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Special topic: how frequently do sovereigns default on local currency debt?

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BoC–BoE Sovereign Default Database
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A long-held view among some market participants is that governments rarely default on local currency sovereign debt.[1] After all, they argue, governments can service such obligations by printing money, which in turn can reduce the real burden of debt through inflation—dramatically so in cases such as Hungary in 1945–46 and Zimbabwe in 2007–08.

Of course, high inflation can be a form of de facto default on local currency debt. Still, outside these exceptional episodes, contractual defaults and restructurings of local currency debt do occur and are more common than is often supposed. A key objective of our work updating the sovereign default database is to document such cases.

Identifying local currency defaults is challenging in part because governments rarely acknowledge them. Another factor contributing to the limited visibility of these defaults is that affected investors are mostly domestic residents with limited avenues of redress. Cross-border investment in sovereign local currency debt instruments, a phenomenon dating back to the 1990s, has undoubtedly contributed to greater awareness of more recent default cases.

Thus far, we have identified 32 sovereigns involved in local currency defaults between 1960 and 2019. These defaults take different forms. Perhaps most surprising is the number involving the exchange of old currency for new on confiscatory terms. We found that 17 sovereigns have undertaken such exchanges, with some (e.g., Ghana, North Korea, Myanmar and USSR/Russia) doing so more than once. Creditor losses result because of the

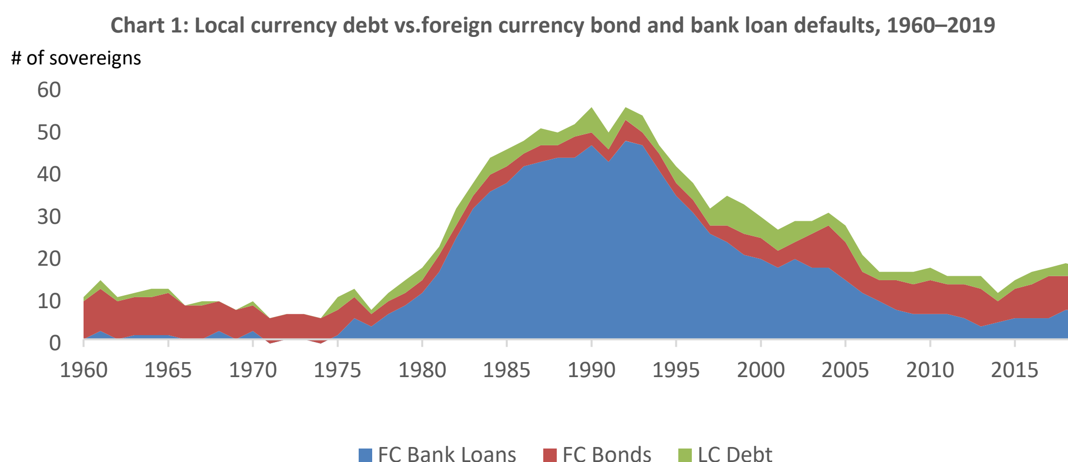
[1] This section has been updated from the working paper published in 2018.

conditionality authorities typically impose—notably setting short time frames in which exchanges of old bank notes for new can occur, placing limits on amounts that can be exchanged, requiring that notes above such limits be deposited in blocked accounts, and barring participation in such exchanges by foreign holders of old currency.

The factors triggering confiscatory currency reforms appear to be idiosyncratic. They can follow a change in political regimes or be part of an official strategy to curtail black markets. As such, these defaults do not always reflect broader financial distress. Among the countries involved, there are only four cases (Democratic Republic of Congo, Nicaragua, USSR/Russia and Venezuela) where the government also defaulted on other types of local currency debt, although many more ultimately defaulted on their foreign currency debt. Another case, Peru, involves bonds adversely affected by high inflation where local courts ordered compensation to creditors that has not yet been implemented. Still other cases involve overdue interest and principal payments and/or restructurings of maturities (16), unilateral reductions in real interest rate coupons on inflation-linked debt (2), restructuring and conversion into foreign currency debt (1), and new taxes targeting local currency debt service (1).

Chart 1 tracks the annual number of defaults on local currency debt we have identified in the 1960–2019 period compared with defaults on foreign currency bank loans and bonds, the two other principal types of sovereign debt owed to private creditors. Through nearly half the survey period, defaults on foreign currency bank loans predominated. However, since the mid-1990s, as international banks curtailed their sovereign lending, defaults on foreign currency bonds have increased. The frequency of defaults on local currency debt has been more variable: their number gradually picked up after the 1970s but has trended down again since the early 2000s. Over the past decade, between five and ten sovereigns have defaulted on foreign currency bonds each year and between two and three on local currency debt.

Chart 1: Local currency debt vs.foreign currency bond and bank loan defaults, 1960–2019



Source: BoC—BoE sovereign default database

Interestingly, since 1960, defaults on foreign and local currency market debt by the same sovereign have happened concurrently less than half the time. These patterns may be starting to shift, however, as government debt burdens grow alongside domestic debt markets,

attracting higher cross-border investment.[2] As a result, defaults on local currency debt could become as common as defaults on foreign currency bonds in future episodes of sovereign debt distress.[3]

[2] In 2018–19, for example, the value of local currency debt Barbados restructured far exceeded that of its foreign currency bank loans and bonds.

[3] Until now, our efforts to identify local currency defaults have focused on *marketable* debt. In the 2020 database update, however, we introduce data for 2018 on *domestic arrears*—covering overdue payments to suppliers, civil servants and pensioners—which, when lawfully contracted, are also effectively defaults on government obligations. For details, see "BoC–BoE Sovereign Default Database: What's New in 2020?"