Public Declarations: The Political Economy of Sovereign Debt Restructuring Negotiations

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Debt Restructuring

The institutional setting of sovereign debt

- Governments borrow to fulfill their policy objectives
- Circumstances prevent governments from repaying debt
- IMF seal of approval and emergency financing
- Private creditors renegotiate lending terms
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Debt restructuring is the exchange of outstanding sovereign debt instruments, such as loans or bonds, for new instruments or cash through a legal process (Das et al. 2012)
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The outcome of restructuring determines “who adjusts”
How much do creditors adjust?

Creditor “haircuts” vary significantly

- Range from no concessions to reductions in payment > 80%
- Poorly explained by economic fundamentals
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Research question

How do creditors and debtors overcome their conflicting preferences to agree on the size of a haircut?
Government faces an impending financial crisis

- Haircuts help office-motivated politicians shore up support
Argument

Government faces an impending financial crisis
  - Haircuts help office-motivated politicians shore up support

Profit-motivated creditors are loathe to yield high concessions
  - Creditors can’t observe government’s political will to repay
  - Government incentives to plead additional distress to creditors

Governments that are politically unwilling to pay can signal their “type” by publicly announcing debt distress

Revealing debt distress invokes domestic political punishment

Separates governments based on political will to repay

Governments who publicly declare their distress will receive higher creditor haircuts
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Government is still accountable to its citizens in the short-term
  - Citizens are incompletely informed about the crisis’ trajectory
  - Government incentives to hide economic distress from citizens
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Governments who publicly declare their distress will receive higher creditor haircuts
Data

- 76 restructuring episodes 1980-2009, covering 25 countries

- Dependent Variable: Creditor haircuts (%) (Cruces and Trebesch 2013)
  \[ H_{it} = 1 - \frac{\text{Present value of new debt} (r_{it})}{\text{Present value of old debt} (r_{it})} \]

- Independent Variable: Explicit moratorium or default declaration (0,1) (Enderlein et al. 2012)

- Controls: Debt to GDP ratio, GDP per capita, Debt restructured, Serial restructuring, IMF program

- Specification: OLS with clustered standard errors
Public declarations are rewarded with higher haircuts
Are public declarations costly?

If public declarations unequivocally increase creditor haircuts, what prevents all indebted governments from using public signals?

Public declarations are only effective at eliciting concessions when they are costly to politicians

- Citizens observe and care about economic distress
- Citizens can sanction the government for economic distress

Among democratic governments, those facing deeper socioeconomic pressures will be more likely to publicly announce debt distress
Data

- 218 country-crisis-year observations for 25 defaulting countries 1980-2009

- Dependent Variable: Explicit moratorium or default declaration (0,1) (Enderlein et al. 2012)

- Political costs of public declaration
  - Democracy (0,1) (Cheibub et al. 2010)
  - Socioeconomic Pressure (ICRG)
  - Democracy x Socioeconomic pressure

- Controls: Debt to GDP ratio, GDP per capita, Investment to GDP, Trade openness

- Specification: Probit with clustered standard errors
Among democracies, socioeconomic pressure increases declarations.
Takeaways

- Default is not dichotomous and the political dynamics of debt restructuring negotiations matter.

- Voters impact the international bargaining behavior of political leaders.

- Opportunistic governments can manipulate predictable domestic costs to win favorable international outcomes.

- As the world becomes more democratic and sovereign debt mechanisms become more complex, the importance of costly signaling should rise.