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**Sovereign Debt: Notes on  
Debtor Incentives to Repay  
Debt**

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Sovereign Bankruptcy**

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The latest proposals for a Sovereign Debt Restructuring Mechanism and for a market based contractual approach have all glossed over the issue of incentives for debtors to repay their loans. It is often asserted that debtors always want to repay their debts -- because the cost of doing so is extremely costly. However, there is little evidence behind this assertion.

The costs of default often cited are: seizure of assets held abroad, a reduction in international trade, the threat of being cut off from capital flows in the future, and political stigma.

Threats to seize overseas assets are probably not credible, both because the value of these assets is unlikely to cover the amount of outstanding debt, and because countries can shield assets from creditors.<sup>1</sup> There is some empirical evidence that the benefits of international trade have declined following default (Andrew Rose, 2000), but it is difficult to say whether the drop in trade was caused by the default and subsequent rise in financing costs, or whether the same shocks that caused the default also caused trade to shrink.

In fact, it is not clear that financing costs should be higher after a default at all. Similarly, it is not clear that countries will be cut off from future capital flows following default. Investors are forward looking, and there is no reason why past defaults should lead to an increased probability of future defaults. Bargaining theory models also indicate that the effect of reputation is probably not enough ensure repayment. (Bulow and Rogoff 1989)

Rather, you could argue the opposite, that default improves the credit fundamentals of a country, reducing the probability of default in the future, thus lowering -- not raising -- credit spreads. Evidence of this was seen in Eastern Europe in the early 1990s: Poland concluded a rescheduling agreement with the London Club in 1994 while Hungary never restructured its debt. But by 1995 Polish bonds was rated investment grade and had spreads tighter than Hungarian bonds, due to Hungary's still high debt burden.

Yet there is evidence, that particularly in the 1990s, countries were seen to actively avoid default (e.g. Romania). Interestingly, at other times, countries defaulted much more willingly (e.g. Venezuela.)

It is possible that the 'political stigma' associated with default is a reason politicians try to avoid it. Although, defaulting on debt owed to foreigners to pay public sector employees and pensioners could also have positive political effects.

The 1990s were characterized by IMF packages for countries in crisis. It has often been argued the IMF 'bailed out' countries because the expected cost of default was thought to be extremely high -- since there was no good mechanism for a clean restructuring. For precisely the same reasons, countries might have avoided default, fearing Russia or Argentina type defaults, with banking crises and domestic panic.

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<sup>1</sup> Argentina was said to have moved assets out of the NY Federal Reserve prior to defaulting on its debt.

One interpretation of the reluctance of countries to default in the 1990s, is not that they were necessarily afraid that they might not be able to borrow in the future, but that they were afraid of complicated restructuring process, and were acting strategically to increase official sector participation. (Marcus Miller, 2002)

An alternative interpretation is that the IMF packages facilitated a ‘clean restructuring’ for creditors, but deliberately imposed macroeconomic policies that simultaneously enhanced the countries ability to repay by building up reserves and imposed large macroeconomic costs, thus deterring strategic default. The cost of the penalty was the delay in declaring bankruptcy. (Stiglitz, 2002)

The high output losses associated with debt restructuring can be viewed as a penalty for non-payment and an incentive for debtors to repay their debt. (Dooley, 2000) If this deadweight loss in output is one of the main incentives for debtors to repay their debt, then having a better mechanism could remove the incentive of countries to avoid reneging when they have the ‘ability’ to pay.

The current situation of crises with huge welfare losses is clearly not an optimal solution. However, in developing a new strategy it’s important to fully analyze the incentives of debtors, as well as creditors, in evaluating alternative scenarios.

### **Effects on the market of an increase in the probability “strategic defaults”**

If the probability of “strategic defaults” were to increase, you could expect several effects on the market for sovereign debt. First, you would expect borrowing rates to rise for all countries. As in any debtor friendly regime, under a more debtor friendly mechanism you would initially expect more credit screening, with weaker creditors in particular finding it more difficult to get funding.

A more debtor friendly regime forces more screening and sorting; thus, higher risk borrowers are less likely to be subsidized by lower risk borrowers, and such borrowers may well be excluded from the market. – Joe Stiglitz, 2002

However, as opposed to private sector defaults, a “strategic default” of a sovereign is a political event. The ability for creditors to price this risk accurately on a country-by-country basis is limited. Even after default, the creditor might not have full information as to whether the default was ‘strategic’ or whether the country was truly unable to repay. Thus credit screening could actually decrease as the returns from screening fall. The strategic defaulters would thus be taxing the non-defaulters.

In addition, lending to emerging markets would most likely fall. As countries would already be penalized, domestic political pressures for default could easily rise, exacerbating the problem. Private capital flows to both emerging market sovereigns and corporates could be significantly curtailed.

A result is that countries would have an incentive to signal that they will never be the ones to default -- by issuing in jurisdictions where default is difficult if possible, writing no default clauses in contracts, or alternative ways. Whichever way they choose, there would most probably be additional inefficiencies and welfare losses associated with this activity.

### **Are there ways to reduce the incentive for “strategic defaults” under a restructuring mechanism?**

If a country doesn't pay, what recourse do creditors have under the different mechanisms being proposed, i.e. what cost can they impose? Is it possible to minimize this cost for 'solvency' defaults while still maintaining it under 'strategic' defaults? And who gets to decide which is which?

Recent events do seem to indicate that the output loss following default in the current system has acted as an enforcement mechanism. How this cost can be maintained for 'strategic default', and minimized for 'solvency default' is more difficult to answer, especially since it is in no one party's interest to do so.

As above, the situation is further complicated by the fact that creditors might not have full information as to whether a default is 'strategic' or a country is actually insolvent.

If creditors believe a debtor is acting unfairly, they can delay resolution, but unless they believe they'll be able to force a better payout, there's no incentive to delay, as delay is expensive for the creditor, as well as for the debtor. Furthermore, the punishment would be to push a country into crises – which would imply an even lower payout for the creditor. As the probability of the enforcement working increases, future payouts decrease. Not only is there no incentive for creditors to act in this way, if there was an incentive, there could be huge welfare losses associated with it.

The second question is obviously how to distinguish a solvency default from a strategic default. A 'solvency default' can be defined as when a country is unable to mobilize the resources to pay back its debt without causing severe hardship on its population. However, the term 'severe hardship' has different meanings to groups (especially to those living inside vs. outside the country).

There has been some discussion of the IMF taking on this role of solvency judge. To some extent the IMF, and all large creditors, always have a role in deciding the timing of bankruptcy since withholding funds is often the trigger of the event. But given the IMF role as a senior creditor it does not seem to be the optimal solution.

Another possibility would be to start with a loose definition of solvency default, based on a combination of credit ratios and poverty indicators. Obviously it would be hard to get

creditors, debtors, and IIFs to agree to a definition, although the question of who interprets the definition would arguably be more important than the definition itself.

With or without such a definition, in a legal framework, the legal body could help determine whether a country is in strategic default. If a country is judged to not be insolvent, bankruptcy would revert to the current system, with the associated output losses following default.

Outside of a legal regime, is it possible to maintain incentives? One possibility would be to have an independent arbiter or 'information agency', as described in Joe's paper. The information agency could take on the role of stating whether a default is or is not 'unreasonable'.

It could be possible to integrate the information agency into the market-based approach. For example, could it be feasible to write a clause in contracts stating that if deemed 'unreasonable' by a 3<sup>rd</sup> party information agency, the collective action clauses revert to a higher percentage vote? In addition, one could see a role for the information agency in sorting out voting rights, and minimizing the ability of debtors – or large creditors, such as banks, with outside incentives -- to distort the collective action process.

In the current system, there do seem to be penalties associated with default, but there are huge welfare losses and inefficiencies. Although debtor incentives have been discussed in the literature to some extent since the 1980s, they have never been fully analyzed and there has been little attention paid to them in the new mechanisms being proposed. To assert that the cost of default is extreme and concentrate on creditor incentives ignores the bargaining inherent in any bankruptcy regime.