FINANCIAL LITERACY
FOR YOUTHS

What Happens When a Country Goes Bankrupt?

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How Can a Country Go Bankrupt?

Theoretically and in a perfect world, governments pay their bills using income from taxes and investment. However, just as how we as individuals often spend beyond our means and resort to credit spending, a government does it by issuing bonds with the promise to pay back the value of the bonds with interest rate at its maturity rate. National debt, also known as sovereign debt, consists of internal and external debts. While internal debts constitute of debts owed to those within the country, external debts refer to foreign-currency-denominated bonds issued by the government and sold to foreign investors (Investopedia, 2017). While internal debts can be financed through fiscal and monetary policy-by raising taxes and printing more cash, external debts may divert fund from all other parts of the revenue-generating activities as it needs to be paid using foreign currency, which government has no control over.

Default happens due to a nation's inability or unwillingness to repay its debts. The latter often happens when there is a change in governing party of a nation: new government would default on the debt it inherited from its predecessor. There are also various reasons as to why a country defaults on its debt such as simple reversal of global capital flows and weak revenues. For instance, Jamaica's default on its $7.9 billion loan in 2010 was due to its government overspending and the deterioration of its key sector - tourism.

"The country goes bankrupt". That is in fact, a wrong statement. Firstly, a country does not go bankrupt but instead, defaulted on its loan when it fails to repay its debts. Secondly, country does not default, its government does (Abascal, 2015). A nation defaulting on its debts may seem like a rare case, but most countries have defaulted or restructured their debts at least once in their history (The Economist, 2014). Greece was the first country to default on its debt in 377BC, apart from its renowned default of $1.8 billion as being the first developed country to ever default on IMF loan. Since its independence in 1829, Greece has spent around half of its time in defaulting its debt (Bojesen, 2012). Spain, on the other hand, has defaulted the most times: 15 times during the eighteenth to nineteenth century.

Often, before defaulting on its loans, member countries of International Monetary Fund (IMF) may seek for bailout rescue from IMF, which not only provide financial resources, but the technical expertise to manage the bailout program (Amaro,2017). However, these bailout funding is never a free lunch, as it comes with stringent conditions such as austerity (cutting expenditure), devaluation of currency and trade liberalization, as established in the Washington Consensus.

What Happens After a Country Defaults?

In the event of individual or company bankruptcy, the assets are repossessed by the creditors. During a country's default however, neither its assets can be seized by its creditor nor can the country be forced to pay with the money it does not have. However, there is no guarantee that this does apply to the country's assets abroad. This was the case when Argentina's navy training ship which was then in Ghana, was seized when Argentina defaulted in 2012.

The only recourse for the creditor of the defaulted country is to renegotiate the terms of the loan. Government bonds will be rescheduled for deferred payment or underwent 'haircut', which involves reducing the value of bonds. After its $81 billion default in 2011, Argentina offered to pay its creditors a third of what it owed. In this regards, 93% of the debt was swapped for performing securities in 2005 and 2010, and not only until 2016 that Argentina repay 85% of the remaining debt held by vulture fund for 75% of its original value (Blitzer, 2016).

What Are the Effects of Defaulting?

The immediate cost of defaulting is the loss of principle and capital of creditor resulting from either partial debt cancellation or debt restructuring. Among the debt owed to different creditors: domestic private creditor, domestic institutional creditor, foreign private creditor and foreign institutional creditor, the government is most likely to cancel debts owed to foreign private creditor due to the less likely retaliation. Besides, just as any other crisis, soaring inflation, unemployment and political pressure to the defaulting government follow as a result of government defaults.

As most of the domestic debt is held by domestic banks, bank runs occur due to the loss of confidence in the banking system. Bank runs occurs as there is massive withdrawal of money due to public panic and loss of confidence. To prevent this, capital control is imposed as government try to restrict the amount of money that can be withdrawn by each depositor. In June 2015, Greek banks were closed for almost 20 days, bank transfers to foreign banks were controlled and cash withdrawals were limited to only €50 per day to avoid banking crisis. Sovereign debt crisis may also lead to subsequent economic crisis and currency crisis as aggregate demand fall and international market lost faith in its currency.

Another effect that is certain about a defaulted country is its lost of accessibility to the credit market. Punitive rate is imposed on its loan or in most cases, it will not get the loan at all. Credit rating of defaulted country will be affected, deterring foreign investment in the country.

An Opportunity for Investing?

Default deters domestic and foreign investment. However, the fall in assets prices and exchange rate of the defaulted country has made these assets easily affordable for foreign investors. This may signify investment potential in the defaulted country. There are also investors who see default as the perfect time to invest. Vulture funds seek to profit from the crisis by mass purchasing high yield (high risk) bonds of the near-default or defaulted country at highly discounted price and anticipate rebound on its values as the country recovers. However, it carries risks as to whether there will be a rebound in the asset prices in the defaulting economy, or if the recovery is worth the wait.

Is Defaulting the Only (Best) Way Out?

Due to the cost of default, a country will choose to default only if it is better off not paying its debts. In Argentina, many think that default was the best thing to happen. After the peso plummeted, Argentina product becomes more competitive in the international market. The inflow of money lead Argentina to its recovery. In addition, evidence suggests that the adverse effects of default are rather short-lived. The borrowing cost due to downgraded credit ratings lasts about 2-7 years, the loss in economic growth may be picked up in few years' time and the loss of confidence may eventually be regained. The effect of default will be less substantial if it relies less on foreign loans as it is able to soothe out these effects through implementation of monetary and fiscal policy.

Defaulting on loan may be a boon than a bane for a heavily indebted country despite its consequential effects. As Paul Blustein, author of *And the Money Kept Rolling In (and Out): Wall Street, the IMF, and the Bankrupting of Argentina* has put it: In the long run it will be better for the country than if they had tried to struggle on and pay debts that were too great a burden for the economy to bear" (NPR, 2011).

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