Sovereign Debt Default: Some Historical Perspective

European nations are struggling with their debt; it does not take a macroeconomic wizard to have seen this coming.

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As Europe continues to be tightly embroiled in an ever-escalating sovereign debt crisis, the meagre weaponry that has been deployed to date seems to be running out of ammunition. As an increasingly wide array of options are presented among member nations in Europe, and as the market apparently continues to shrug all of them off as unrealistic alternatives, the prospect of default in one or more European countries is becoming increasingly real. Some see it as inevitable.

Meanwhile, the widening of CDS spreads and increasing interest rates for all impacted nations makes short-term financing more expensive, pushing the battered countries further towards the brink. What once was considered a periphery issue for Europe is inching its way into the core countries, including nations such as The Netherlands and Belgium in addition to France and Germany.

The real shock here is not that these European nations are struggling with their debt; it does not take a macroeconomic wizard to have seen this coming. Aging populations, enormous numbers of public workers, large welfare states, decreasing productivity, and declining economic growth were all very apparent well before this became the full-blown crisis that we are experiencing today. In fact, even a brief overview of the history of sovereign debt defaults would have suggested that this crisis was, to a large extent, within expectations.

Part of the reason this crisis has been so pronounced, at least in this author's opinion, is that memories are becoming increasingly short. The last twenty years or so have seen relatively few sovereign debt defaults and those that have occurred have been relatively minor. While exceptions such as Argentina in 2001 and Russia in 1998 stand as counterexamples, the rest are largely forgotten. After all, given their comparatively small size, it is easy to forget the defaults of Pakistan (1999), Peru (2000), Moldova (2002), and Belize (2006). The comparisons to Greece are almost laughable; while Greece has been discussing a $180 billion debt write down, the total default in Moldova in 2002 was $145 million.

In a way, it seems fitting that so much of the distress today has been centered in Greece. This nation's pedigree for defaulting on debt to external creditors is the stuff of legend. Greece holds the honour of what is considered to be the first sovereign debt default in 377 B.C. At that time, thirteen Greek city-states borrowed from the Temple of Delos; the lack of repayment meant an 80% loss of principal to the debt holders (I will resist the temptation to compare the Temple of Delos to European banks).

In addition, in the last 200 years, Greece has defaulted on its external debt obligations no less than five times. All told, Greece has been subject to 90 years in default, meaning that the nation has spent approximately half its time as an independent nation in default on its sovereign debt. It is easy to blame these defaults on larger, overarching factors; the first default occurred on loans taken during their battle for independence, the last during the Great Depression. However, the historical experience of Greece and its sovereign debt is telling. One could even make the argument that Greece was overdue for a default.

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The incredible thing is that it is relatively unfair to pick on Greece. Indeed, the global capital markets seem to feel the same way, as attention has turned to countries such as Italy, Spain, and France. What makes it so unfair is that Greece is hardly alone in having a less-than-impressive repayment record on sovereign debt, both compared to its European neighbours as well as the rest of the world. Very few nations, large and small, advanced or developing, have been able to truly "graduate" from the status of a serial defaulter.

Spain is a tremendous example, especially given the country's current predicament. The national experience of default has been remarkable, with defaults in 1557, 1575, 1596, 1607, 1627, 1647, 1809, 1820, 1831, 1834, 1851, 1867, 1872, 1882, and 1936. These periods of default, scattered over hundreds of years, demonstrate that some countries apparently never can truly kick the habit of default. An interesting item to note in Spain's long history is that there was a stretch of more than 150 years where the country did not default, between 1647 and 1809. Following that period, however, the country defaulted eight times in less than 75 years. The implication is important: just because something has not happened for a while does not mean it cannot happen again.

Another interesting aspect from the historical perspective is the frequency of default following periods of profound economic contraction. We can see this if we examine the years immediately following the onset of the Great Depression, which is generally accepted as 1929. Over the next ten years, before the onset of World War II, a large number of nations defaulted on their external debt.

In the Americas, Bolivia, Brazil (twice), Chile, Columbia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay all experienced some form of external default. In Europe, Austria, Greece, Germany, Hungary, Poland, Romania, Spain, Turkey, and the United Kingdom all had similar periods of default on their obligations.

Notice that, effectively, all of Central and South America as well as a huge part of Europe were in default throughout the full decade following the stock market crash of 1929. Many observers are wondering if we are heading into a similar period of default. Widespread economic contraction in 2007-2008 led many governments to take on enormous amounts of debt in an attempt to boost growth and bailout organizations deemed "too big to fail". As growth has been slow to return, these inflated public debts have become hugely burdensome and perhaps unsustainable.

What lies ahead for the global economy, specifically with respect to the finances of sovereign nations, remains to be seen. However, even a cursory glance in the rearview mirror could potentially offer some insights on what is to come. One of our largest issues in the current debt crisis appears to be our unwillingness to extend our observation periods back far enough. Just as it would be foolish for a portfolio manager to back test an investment strategy using only a couple of years of data, it is equally inappropriate to think that the last few decades are indicative of the long-run trend in sovereign debt defaults; we ignore the lessons of our collective financial history at our own peril. *

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