Hierarchy and Sovereign Debt: 
Crises and Consequences in International Capital Markets 

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**Lauren L Ferry**  
University of Mississippi  

**Patrick E Shea**  
University of Houston
Covid-19 and sovereign debt

The New York Times

Poor Countries Face a Debt Crisis ‘Unlike Anything We Have Seen’

Dozens of countries that borrowed from private investors have debt payments coming due as their economies have crashed because of the coronavirus.
Covid-19 and sovereign debt questions

- How will states address debt distress?
Covid-19 and sovereign debt questions

• How will states address debt distress?
  □ Default
Covid-19 and sovereign debt questions

• How will states address debt distress?
  - Default
  - Restructure or Relief
Covid-19 and sovereign debt questions

• How will states address debt distress?
  ■ Default
  ■ Restructure or Relief

• What will be the consequences of debt outcomes?
What are the consequences of debt outcomes?

- Exclusion from market
- Higher borrowing costs
- Trade decline

Empirically: consequences are uneven and not as harsh as expected.
What are the consequences of debt outcomes?

- Exclusion from market
- Higher borrowing costs
- Trade decline
- Empirically: consequences are uneven and not as harsh as expected
Puzzle: Why the lack of punishment for defaults

- Debts forgiven are forgotten (Bulow and Rogoff 1989)
- Investors delude themselves (Reinhart and Rogoff 2008)
Puzzle: Why the lack of punishment for defaults

- Debts forgiven are forgotten (Bulow and Rogoff 1989)
- Investors delude themselves (Reinhart and Rogoff 2008)
- Not all defaults are the same (Cruces and Trebesch 2012)
Not all defaults are the same

- The size of the default
- The economic characteristics of defaulter
- The institutional characteristics of defaulter
Not all defaults are the same

- The size of the default
- The economic characteristics of defaulter
- The institutional characteristics of defaulter
- What about states’ relationships with creditors?
Argument

- U.S. supports to other states: an exchange
- Expectations for bailout (Aklin and Kern 2019)
- Inflow of aid
Argument

- US supported states
  - More likely to default
  - Tougher negotiators
  - Face less punishments
Argument

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- US wants stability: currency and politically
Empirical Analysis

• Developing countries, 1970-2018
Empirical Analysis

- Developing countries, 1970-2018
- Four main tests:
  1. Pr(Debt crisis onset)
  2. Size of crisis
  3. Cost consequences
  4. Market exclusion
Defining debt crisis

• Lots of measures of default
• Focus on debt restructuring events
  ■ Well-defined start/end dates
  ■ Well-defined outcomes: haircuts
  ■ 202 events since 1970 (Cruces and Trebesch)
US Support

- McManus and Nieman’s (2019) Bayesian latent measure
US Support

- McManus and Nieman’s (2019) Bayesian latent measure
- Control variables:
  - GDP, GDP per cap, oil rents, trade, institutions
Test 1a
Test 3
Test 3: Bond spreads post-crisis
Table: US Support and Bond Spreads

<table>
<thead>
<tr>
<th></th>
<th>Full Sample (1)</th>
<th>Post Restructure (2)</th>
<th>Post Restructure (1-7 yrs) (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Support</td>
<td>-142.886*</td>
<td>-201.136*</td>
<td>-194.300*</td>
</tr>
<tr>
<td></td>
<td>(59.479)</td>
<td>(36.412)</td>
<td>(56.977)</td>
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</tbody>
</table>
## Test 4: Re-entry in bond market post-crisis (BMW data)

### Table: US Support and Re-entry into Bond Market, Cox Model

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Support</td>
<td>2.569*</td>
<td>2.621*</td>
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<tr>
<td></td>
<td>(1.071)</td>
<td>(1.128)</td>
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</tbody>
</table>
Further tests

• More aid? No*

• Bailouts? Yes*
Further tests

- More aid? No*
- Bailouts? Yes*
- Stabilization of currency
Discussion

- Bondholders stand to lose
- U.S. support aimed at currency stability
- Post-crisis focus on maintaining, increasing investment