

Sovereign Debt Tolerance with Potentially Permanent Costs of Default

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Contribution of the paper

The paper proposes a smart variation of the Eaton-Gersovitz model of sovereign debt designed to overcome the main limitation of that model: exclusion from capital markets alone yields debt limits which are close to zero

To obtain realistic debt limits the EG model has been adapted (including by Rogoff) assuming, for instance, that default permanently lowers the level of output

In those models the costs of default are assumed to be known with certainty and are a black box, calibrated to match moments on debt and spreads in the data

Contribution of the paper (cont.)

The contribution of this paper resides in showing that one can obtain (endogenously) higher debt limits assuming debtors know that default might produce a loss of output, but ignore whether this loss is permanent or transitory

Uncertain costs of default

To allow for the possibility that a default might trigger a permanent fall in output, the paper uses a setup that resembles the literature on disaster risk, where rarely observed extreme shocks can have lasting implications on output

Technically, borrowers are assumed to use robust decision rules – e.g. rules that select an action that optimizes the agent's payoff in the most adverse situation – to address the uncertainty about the effects (temporary or permanent) of default

Uncertainty regarding persistence increases the amount of debt a country can sustain

The persistence of output costs following a default can significantly increase the willingness of a country to repay its debt and, hence, its debt capacity

This is because debtors use the extra credibility afforded by the higher default costs to sustain higher levels of indebtedness, rather than keeping debt the same and facing the costs of default less frequently

Thus, most of the increase in perceived costs of default translates into additional borrowing.

Calibration

Calibrated using Argentinian data, the model yields debt-to-GDP levels that can be as high as 30% – lower than what we observe in the real world, but higher than what we get in standard models

Limits of the model

Different types of lenders are subject to very different incentives:

- commercial lenders
- multilateral agencies
- politically motivated lenders

Representative agents models can work for commercial lenders, but are problematic for politically motivated lenders

Politically motivated lenders

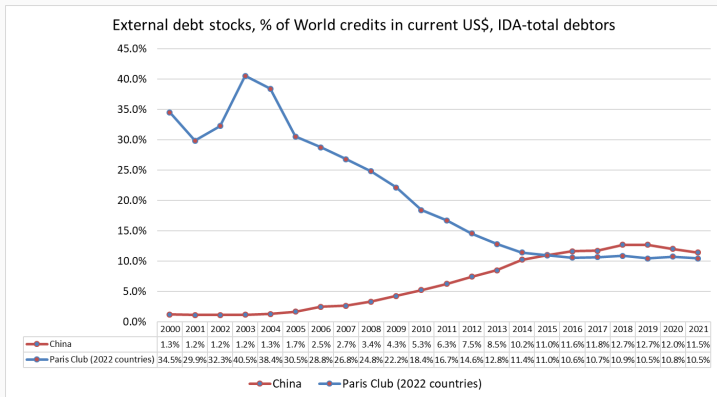
Alberto Alesina 1995: Social planners do not exist

We have a huge literature that focuses on the politics of budget deficits (with important contributions by Rogoff), but when we talk about debt (which is the outcome of fiscal policy) we often use social planner models

Ken Rogoff 2022: There is a disconnect between theory and reality

When it comes to understanding sovereign debt bailout and rescheduling negotiations, there is a disconnect between theory and reality. It is so extreme that the most popular class of theoretical models, those building on Eaton and Gersovitz (1981) seminal reputation model of debt repayment, has limited practical relevance, despite decades of elegant generalizations and extensions

The rise of politically motivated lenders



Why is China a special lender

- Impatient young creditor: Takes time for a young creditor to understand that waiting to recover the entire principal is a losing strategy
- Lengthy decision-making process: various arguments why decision making in the Chinese bureaucracy is a slow process
- Time needed for politically motivated lender lender to organize the extraction of non-economic benefits, including the transfer of sovereignty (infrastructure projects, military procurement, etc)

China and the Paris Club

- The case of Sri Lanka: the country agreed with all other lenders committing not to give China better conditions

Debtors delay default because it is costly – immediately and over time

- Since early default is optimal, the Imf and other lending institutions should lower the cost of default
- They should also ask for smoother adjustments (and adjustment that protects investment) to reduce the output cost
- They should also make default more convenient for debtors but this would negatively affect borrowing (e.g. larger haircuts)