Annual Bank Conference on Development Economics 2024
The Great Incoherence: Growth and Human Development in An Era of Stagnation

Session 2: Sovereign Debt and Default
Comments by Luca Bandiera

July 9, 2024
Comments

• Key contributions
  o Paper 1: The Financial Returns on China’s Belt and Road (Christoph Trebesch, Kiel University) [B&R]
  o Paper 2: Sovereign Defaults at Home and Abroad (Enrico Mallucci, Federal Reserve Board) [DH&A]
  o Paper 3: Why do Some Countries Default More Often Than Others? The Role of Institutions (Rong Qian, World Bank) [D&I]

• What could be clarified
  • Policy implications
  • Data and definitions
  • Regression, regressors
  • Theoretical model
Key contributions

• Granularity of the default and restructuring data has invaluable importance for empirical analysis on debt distress
  • When do default events start?
  • How long do they last?

• Growing importance of domestic debt default episodes and difference wrt external default episodes
  • Most domestic debt default episodes do not overlap with external ones
  • Different macro, political and financial architecture contexts

• Importance of political-related variables, in addition to quality of institutions, for defaults frequencies
  • Polarization, Election cycle, political constraints

• Features of default episodes and their resolutions
  • Mainly debt reprofiling, no nominal haircuts
  • Many pre-emptive
  • Deeper creditors losses in domestic debt restructuring
Policy implications

Clear messages

- Defaults are costly, better to avoid them
  - Better institutions lower risk of default, independently from polarization [D&I]: Policy dialogue and TA matter.
  - Focus of support is different in external (BOP, capital flight) and domestic (financial stability) defaults [DH&A]

- Deep debt relief and fast debt workout do not go together
  - Most debt restructuring increase maturity, reduce coupons both for commercial [DH&A] and Chinese banks [B&R]

- Loans from Chinese banks do not follow economic/financial risk assessments but are politically motivated or facilitate other objectives
  - The largest creditor may not help countries maintain debt sustainability [B&R]

Other policy implications are less clear

- IFIs have little leverage on political systems (polarization and political constraints) or electoral cycles. [D&I]
  - Alternate different meaning of “polarization” implies different solutions
    - Leverage of subnational governments and SOEs over national government
    - Unequal distribution of income (high Gini coefficient)

- Are Chinese debt restructuring coordinated with comprehensive debt restructuring? With similar NPV losses? [B&R]
  Why “Belt and Road”? Data starts in 2000, the Belt and Road Initiative in 2013

- External debt restructuring not associated with IMF program, but with Paris Club restructuring (that takes place in the context of the IMF programs). [DH&A]
Data and definitions

- [B&R] and [DH&A] build a database of default and restructuring, but no precise definition of defaults and restructuring periods. This is very relevant for empirical analysis.

- [B&R] implies that many loans (slide 10) are not from China EximBank or CDB. This is new but no sufficient discussion.

- [D&I] uses default probabilities from Reinhart and Rogoff (2009), there are more updated databases, including: CRAs, Farah-Yacoub et al. 2022, Horn et al., 2022, IDS tracks arrears to commercial creditors; Bank of Canada database of debt in default.

- Measures of quality of institutions [D&I] and [DH&A]
  - International Country Risk Guide (ICRG): highly correlated with GDP per capita (81%)
  - A regulation of participation index: unusual and correlated with ICRG (61%)
  - Why not Worldwide Governance Indicators?
  - Institutional variables: parliamentary/presidential democracies, federal states, presence of fiscal rules, legal system.
Regressions, regressors

• [B&R] focuses regression on financial returns and emphasis on loan purpose and characteristics.
  • Would country characteristics matter? LICs/MICs, recipient of concessional financing and grants
  • No similar analysis for PV reduction. Are there countries where China provide more/less debt reduction? Do loans terms matter for type/amount of PV reduction? Do different banks provide different debt relief?

• [DH&A] Regressions to measure how macro, financial and political/geopolitical variable deviate from normal times during domestic and external restructuring episodes.
  • A probit/logit regression would instead measure how those regressors would determine the probability of domestic and external default

• [D&I] Some regressors are highly correlated (log GNI per capita, ICGR, ParReg)
  • Robustness check with other variables, IV?
Theoretical model

- [D&I] There is no variable for quality of institutions in the model
  - the result of the model (the two propositions) and the calibration seem to imply that polarization always negatively impact on the probability of default, cost of borrowing and level of borrowing.

- Calibration well grounded in economic literature
  - The risk aversion parameter $\sigma=2$, while in economic literature is $\sim1$. Does this change results?
Thanks