Economist on why emerging markets renege on loans

January 8 2014, by Kathy Hovis

For emerging markets struggling to stay afloat, securing loans from foreign investors can be a lifesaver. But when neither creditors nor investors are sure of the economy's chance of success, the outcome can be unpredictable.

Countries that are willing to raise taxes during good times – who have confidence that their economy will improve and political leaders courageous enough to make spending cuts – will fare better than others in avoiding defaults to foreign investors, according to research from Viktor Tsyrennikov, assistant professor of economics.

Tsyrennikov researched the behavior of investors and governments to discover the factors that lead emerging market countries to default on their loans for his paper, "Fiscal Policy, Sovereign Debt and Default in the Light of Model Uncertainty," presented in November 2013 at a New York University reading group.

Tsyrennikov's research focuses on Argentina's fiscal crisis of 2001 and 2002. In 2001, Argentina was in a major economic depression, spurred in part by economic problems in Mexico and Brazil and its own heavy borrowing.

The economic crisis caused widespread unemployment, increased poverty, riots and the eventual fall of the government, as well as the country's default on foreign its debt.

"The Argentinian government cared about its people and wanted to stimulate the economy by lowering taxes," Tsyrennikov said of the crisis. "But there came a tipping point when they came close to default. They needed to go back and tax citizens to support government spending."

Along with taxation, Argentinian officials also tried to lower spending, cutting workers' salaries by 13 percent, but encountered mass protests and social unrest.

These factors led the country to default on 70 percent of its debt – or $154 billion – in January 2002. Tsyrennikov's research shows the relationship between a number of factors (e.g., reduced economic activity and inability to control fiscal deficit) and how they affect government borrowing and default decisions.

Government debt is volatile, Tsyrennikov said. During good economic times, governments often have very little debt. However, when crisis strikes, governments quickly deplete their savings and amass debt just as quickly.

Tsyrennikov said his research could help government policymakers to assess their strategies when borrowing and managing a volatile economy, perhaps most importantly the need to consider other options before borrowing, he said. Tsyrennikov's model also could be used to construct an "early warning" default indicator similar to the Emerging Market Bond Index produced by J.P. Morgan.

Tsyrennikov's research interests lie in macroeconomics and international finance, with a focus on computer modeling to answer complex economic questions. He teaches macroeconomic theory and computational economics at the graduate level as well as an undergrad course in international finance.

"In my international finance class, the students talk about issues like the default in Argentina and interpret such events using the theories they learn in class," he said. "Then over the holidays, they can go home and explain to grandma what's going on in the world."

More information: The paper, "Fiscal Policy, Sovereign Debt and Default in the Light of Model Uncertainty," is available online: www.economics.cornell.edu/tsyr … iles/default-gov.pdf

Provided by Cornell University

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