

# Costs of Sovereign Defaults: Restructuring Strategies, Bank Distress and the Credit-Investment Channel

Tamon Asonuma, Marcos Chamon, Aitor Erce and Akira Sasahara

Discussed by  
Johannes Fleck, EUI

– Fiscal Risk and Public Sector Balance Sheets –  
July 6-7, 2017

# Research question

## **How do different ways to restructure sovereign debt affect GDP?**

- ▶ Restructuring strategies considered
  1. strictly pre-emptive
  2. weakly pre-emptive
  3. post-default
  
- ▶ The paper estimates their effects on cumulative GDP loss and investigates the roles of several transmission channels
  - ▶ investment
  - ▶ private credit, net capital inflows, lending rates
  - ▶ probability of banking crises

# Sovereign defaults: Known unknowns

- ▶ What is the 'true' cost of defaulting?
    - ▶ Literature estimates: 0% - 20% of cumulative GDP loss
  - ▶ How to model sovereign default costs?
    - ▶ restricted borrowing
    - ▶ productivity or exports affected
    - ▶ disruption to financial intermediation
  - ▶ What are the motivations of defaulting governments?
    - ▶ Self-fulfilling debt run
    - ▶ Stochastic GDP and external assistance
    - ▶ Cost of repayment very large for low GDP realizations
- All three determine optimal design of assistance programs
- ▶ prevent default by loans with low rates and long maturities?
  - ▶ allow default and give transfers to stabilize economy?

# This paper speaks to the unknowns

- ▶ Large dataset: Many countries over a long time horizon
  - ▶ Episodes of restructuring strategies: Asonuma and Trebesch (2016)
  - ▶ Banking crises: Laeven and Valencia (2013)
  - ▶ Target and control variables: various databases
- ▶ Methodology:
  - ▶ GDP impulse responses for distinct restructuring strategies  
LP: Local Projection (Jorda 2005)
  - ▶ Combine LP with endogenous strategy choice  
AIPW: Augmented Inv. Probability Weighting (Jorda and Taylor 2016)
- ▶ Findings:
  1. Cumulative GDP and investment losses increase in strategy number
  2. Same for risk of credit crunch and banking crisis
    - ▶ strategies differ in cost due to distinct effects on transmission channels
  3. Ex-ante conditions of strategies differ substantially

## Comments and suggestions (1/2)

### 1. *The paper is contributing to a specific but crowded literature*

To make it stand out, focus more on its innovative feature

- ▶ Address endogeneity due to distinct strategy choices further
  - ▶ First stage of AIPW: estimate propensity score using probit

$$Pr(S_j)_{i,t} = \Phi(Z_{i,t-1}, X_{i,t-1}, \gamma^{S_j}) \text{ for } j = 1, 2, 3$$

- ▶ Identification assumption  $u \perp S_j | Pr(\cdot)$  "selection on observables"
- ▶ To address remaining sources of endogeneity add controls for
  - simultaneous crises (banking, bop, currency, political)
  - availability and conditions of assistance programs
- ▶ Zoom into episodes of different restructuring strategies
  - increase data frequency to account for timing (if/where possible)
  - look more closely at countries which pursued several strategies

## Comments and suggestions (2/2)

### 2. *What is the 'complete' motivation to pursue a specific strategy?*

Quote from the paper:

"Restructuring decisions (...) are optimal choices by the sovereign debtors"

- ▶ Data show largest number of choices for strategy with highest cost
- ▶ But size of interest payments missed is non-increasing in costs
- ▶ Are there other benefits associated with strategies 1 to 3?
  
- ▶ Any strategy offers insurance...  
but the insurance values might depend on
  - ▶ types of ex-ante GDP shocks (size, persistence) to be smoothed
  - ▶ welfare costs of raising public revenue
  
- ▶ Two suggestions for next steps of the paper
  - selection on observables assumption problematic in current form
  - consider welfare measures to fully endogenize strategies

## My concluding thoughts

This paper is a great read

- ▶ It is very well written and structured
- ▶ Its topic is interesting and thought provoking
- ▶ It applies state of the art methods in this field
- ▶ It investigates essential questions related to sovereign default