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Sovereign Default Risk and Private Sector Access to Capital

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"Top down" spillovers of sovereign default risk to domestic corporations in emerging markets have serious consequences for the private sector. This paper analyzes the effects of these spillovers, assessing in particular how sovereign default risk affects private sector access to international capital markets, in the form of external credit (loans and bond issuances) and equity issuances. The study focuses first on default episodes during the 1980s and 1990s, to assess the effect of sovereign debt crises on corporate external credit. It goes on to examine the 1993 to 2007 period, using additional measures of sovereign risk – sovereign bond spreads and sovereign ratings – as explanatory variables.

An innovation of the study is its focus on access of the private sector in emerging markets to foreign capital. Few studies have explicitly investigated this issue, and even fewer have explored the link between sovereign risk and private sector external capital. But the increasing importance of corporate external financing for developing countries calls for more systematic analysis; the study draws on new data sets in an attempt to fill the gap.

The analysis is based on aggregate firm-level data from the Dealogic database on corporate external loans and bond issuances, as well as equity; the advantage of these datasets is that they avoid some potential biases of aggregate, country-level capital flow data. In addition, the study uses a new, comprehensive dataset on sovereign debt crises of the last three decades, built via a systematic evaluation of more than 20,000 pages of case studies and news material on crisis cases, as well as all standard reference books and data sources. We assess the effect on corporate external credit during debt crises of the following: (i) duration of debt crisis and month of agreement (start of distress and negotiations, interim agreements, final agreements), (ii) periods of breakdowns and delays in debt renegotiations, (iii) litigation episodes between governments and private creditors (vulture funds, for example), and (iv) episodes of disputes among creditors.

The study's findings have several important implications for policy. Our finding that sovereign defaults towards private creditors cause a drop in private sector borrowing of more than 40 percent (an effect that holds for one year after the crisis ends) offers a new insight: so far, studies had found a strong adverse impact only for defaults towards official, Paris Club creditors. We attribute the different findings to the new, more accurate measures of debt-crisis episodes and restructuring agreements.

Another finding is that delays in debt negotiations have adverse effects for private sector credit, whereas IMF programs have a positive effect. Interestingly, inter-creditor disputes and litigation have no negative spillovers. Apparently, government behavior in distress situations has a larger impact than creditor behaviour. Policymakers may take these findings into account when facing situations of debt distress or the need for a sovereign debt restructuring.

The analysis of corporate external credit for the period 1993 to 2007 – extended to include equity issues because equity has become an important, alternative source of financing for emerging market firms during that time – establishes that sovereign risk plays a crucial role for private sector access to capital. Specifically, we find that higher sovereign bond spreads, using JP Morgan's emerging market bond index (EMBI), and lower sovereign ratings, taken from Standard & Poor's and the Institutional Investor magazine, have a strong negative effect on the volume of corporate credit and/or equity issued.

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The results of the study provide novel evidence on sovereign risk spillovers to the private sector, corporate access to capital in emerging markets during crises, and the broad domestic costs of sovereign default. Emerging market governments should be aware of the effect of country-risk perceptions on their domestic economies. Government actions affecting sovereign risk, such as threats to default on sovereign debt, might have unintended consequences for the volume and terms of external borrowing of the country's corporations. In view of the current financial crisis in the United States and Europe and a possible global economic slowdown, sovereign risk in emerging economies is likely to be on the rise again – which might well constrain future corporate external financing in these countries.