The curious case of the missing defaults

By Carmen Reinhart

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Usually, a sudden stop in capital inflows sparks a currency crash, sometimes a banking crisis, and quite often a sovereign default. Why, then, has the worldwide incidence of sovereign defaults in emerging markets risen only modestly?

Booms and busts in international capital flows and commodity prices, as well as the vagaries of international interest rates, have long been associated with economic crises, especially – but not exclusively – in emerging markets. The "type" of crisis varies by time and place. Sometimes the "sudden stop" in capital inflows sparks a currency crash, sometimes a banking crisis, and quite often a sovereign default. Twin and triple crises are not uncommon.

The impact of these global forces on open economies, and how to manage them, has been a recurring topic of discussion among international policymakers for decades. With the prospect of the US Federal Reserve raising interest rates in the near and medium term, it is perhaps not surprising that the International Monetary Fund's 18th Annual Research Conference, to be held on November 2-3, is devoted to the study and discussion of the global financial cycle and how it affects cross-border capital flows.

Rising international interest rates have usually been bad news for countries where the government and/or the private sector rely on external borrowing. But for many emerging markets, external conditions began to worsen around 2012, when China's growth slowed, commodity prices plummeted, and capital flows dried up – developments that sparked a spate of currency crashes spanning nearly every region.

In my recent work with Vincent Reinhart and Christoph Trebesch, I show that over the past two centuries, this "double bust" (in commodities and capital flows) has led to a spike in sovereign defaults, usually with a lag of 1-3 years. Yet, since the peak in commodity prices and global capital flows around 2011, the incidence of sovereign defaults worldwide has risen only modestly.

If the model fitted to almost 200 years of data is used to predict the share of countries in default, the predictions are consistently higher than what has materialized to date. This is the case of the *missing defaults*.

A caveat, as our study highlights, is that there is a potential mismeasurement of the "true" incidence of default, which we cannot begin to quantify at this time – namely, defaults or accumulated arrears on Chinese loans. China's lending to many emerging markets, most notably commodity producers, rose significantly during the last boom. While most of this lending is from official Chinese sources, much of it is not reflected in the World Bank data, and unknown amounts may well be in default or protracted arrears.

This state of affairs describes the situation in a number of African commodity producers and Venezuela. While Venezuela's government-run oil company continues to service its external bonds (which is why no default appears in the books of the credit rating agencies), debts owed to China are understood to be in arrears.

Measurement issues aside, there are two types of explanation for the *missing defaults*. The first is that emerging market economies are more resilient this time around. This view, which suggests a structural shift, was emphasized in early October during one of the most upbeat IMF/World Bank annual meetings in recent memory, and the message was echoed in *The Economist*'sspecial report "Freedom from financial fear."

Recent studies suggest that less procyclical fiscal and monetary policies and stronger macroprudential measures during the inflow phase or boom may have left countries on a more solid footing to cope with sudden capital-flow reversals. In the past, it was all too common for policymakers to convince themselves that a boom in commodity prices and associated surge in government revenues was permanent. Government expenditures would then ratchet up during the boom, only to be slashed as revenues sank along with commodity prices. Aside from waning procyclicality, macroprudential policies and capital controls appear to help restrain the intensity of aggregate credit booms and asset bubbles, with policies in place during the boom enhancing economic resilience during the bust.

The second type of explanation focuses on external factors. The largest global surges in sovereign defaults have usually followed a capital-flow reversal that overlaps with a spike in international interest rates. The worst outcomes (Category 5 hurricanes of debt) involved a triple blow to a class of capital importers (the commodity producers).

Today, global liquidity conditions have not tightened as markedly or as rapidly as in the bust phase of previous cycles. Exceptionally low and stable interest rates have acted to dampen debt-servicing difficulties among the debtor countries and may also help explain the missing defaults.

In sum, while there is evidence to suggest that the macroeconomic management of capital inflow surges has been improving over time in emerging markets as a whole, one has to recall that prior to the 2007-2009 global financial crisis, a widely accepted view was that the advanced economies had tamed the business cycle. This was the short-lived era of the so-called Great Moderation.

Perhaps the change is structural. But a more cautious interpretation of the missing defaults is that the protracted nature of the downturn in international conditions has yet to take its cumulative toll, or that lingering weaknesses will only become evident once the major central banks move further along in renormalizing their policy stances.

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