), Belize (2006, 2012, 2017), Barbados (2018), Lebanon (2020)*

**Sovereign defaults by four stylized causes**




### 2. Institutional and political factors

Civil conflict or institutional weaknesses, such as weak budget management, mismanagement of contingent liabilities and administrative delays, caused a default

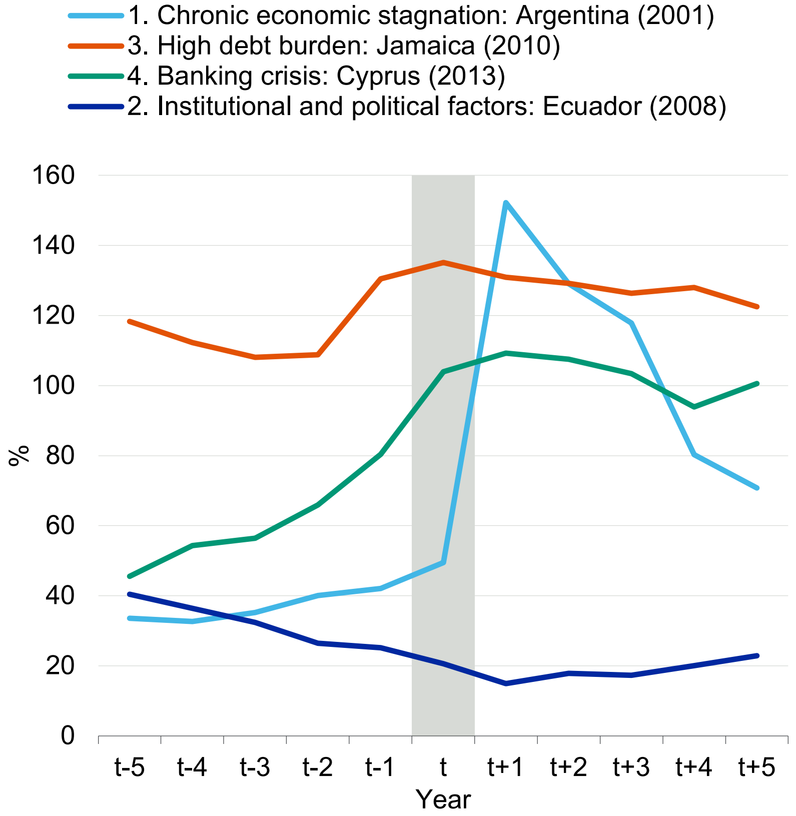
*Mongolia (1997), Venezuela (1998), Turkey (1999), Côte d'Ivoire (2000, 2011), Cameroon (2004), St. Kitts and Nevis (2013), Argentina (2014, 2019), Ukraine (2015), Mozambique (2016, 2017), Republic of Congo (2017), Ecuador (2008, 2020)*

### 4. Banking crisis

Systemic banking crises and capital outflows contributed to a large and sudden buildup of public debt and eventually triggered a default

*Ecuador (1999), Uruguay (2003), Nicaragua (2003, 2008), Dominican Republic (2005), Cyprus (2013)*

**Evolution of debt ratios around default differs across the four categories of sovereign defaults**
*Government debt as a share of GDP (t = year of default)*

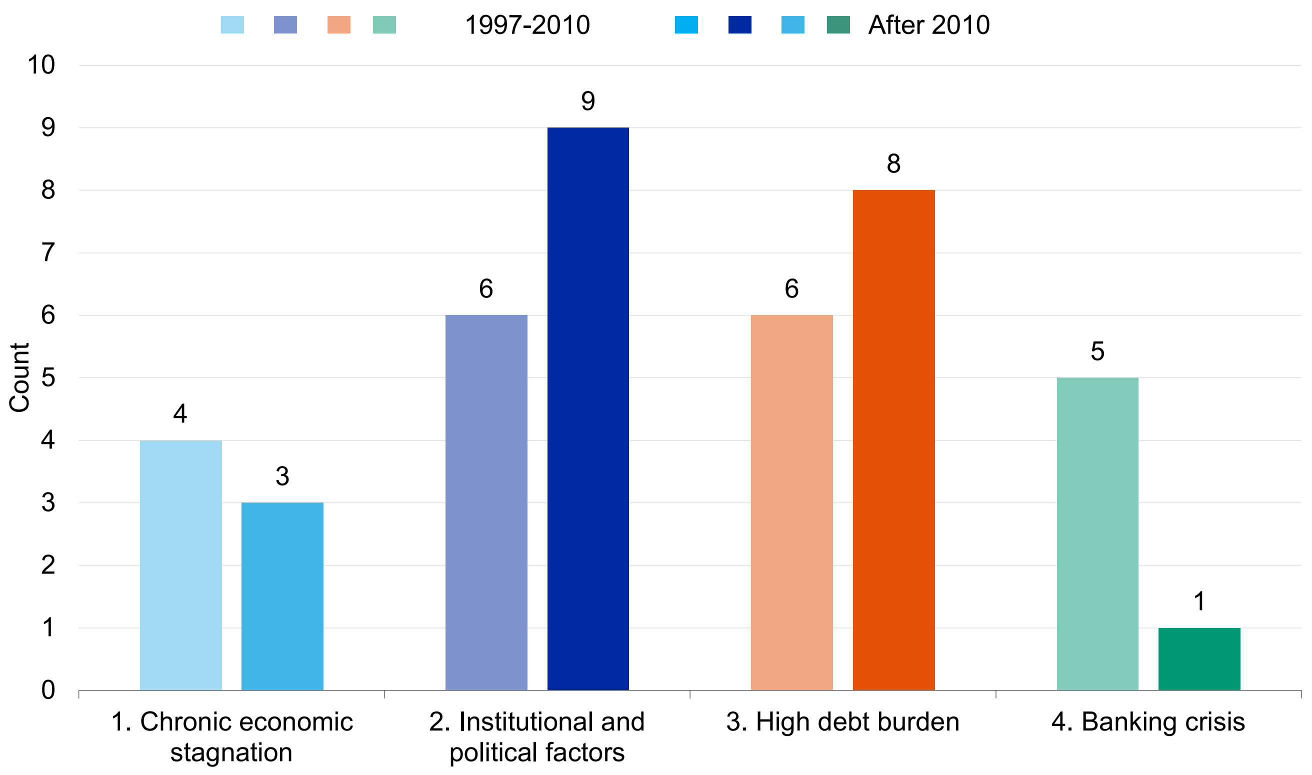



Source: Moody's Investors Service

# Defaults resulting from institutional and political factors and high debt burdens have risen since 2010

- The share of defaults caused by banking crises has fallen in the last decade
- The share resulting from institutional and political factors and high debt burdens has risen
- The average debt-to-GDP ratio for sovereign defaulters is 98% since 2010, compared with 71% in the 1997-2010 period
- The more recent experience has also highlighted that public enterprises' contingent liabilities can also trigger sovereign defaults

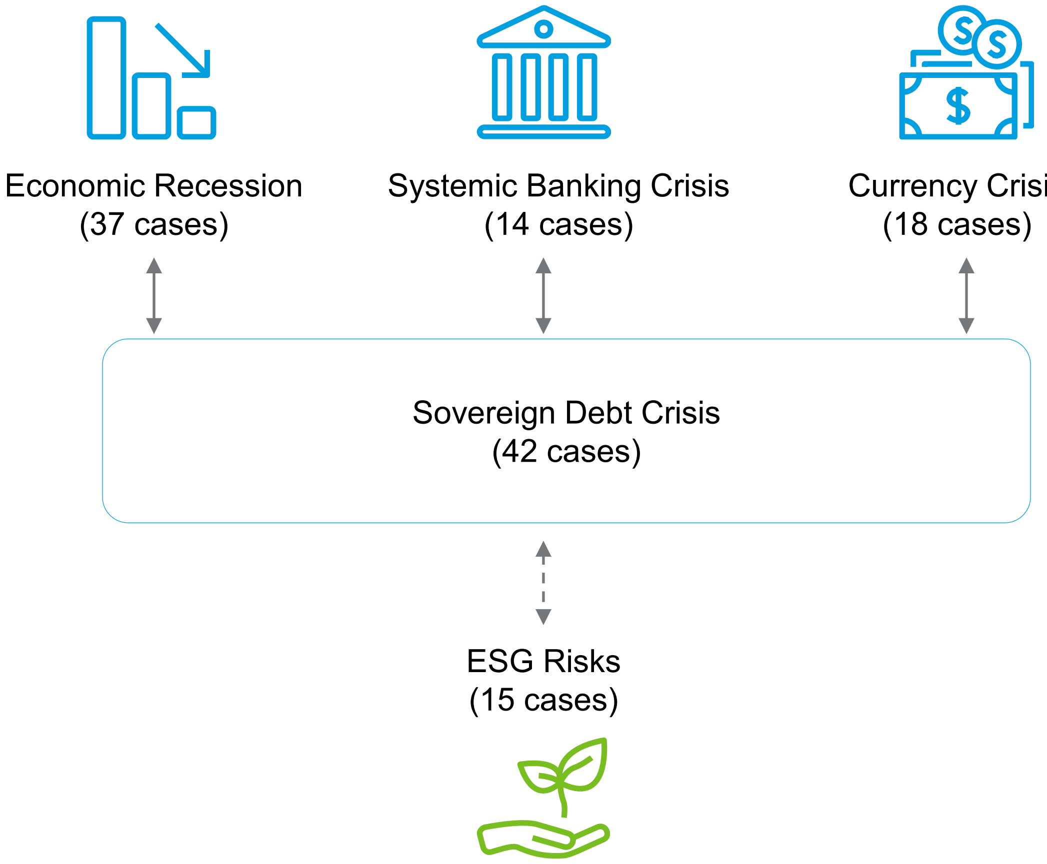
**Institutional factors and high debt burdens remain main drivers of sovereign defaults, while the share of defaults caused by banking crises has fallen in the last decade**




Source: Moody's Investors Service

# Sovereign defaults occur alongside recessions, banking crises, currency crises and other shocks

- Recessions accompanied almost 90% of defaults
- Systemic banking and/or currency crises accompanied 55% of defaults
- 14 defaults occurred along with deposit freezes and/or moratoriums on external private sector debt payments
- Environmental, social and governance (ESG) factors played a significant role in at least 36% of defaults
  - Natural disasters contributed to 21% of defaults, including a wave of defaults in the Caribbean region
  - Governance risks contributed to a number of defaults (e.g., administrative delays in Venezuela in 1998, materialization of public-sector contingent liabilities in Mozambique in 2016)
  - The coronavirus pandemic was a trigger in two defaults as of the end of July, Ecuador and Suriname, and Belize in August




Source: Moody's Investors Service

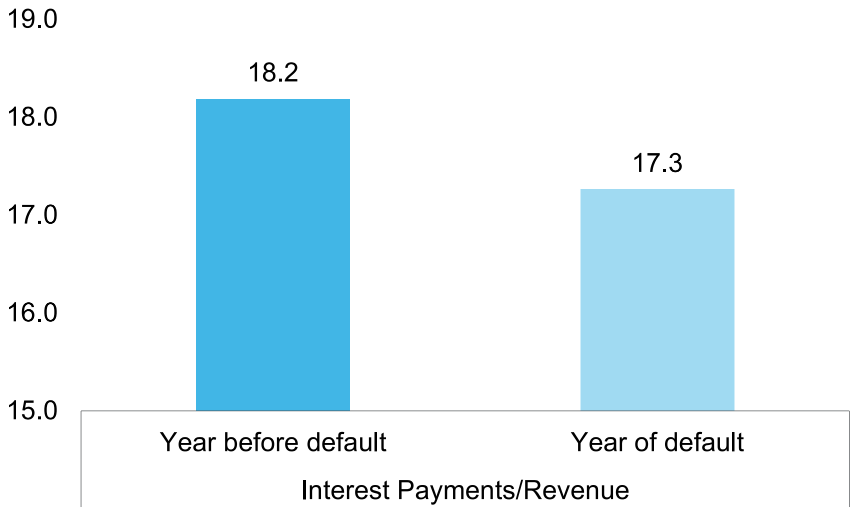
# Debt levels are not the only factor that determines ability to manage sovereign debt crises

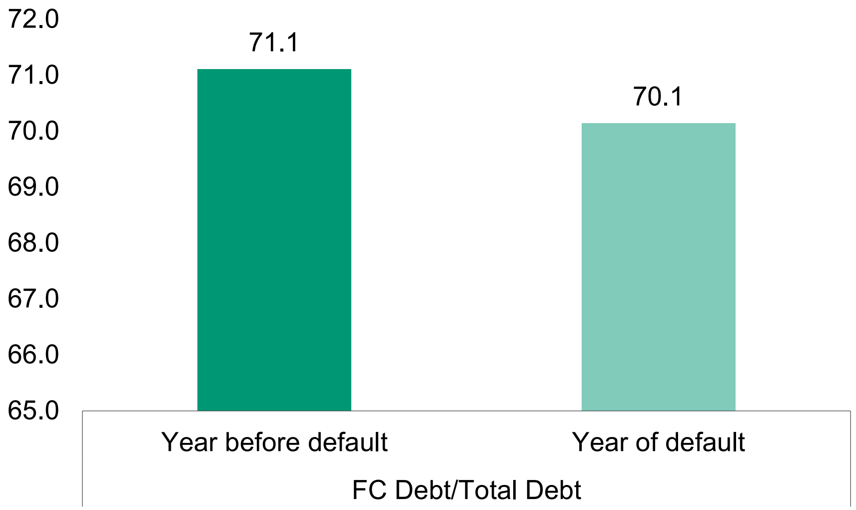
**Debt affordability is better correlated with past default experience than debt to GDP**

- A high debt-to-GDP ratio is neither a necessary nor sufficient condition leading to sovereign default
- Debt affordability ratios are better correlated with past default experience than are debt-to-GDP ratios

**Foreign-currency exposure presents a significant vulnerability**

- The existence of significant amounts of foreign-currency debt has been a critical vulnerability of defaulters
- In the year before default, the share of foreign-currency debt averaged around 70% of total debt



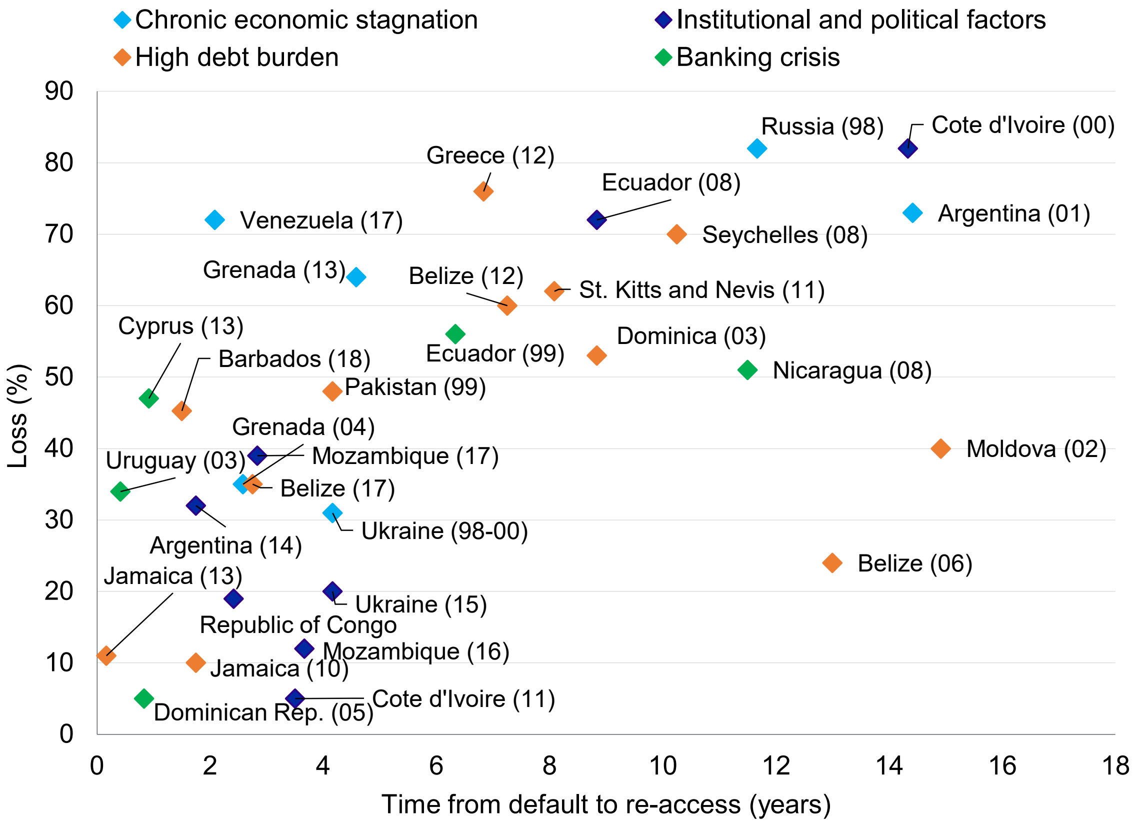




Source: Moody's Investors Service

# Recovery rates are somewhat correlated with the causes of default

- There is some correlation between recovery rates and the causes of default (although the sample size is small)
  - Defaults stemming from banking crises have the highest average recovery rate at 61%
  - In contrast, the average recovery rate for defaults resulting from chronic economic stagnation is the lowest at 41%
- Overall, sovereign recovery rates have varied considerably, ranging from 17% to 95%
  - Some of the largest defaults garnered low recovery rates, including Russia 1998, Argentina 2001, Greece 2012 and Venezuela 2017
- Market exclusion is highly correlated with the losses experienced by investors
  - There does not seem to be much correlation between the cause of default and the period of market exclusion post-default

**Market exclusion is highly correlated with the losses experienced by investors**




Source: Moody's Investors Service

# Moody's related publications

» Sovereign Defaults Series: The causes of sovereign defaults, August 2020

» Sovereigns — Global: FAQ on sovereign credit implications of the coronavirus pandemic, July 2020

» Sovereign defaults, deposit freezes and private-sector external debt moratoriums, May 2020

» Sovereign default and recovery rates, 1983-2019, May 2020

» Coronavirus — Global: FAQ on the credit implications of moratoriums on private-sector debt, April 2020

» Sovereigns – Global: Official debt relief would benefit weakest sovereigns, but uncertain role of private-sector creditors is credit negative, March 2020

» Sovereign Ratings Methodology, November 2019

» Sovereign Defaults Series: FAQ: The increasing incidence of local currency sovereign defaults, April 2019

» Slow productivity growth will pressure sovereign debt sustainability, February 2019

» General Principles for Assessing Environmental, Social and Governance Risks, January 2019

» Sovereigns - Global: Environmental, social and governance risks influence sovereign ratings in multiple ways, June 2018

» Sovereign Contingent Liabilities: Public Enterprises Represent a Material Source of Fiscal Risk to Some Sovereigns, January 2017

» Understanding the Impact of Natural Disasters: Exposure to Direct Damages Across Countries, November 2016

» Caribbean Sovereigns: The Silent Debt Crisis, February 2016

» FAQ: Credit impact of sovereign defaulting on official sector debt, May 2015

» Sovereign Defaults Series: The Aftermath of Sovereign Defaults, January 2014

» The Causes of Sovereign Defaults: Ability to Manage Crises Not Merely Determined by Debt Levels, November 2010

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