

Why Countries Default

BY DOUG CAMPBELL

“The Economics of Sovereign Defaults.” Juan Carlos Hatchondo, Leonardo Martinez, and Horacio Sapriza. Federal Reserve Bank of Richmond *Economic Quarterly*, Spring 2007, vol. 93, no. 2, pp. 163-187.

Nations have been defaulting on their debt for ages, and recent history has certainly seen its share. Sovereign defaults peaked at \$335 billion worldwide in 1990 before easing through the early 1990s. Then began a new string of problems as Russia defaulted on billions of dollars of debt in 1998, roiling global markets. Argentina’s default of \$82 billion was one of the largest recorded episodes in history.

In a new paper published by the Richmond Fed, a trio of economists survey the vast literature on sovereign defaults and conclude that even though there has been progress in the understanding of the economics of sovereign default, much remains unknown. Specifically, the precise costs that nations weigh in deciding whether to default are not well understood.

There is a consensus about what could be the main determinants of default episodes. Changes in external circumstances, such as unfavorable movement in international capital markets, can make it difficult for emerging countries to borrow at acceptable rates and terms. Changes in internal circumstances, such as declines in tax revenues during cyclical downturns or a change in political circumstances, may also trigger a default decision.

The big debate on sovereign defaults centers on identifying the costs associated with a default decision. Some analysts believe that creditors impose higher borrowing costs on nations that default. But the authors point out that this would require an unlikely degree of coordination among lenders in a time when international markets have evolved to the point where “almost anyone” can buy sovereign bonds. Also, the notion that defaulters are excluded from borrowing markets does not seem to be supported by empirical evidence. Finally, there may be “signaling costs” associated with a default. For instance, a default may signal that the policymakers in office are less prone to respect property rights or it may signal that the prospects of the economy are worse than what investors previously perceived. Though signaling costs seem plausible, the importance of this mechanism is unclear, the authors conclude.

Of particular interest to the authors are the political factors that drive default decisions. Some research has found that changes in top policymakers — such as among finance ministers — affect interest rate spreads, revealing “important signals about the government’s future policy course.” It is widely assumed that Argentina’s 2001 default was driven in large part by political ousters. In an upcoming

paper, the same authors try to extend these insights about political factors in default episodes. They develop a model in which policymakers of different types alternate in power. They find that the model may help explain both the high and volatile nature of interest rates in emerging markets.

“The Role of Small and Large Businesses in Economic Development.” Kelly Edmiston. Federal Reserve Bank of Kansas City *Economic Review*, Second Quarter 2007, vol. 92, no. 2, pp. 73-97.

With “smokestack chasing” increasingly out of favor, communities are looking to pour their resources into a different sort of economic development effort: cultivating entrepreneurs and encouraging existing businesses. Kansas City Fed economist Kelly Edmiston argues that economic developers are shifting their strategies to focus on small and local businesses. In this paper, she questions the effectiveness of this approach and ultimately finds that it makes sense but with some caveats.

“Small businesses may not be quite the fountainhead of job creation they are purported to be, especially when it comes to high-paying jobs that are stable and offer good benefits,” Edmiston writes. At the same time, small firms create the majority of new jobs and are important innovators in the economy. With recruitment of large enterprises unlikely to be cost-effective or successful, “concentrating on organic growth, or the growth of existing or ‘home-grown’ businesses, is likely to be a much more successful strategy.”

“Anxious Workers.” Rob Valletta. Federal Reserve Bank of San Francisco *Economic Letter*, June 1, 2007, no. 2007-13.

Unemployment is low, output is high, and jobs are plentiful. So why are American workers so worried about keeping their jobs? The dynamism of the U.S. economy raises living standards, but it leads to a constant churning of workers and firms.

Robert Valletta of the San Francisco Fed digs into job tenure statistics and discovers some plausible reasons for worker anxiety. Median job tenure has been falling since 1983 for most workers, except for women aged 35 to 54. Median tenure fell 30 percent for men aged 35 to 44 and 38 percent for men aged 45 to 64, or from 12.8 years to 8.1 years for this latter demographic. Meanwhile, firms are permanently laying off workers with more frequency, even highly educated workers. These findings, the author concludes, “lend credence to the view that worker anxiety about job stability and security is real rather than illusory.”

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