Introduction

Sovereign Debt and Financial Crises: Theory and Historical Evidence
Sebnem Kalemli-Ozcan, University of Maryland, Carmen Reinhart, Harvard University and Kenneth Rogoff, Harvard University

Abstracts

Distributional Incentives in an Equilibrium Model of Domestic Sovereign Default
Pablo D’Erasmo, Federal Reserve Bank of Philadelphia and Enrique G. Mendoza, University of Pennsylvania

Europe’s debt crisis resembles historical episodes of outright default on domestic public debt about which little research exists. This paper proposes a theory of domestic sovereign default based on distributional incentives affecting the welfare of risk-averse debt- and non-debt holders. A utilitarian government cannot sustain debt if default is costless. If default is costly, debt with default risk is sustainable, and debt falls as concentration of debt ownership rises. A government favoring bond holders can also sustain debt, with debt rising as ownership becomes more concentrated. These results are robust to adding foreign investors, redistributive taxes, or a second asset. (JEL: E6, E44, F34, H63)

Sovereigns versus Banks: Credit, Crises, and Consequences
Óscar Jordà, Federal Reserve Bank of San Francisco and University of California, Davis, Moritz Schularick, University of Bonn and Alan M. Taylor, University of California, Davis

Two separate narratives have emerged in the wake of the Global Financial Crisis. One interpretation speaks of private financial excess and the key role of the banking system in leveraging and deleveraging the economy. The other emphasizes the public sector balance sheet and worries about the risks of lax fiscal policy. However, the two may interact in important and understudied ways. This paper examines the co-evolution of public and private sector debt in advanced countries from 1870 to 2012. We find that in advanced economies financial crises are not preceded by public debt build-ups nor are they more likely when public debt is high. However, history shows that high levels of public debt tend to exacerbate the effects of private sector deleveraging after financial crises. The economic costs of financial crises rise substantially if large private sector credit booms are unwound at times when the public sector has little capacity to pursue macroeconomic and financial stabilization. (JEL: C14, C52, E51, F32, F42)

Systemic and Idiosyncratic Sovereign Debt Crises
Graciela Laura Kaminsky, George Washington University and Pablo Vega-García, George Washington University

The theoretical literature on sovereign defaults has focused on adverse shocks to debtors’ economies, suggesting that defaults are of an idiosyncratic nature. Still, sovereign debt crises are also of a systemic nature, clustered around panics in the financial center such as the European Sovereign Debt Crisis in the aftermath of the U.S. Subprime Crisis in 2008. Crises in the financial centers are rare disasters and thus, their effects on the periphery can only be captured by examining long episodes. This paper examines sovereign defaults from 1820 to the Great Depression, with a focus on Latin America. We find that 63% of the crises are of a systemic nature. These crises are different. Both the international collapse of liquidity and the growth slowdown in the financial centers are at their core. These global shocks trigger longer default spells and larger investors’ losses. (JEL: F30, F34, F65)
The Euro and the Geography of International Debt Flows
Galina Hale, Federal Reserve Bank of San Francisco and Maurice Obstfeld, University of California, Berkeley

Greater financial integration between core and peripheral EMU members not only had an effect on both sets of countries but also spilled over beyond the euro area. Lower interest rates allowed peripheral countries to run bigger deficits, which inflated their economies by allowing credit booms. Core EMU countries took on extra foreign leverage to expose themselves to the peripherals. We present a stylized model that illustrates possible mechanisms for these developments. We then analyze the geography of international debt flows using multiple data sources and provide evidence that after the euro's introduction, core EMU countries increased their borrowing from outside of EMU and their lending to the EMU periphery. Moreover, we present evidence that large core EMU banks' lending to periphery borrowers was linked to their borrowing from outside of the euro area. (JEL: F32, F34, F36)

Repatriation of Debt in the Euro Crisis
Filippo Brutti, UBS and Philip Sauré, Swiss National Bank

With the beginning of the Euro Crisis, the long-standing trend of European financial integration reversed. Investors unwound cross-border positions of debt obligations and increased holdings of locally issued debt. In other words, debt obligations were repatriated. We use data on bank portfolios to document three new empirical regularities of the financial disintegration: (i) repatriation affected mainly debt of crisis countries; (ii) repatriation affected mainly public debt; (iii) the public debt of crisis countries that was not repatriated was reallocated to large and politically influential countries within the Euro Area. We read these results in light of standard theories of cross-border portfolio allocation and argue that the sum of these patterns constitutes evidence for the secondary market theory of public debt. (JEL: F34, F36, G01, G11, G21)

Sovereign Debt Restructurings: Preemptive or Post-Default
Tamon Asonuma, International Monetary Fund and Christoph Trebesch, University of Munich

Sovereign debt restructurings can be implemented preemptively - prior to a payment default. We code a comprehensive new dataset and find that preemptive restructurings (i) are frequent (38% of all deals 1978-2010), (ii) have lower haircuts, (iii) are quicker to negotiate, and (iv) see lower output losses. To rationalize these stylized facts, we build a quantitative sovereign debt model that incorporates preemptive and post-default renegotiations. The model improves the fit with the data and explains the sovereign's optimal choice: preemptive restructurings occur when default risk is high ex-ante, while defaults occur after unexpected bad shocks. Empirical evidence supports these predictions. (JEL: F34, F41, H63)

Sovereign Debt Relief and its Aftermath
Carmen M. Reinhart, Harvard University, Kennedy School and Christoph Trebesch, University of Munich

This paper studies sovereign debt relief in a long-term perspective. We quantify the relief achieved through default and restructuring in two distinct samples: 1920-1939, focusing on the defaults on official (government to government) debt in advanced economies after World War I; and 1978-2010, focusing on emerging market debt crises with private external creditors. Debt relief was substantial in both eras, averaging 21% of GDP in the 1930s and 16% of GDP in recent decades. We then analyze the aftermath of debt relief and conduct a difference-in-differences analysis around the synchronous war debt defaults of 1934 and the Baker and Brady initiatives of the 1980s/1990s. The economic landscape of debtor countries improves significantly after debt relief operations, but only if these involve debt write-offs. Softer forms of debt relief, such as maturity extensions and interest rate reductions, are not generally followed by higher economic growth or improved credit ratings. (JEL: E6, F3, N0, H6)
We propose a dynamic general equilibrium model that yields testable implications about the fiscal policy run by governments of different political color. Successive generations of voters choose taxation, expenditure and government debt through repeated elections. Voters are heterogeneous by age and by the intensity of their preferences for public good provision. The political equilibrium switches stochastically between left- (pro-public goods) and right-leaning (pro-private consumption) governments. A shift to the left (right) is associated with a fall (increase) in government debt, an increase (fall) in taxation, and an increase (fall) in government expenditures. However, left-leaning governments engage in more debt accumulation during recessions. These predictions are shown to be consistent with the time-series evidence for the U.S. in the post-war period, and also with the evidence for a panel of OECD countries. (JEL: D72, E62, H41, H62, H63)