

Carmen Reinhart Presentation on Debt Intolerance

June 2, 2004

Speaking before the IDB Board of Directors, Carmen Reinhart discussed the syndrome of "debt intolerance," whereby countries with weak institutional structures and problematic political systems borrow in order to avoid difficult fiscal decisions but subsequently find themselves unwilling or unable to repay. Debt intolerance, it should be noted, is by no means a recent phenomenon: the historical record shows repeated defaults by several European countries before 1900 and, in some instances, well into the twentieth century.

For currently debt-intolerant countries, which are found among the emerging economies, the threshold for "safe" debt levels is surprisingly low, at approximately 35 percent of Gross National Product, with attendant risks of default and debt restructuring. For some countries, which have histories of bad credit and high inflation, the threshold is even lower. Another notable characteristic of debt-intolerant countries is that their debt-to-GNP ratio is much higher than that of countries with no history of default (on average, the figure for frequent defaulters is 28 percent, while that of their non-default peers is only 14 percent). Moreover, these ratios appear to predict default more accurately than the Institutional Investor country ratings.

For purposes of cross-national comparison, countries are divided into three "debtors' clubs." The first, and most exclusive, consists of advanced economies with continuous access to capital markets. At the other extreme are highly indebted poor countries with no access to capital markets. Between these two clubs lies a continuum of countries with intermittent access to capital, and for them only incremental changes in risk can greatly increase the chance of default. That risk is influenced particularly by debt level, a history of high inflation, and a history of previous defaults.

General trends notwithstanding, safe debt thresholds are country-specific and may be well above or well below average levels.

Whatever countries' debt history may be, it appears that they can graduate from debt intolerance through sustained discipline in borrowing. Under almost no circumstances has it been possible for countries to grow out of their debts; the only available example is provided by Swaziland in 1985. Foreign debt reversals, defined as a decline of 25 or more percentage points of GNP within a three-year period, are generally achieved by one of the following two means: i) default or restructuring, or ii) significant debt repayment. Once countries have achieved debt reversals, though, they must refrain from quickly releveraging to previous levels of indebtedness, and they must hold down debt levels for approximately 25 years in order to escape the cycle of debt intolerance. Experience to date indicates that financial markets cannot be counted upon to discipline countries' borrowing behavior, as the pursuit of high yields has repeatedly led to ill-advised investments in emerging markets.

In addition to international debt intolerance, the newer phenomenon of domestic debt intolerance poses additional dangers. Before the 1980s domestic debt in developing countries did not represent a great cause for international concern, as financial repression through bank financing usually provided access to funds at low interest rates. In addition, until that time domestic debt was not widely traded. Following the banking crises in many developing countries during the 1980s, the restructuring and in some case privatization of financial systems led governments to seek new sources of debt. Movement toward other sources, including debt denominated in foreign currencies, increasingly blurred the line between debt placed on domestic and international markets.

Governments' use of debt to finance deficits appears to have been intensified by the effects of structural reform policies such as lower tariff revenues and a reduction in the de facto "inflation tax" as macroeconomic discipline figured more prominently in national policies.

The tendency to incur dollarized domestic debt calls for particular attention, as this represents a form of domestic debt intolerance. Resulting from the same factors as external debt intolerance, namely

concerns regarding inflation in national currencies and governments' ability to repay, dollarized debt paradoxically makes countries more vulnerable due to a currency mismatch between revenues and debts. Given debt-intolerant governments' past behavior toward foreign creditors, it appears quite possible that a wave of restructurings or outright defaults of domestic debt may take place in the early part of the twenty-first century.