

The Economics of Sovereign Debt and Default: An Analysis of Debt Dilution

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Comments by
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Introduction

- Super interesting work by two leading economists
- Provides simple, unified, canonical framework about sovereign debt
- Book
 - Frictions in debt markets
 - Commitment/enforcement
 - Self-fulfilling debt crises
 - Government choices about debt and default
 - Long-term bonds
 - Different equilibrium outcomes
 - How model behaves under different scenarios
- Must read for how sovereign debt and defaults work
- Plenty food for thought for one talk and one discussion

Comments/observations about some areas for further discussion

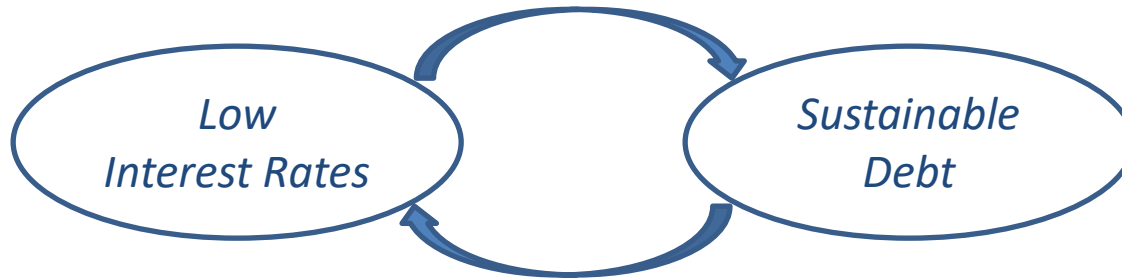
1. Sovereign debt vs. private debt (benchmark)
2. Multiple equilibria and choice of instruments
3. Defaults
4. Political economy and role of institutions
5. Role of the IFIs and heterogenous debtors
6. Other questions

Sovereign debt vs. private debt

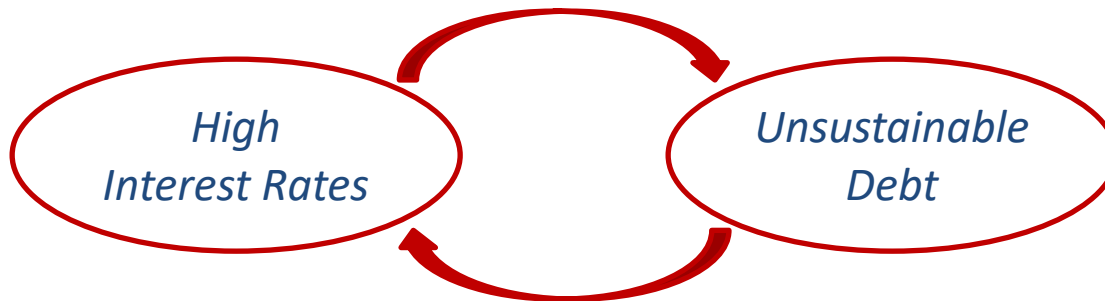
	Private debt	Sovereign debt
Contracts	Enforceable contracts	Non-enforceable contracts, limited commitment
Resolution	Bankruptcy and liquidation	Lack of liquidation capacity, countries continue to exist
Principals	Shareholders at risk from default	Voters (households): balance cost of default with incentives to renege
Agent	Manager: short-term monitoring, long-term view	Government: short-term incentives, political cycle
Lenders	At risk of losing everything	Risky given default incentives, but better loss-given-default, recovery value > 0

Multiple equilibria and instrument choice

- Normal times



- Crisis times

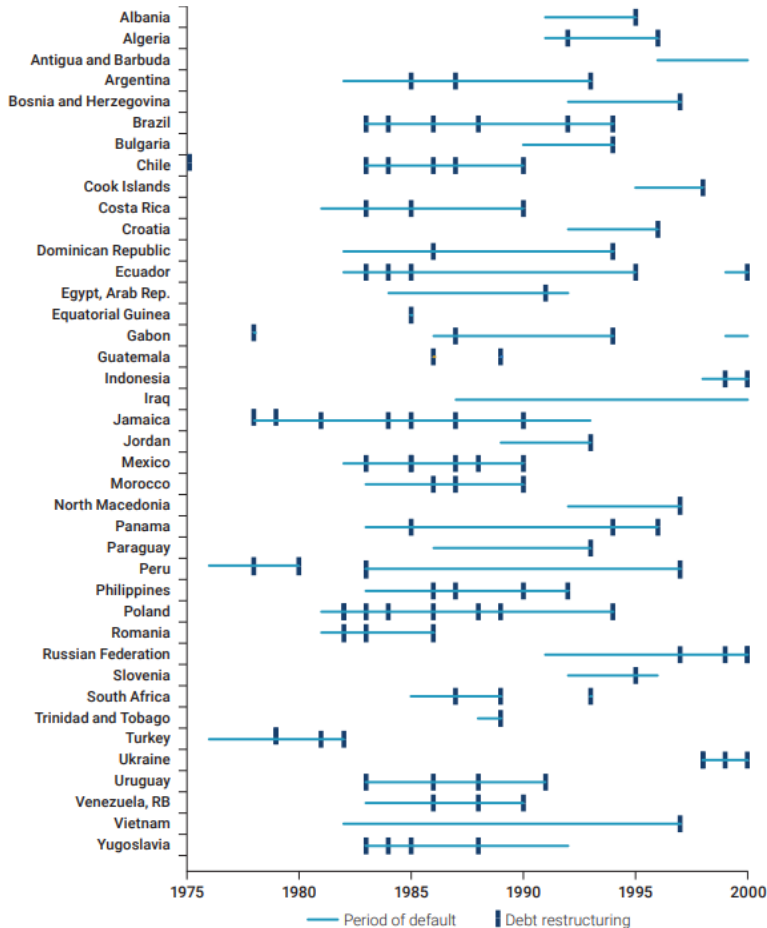


- Short-term debt necessary, risk toward debtors but low cost to borrow
- Long-term debt transfers risk to creditors, but comes at *ex ante* cost
- LT debt can avoid self-fulfilling crises, but not fundamental ones
- Short-term debt somewhat similar to foreign currency debt

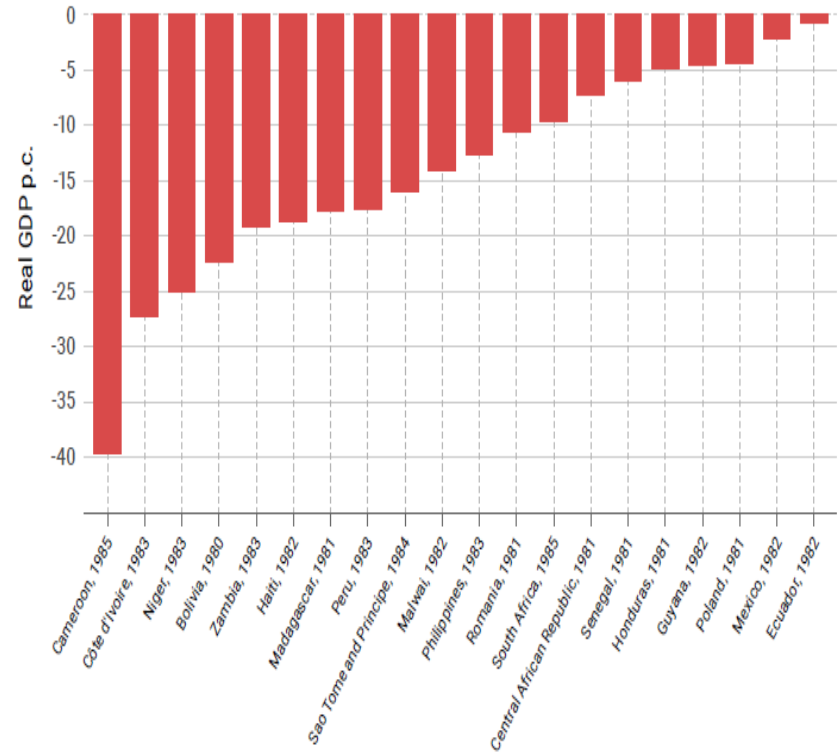
Defaults are costly, deadweight loss

Average default spell = 8 years,
2 restructurings

Lost decade



b. Cumulative change in real per capita GDP, ten years after default



WDR 2022

Source: WDR 2022 team, based on Cruces and Trebesch (2013); Farah-Yacoub, Graf von Luckner, and Reinhart (2021); Meyer, Reinhart, and Trebesch (2019); Reinhart and Rogoff (2009).

Note: The figure shows a timeline of sovereign defaults and debt restructuring from 1975 to 2000. The figure excludes countries covered by the International Development Association (IDA) and the Heavily Indebted Poor Countries (HIPC) Initiative.

Defaults

- High default costs makes debt financing possible
 - Given lack of enforcement, defaults would occur often otherwise
 - High costs prompt borrowers to repay
- Given cost of defaults, efforts to speed up resolution
 - E.g., collective action clauses (CACs)
 - Are these efforts worthless?
- To what extent are difficulties in resolution intrinsically high?
 - Does high cost come from penalty needed on bad debtors?
 - Is there an intermediate solution, where defaults can be resolved at lower costs and debt remains viable?
 - Or are defaults hard to resolve because of other inefficiencies (market microstructure, courts)?

Political economy and role of institutions

- Impatient politicians
 - Reap benefits of higher borrowing, at low cost now
 - Risky bets, including short-term debt and foreign currency debt
 - Kick can down the road, during good times and bad times
- Could any institution or framework help to solve the problem?
- Can a fiscal stability pact help?
 - Even if hard to enforce, impose some constraints
 - Is zero debt desirable, even debt is beneficial (smoothing, growth)?
- Other solutions?
 - Can limits on certain types of debt be imposed?
 - Distinguish transitory vs. more permanent shocks given impatience

Political economy and role of institutions

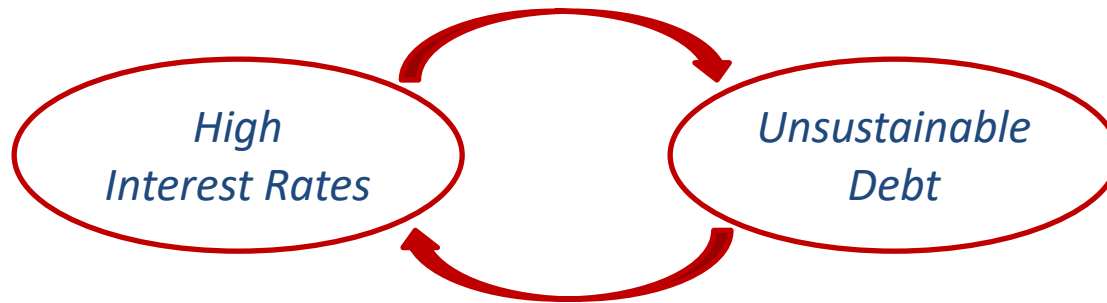
- What is a reasonable debt sustainability analysis (DSA) given political economy frictions?
- Focus on debt levels

$$D_\tau \approx \frac{(1+r) D_0}{(1+g) GDP_0} \leq K$$

- But other indicators like maturity and seniority already considered
- How should those be modified in practice?
- How should political economy frictions be incorporated in the analysis?
 - Domestic level
 - International level

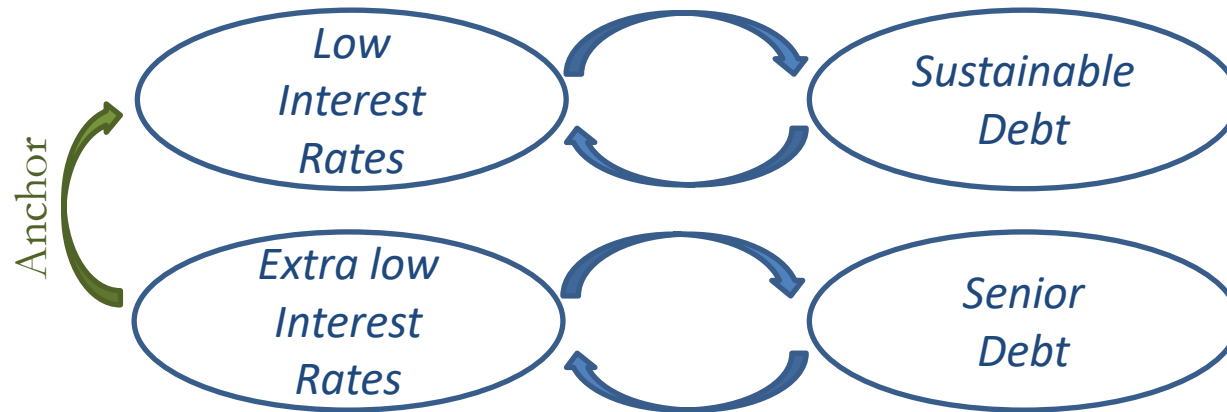
Role of the IFIs and heterogenous debtors

- IFIs and other institutions called in during crisis times

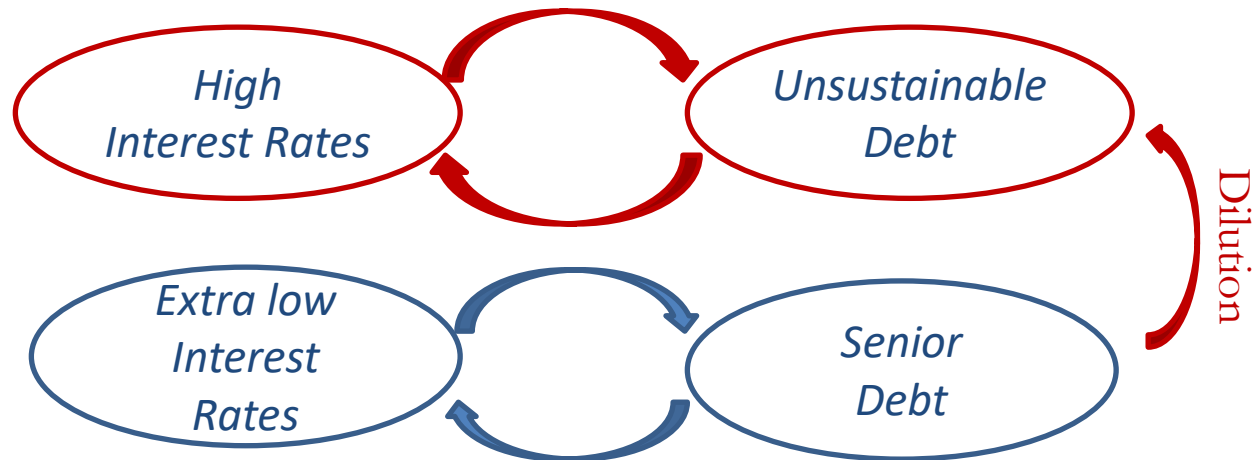


Role of the IFIs and heterogenous debtors

- Successful IFI intervention



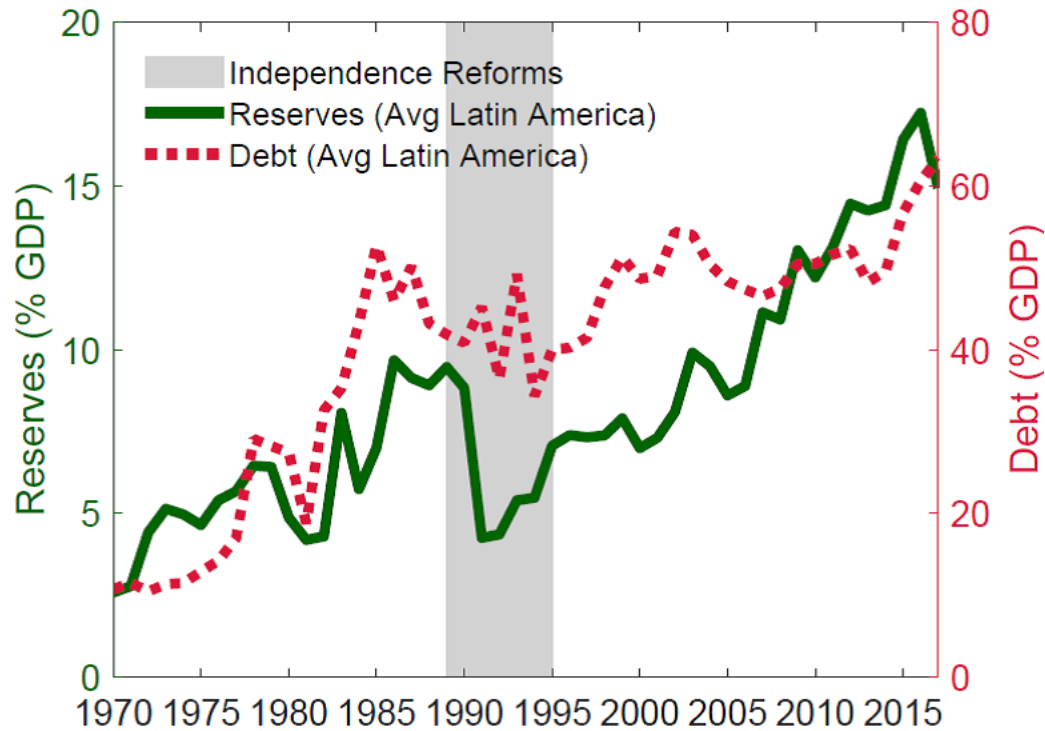
- Unsuccessful IFI intervention



Other questions

- More on heterogenous investors, beyond representative agent
 - Secondary market trading between domestic and foreign investors
 - What is the role of bilateral lenders (China) in debt markets?
- Gross versus net debt
 - What is the role of reserve accumulation with debt accumulation?
- Heterogenous debt
 - Floating rate debt. Equity like? Similar to indexed debt?
 - What is their preponderance? Why little take up?
 - What are the incentives to default in domestic currency debt?
- Secondary markets
 - Framework fully accounts for infrequent, costly repurchases?
- Risk premia
 - Given importance, how difficult to incorporate in analysis?

Reserves and public debt



Source: Samano Penaloza (2022). Average level of international reserves and public debt for: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.

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Thank you!