Expenditure Consolidation and Sovereign Debt Restructuring: Front- or Back-Loaded

Tamon Asonuma and Hyungseok Joo

Discussion:

Fernando Broner
CREI, UPF, BSE
May 2022

Summary

- When do governments carry out "expenditure consolidations"?
  - before restructuring, i.e. "front loaded"
  - after restructuring, i.e. "back loaded"

Summary

- When do governments carry out "expenditure consolidations"?
  - before restructuring, i.e. "front loaded"
  - after restructuring, i.e. "back loaded"

- It depends on the nature of restructuring
  - preemptive restructurings $\rightarrow$ front loaded
  - post-default restructurings $\rightarrow$ back loaded

Summary

- When do governments carry out "expenditure consolidations"?
  - before restructuring, i.e. "front loaded"
  - after restructuring, i.e. "back loaded"

- It depends on the nature of restructuring
  - preemptive restructurings $\longrightarrow$ front loaded
  - post-default restructurings $\longrightarrow$ back loaded

- Empirical analysis combines
  - new dataset on expenditure consolidations
  - previous data on preemptive vs post-default restructurings (Asonuma and Trebesch, 2016)

Summary

- When do governments carry out "expenditure consolidations"?
  - before restructuring, i.e. "front loaded"
  - after restructuring, i.e. "back loaded"
- It depends on the nature of restructuring
  - preemptive restructurings $\rightarrow$ front loaded
  - post-default restructurings $\rightarrow$ back loaded
- Empirical analysis combines
  - new dataset on expenditure consolidations
  - previous data on preemptive vs post-default restructurings (Asonuma and Trebesch, 2016)
- Theoretical model
  - add public expenditure to previous model of preemptive restructurings (Asonuma and Trebesch, 2016)

Expenditure consolidations

- Definition 1
  - sudden fall in cyclically adjusted expenditure-to-GDP ratio (Alesina and Perotti 1997)

Expenditure consolidations

- Definition 1
  - sudden fall in cyclically adjusted expenditure-to-GDP ratio (Alesina and Perotti 1997)
- Definition 2
  - sudden fall in expenditure-to-potential GDP ratio

Expenditure consolidations

- Definition 1
  - sudden fall in cyclically adjusted expenditure-to-GDP ratio (Alesina and Perotti 1997)
- Definition 2
  - sudden fall in expenditure-to-potential GDP ratio
  - comment: why would crisis that leads to fall in both GDP and expenditure constitute a consolidation?

Expenditure consolidations

- Definition 1
  - sudden fall in cyclically adjusted expenditure-to-GDP ratio (Alesina and Perotti 1997)
- Definition 2
  - sudden fall in expenditure-to-potential GDP ratio
  - comment: why would crisis that leads to fall in both GDP and expenditure constitute a consolidation?
- Types of consolidations
  - front-loaded: before start of restructuring
  - back-loaded: after start of restructuring

Figure 1: Strategies of Expenditure Consolidation and Debt Restructurings in 1975–2020

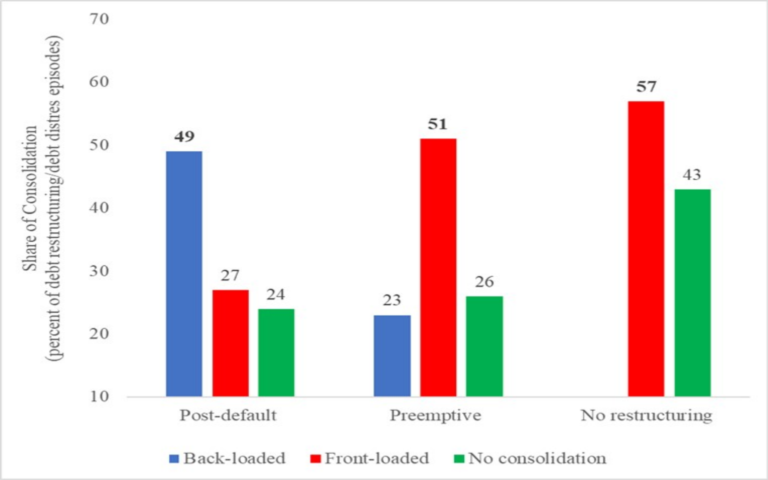
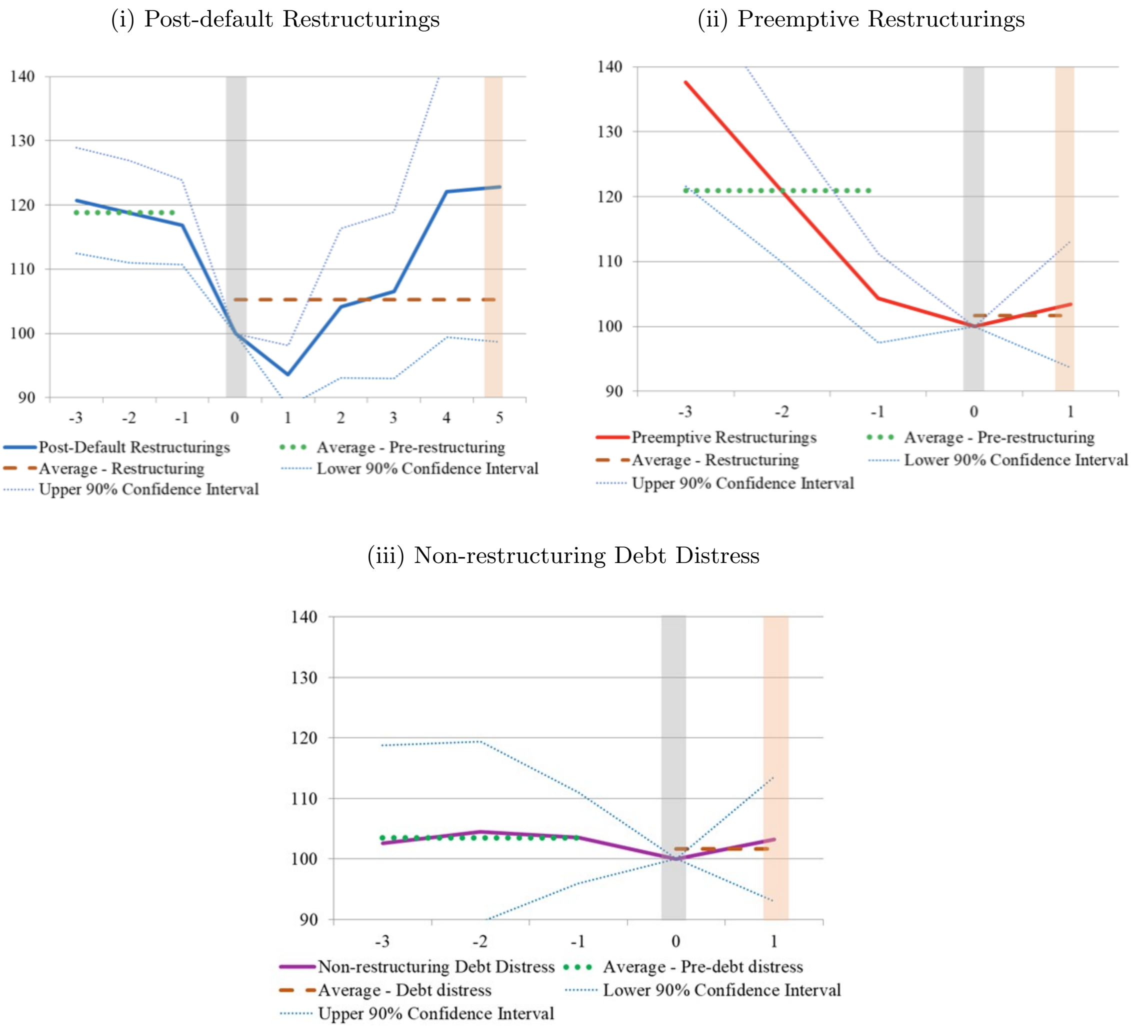


Figure 2: Public Investment



Model

- Quite standard model of sovereign risk with lots of moving parts

Model

- Quite standard model of sovereign risk with lots of moving parts

- Public investment

$$y_t = a_t \cdot (l_t)^{\alpha_l} \cdot (k_t^g)^{\alpha_k} \cdot \left(\bar{k}^p\right)^{1-\alpha_l-\alpha_k}$$

  - return to public investment falls with a_t
  - there are adjustment costs, so expected fall in future a_t reduces current public investment

Model

- Quite standard model of sovereign risk with lots of moving parts

- Public investment

$$y_t = a_t \cdot (l_t)^{\alpha_l} \cdot (k_t^g)^{\alpha_k} \cdot \left(\bar{k}^p\right)^{1-\alpha_l-\alpha_k}$$

  – return to public investment falls with a_t

  – there are adjustment costs, so expected fall in future a_t reduces current public investment

- Two types of renegotiations

  – standard default: causes large reduction in a_t

  – preemptive renegotiation: causes small reduction in a_t

Model

- Preemptive renegotiations take place when probability of future default is high
  - investors accept debt reduction because it increases expected repayment
  - move to the "good side of the debt Laffer curve"

Model

- Preemptive renegotiations take place when probability of future default is high
  - investors accept debt reduction because it increases expected repayment
  - move to the "good side of the debt Laffer curve"

- Preemptive renegotiations
  - are predictable, so public investment starts falling earlier on (front-loaded)
  - associated with small reduction in a_t, so public investment does not fall much

Model

- Preemptive renegotiations take place when probability of future default is high
  - investors accept debt reduction because it increases expected repayment
  - move to the "good side of the debt Laffer curve"
- Preemptive renegotiations
  - are predictable, so public investment starts falling earlier on (front-loaded)
  - associated with small reduction in a_t, so public investment does not fall much
- Standard defaults take place when there is large, unexpected negative shock to a_t
  - why unexpected? because otherwise there would have been a preemptive renegotiation before the shock

Model

- Preemptive renegotiations take place when probability of future default is high
  - investors accept debt reduction because it increases expected repayment
  - move to the "good side of the debt Laffer curve"
- Preemptive renegotiations
  - are predictable, so public investment starts falling earlier on (front-loaded)
  - associated with small reduction in a_t, so public investment does not fall much
- Standard defaults take place when there is large, unexpected negative shock to a_t
  - why unexpected? because otherwise there would have been a preemptive renegotiation before the shock
- Standard defaults
  - are unpredictable, so public investment does not start falling earlier on (back-loaded)
  - associated with large reduction in a_t, so public investment falls a lot

Model comments

- In the model private investment is exogenous
  - if it were endogenous would private and public investment not behave similarly?
    - if so, is this consistent with the data?

Model comments

- In the model private investment is exogenous
  - if it were endogenous would private and public investment not behave similarly?
    - if so, is this consistent with the data?
- In the model standard defaults are unexpected
  - does it predict that preemptive renegotiations should be much more prevalent than standard defaults?
    - if so, is this consistent with the data?

Application to Argentina and Uruguay

- Types of default
  - Argentina 2001-2005 is an example of a standard default
  - Uruguay 2003 is an example of a preemptive renegotiation

Application to Argentina and Uruguay

- Types of default
  - Argentina 2001-2005 is an example of a standard default
  - Uruguay 2003 is an example of a preemptive renegotiation

- The model can replicate several important features of these events

Application to Argentina and Uruguay

- Types of default
  - Argentina 2001-2005 is an example of a standard default
  - Uruguay 2003 is an example of a preemptive renegotiation

- The model can replicate several important features of these events

- But what was the large unanticipated shock that prompted Argentina to default instead of carrying out a preemptive renegotiation?

Final comments

- Very interesting analysis, with new data and new theory
- Preliminary, but with lots of potential!