Expenditure Consolidation and Sovereign Debt Restructurings: Front- or Back-loaded

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Disclaimer

- The views expressed herein are those of the authors and should not be attributed to the IMF, its Executive Board, or its management

Motivation

- Theory – Existing literature
  - Fiscal austerity literature in AMs
    - Front-loaded consolidation & no restructuring
  - Sovereign debt literature
    - Back-loaded consolidation & default/restructuring
- Data – Three strategies
  - Front-loaded consolidation & no restructuring
  - Front-loaded consolidation & preemptive restructuring
  - Back-loaded consolidation & post-default restructuring
- Question – How can we fill a gap between theory and data?

What We Do in This Paper

- Empirical, theoretical, and quantitative paper
- Empirics
  - Data on strategies of expenditure consolidation and restructurings
  - New stylized facts
- Theory
  - Sovereign debt model with preemptive and post-default restructurings and public capital
  - (i) front-loaded & preemptive, (ii) front-loaded & no restructuring
  - Choice between front- and back-loaded expenditure consolidation
- Quantitative analysis
  - Replication of the five stylized facts

Data: Debt Restructurings and Debt Distress

- Debt Restructurings – Asonuma and Trebesch (2016)
  - 197 sovereign debt restructurings in 1975–2020
    - Post-default restructurings: 116 episodes
    - Preemptive restructurings: 81 episodes
- Non-restructuring Debt Distress — New
  - 25 episodes in 1975–2020
    - High likelihood of restructurings
      (i) EMBIG bond spreads
      (ii) Estimated restructuring probability (probit regression)
    - No overlap with restructuring
    - Debt distress being cured (an interval of at least 2 years)

Data: Expenditure Consolidation

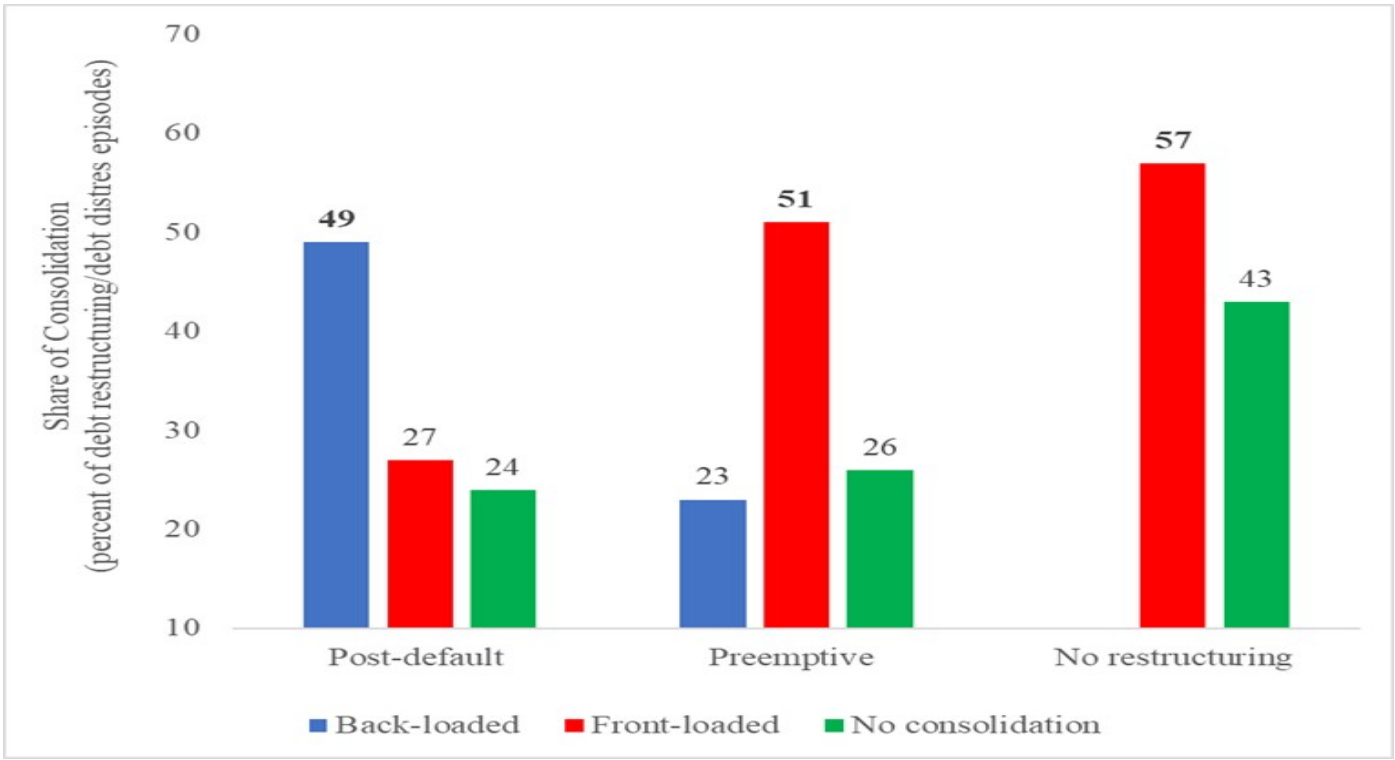
- Public expenditure composition data - Asonuma and Joo (2021)
  - Consumption, transfers, investment and capital in 1975–2020
- Expenditure consolidation:
  - Alesina and Perotti (1997)– *cyclically adjusted* expenditure/GDP
  - Alternative classification – expenditure /*potential (lagged)* GDP
  - Criteria:
    1) *Cyclically adjusted* expenditure-to-GDP ratio falls more than 1.5 percent
    2) It falls at least 1.25 percent a year in two consecutive years
- Front- and back-loaded expenditure consolidation
  - Front-loaded – prior to start of restructuring (year t-2, or t-1)
  - Back-loaded – after start of restructuring (year t, t+1,. . .)

Data: Strategies

- 8 strategies of expenditure consolidation and debt restructuring
  - Post-default + back-loaded consolidation
  - Post-default + front-loaded consolidation
  - Post-default + no consolidation
  - Preemptive + back-loaded consolidation
  - Preemptive + front-loaded consolidation
  - Preemptive + no consolidation
  - Debt distress/no restructuring + front-loaded consolidation
  - Debt distress/no restructuring + no consolidation
- 3 dominant strategies

Stylized Facts on Expenditure Consolidation

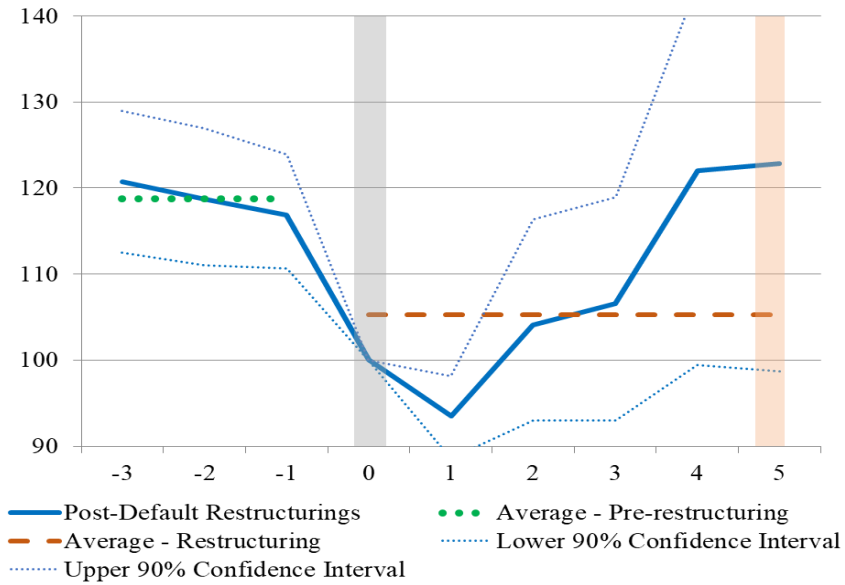
- **Stylized Fact 1**: Three strategies of expenditure consolidation and debt restructuring are dominant



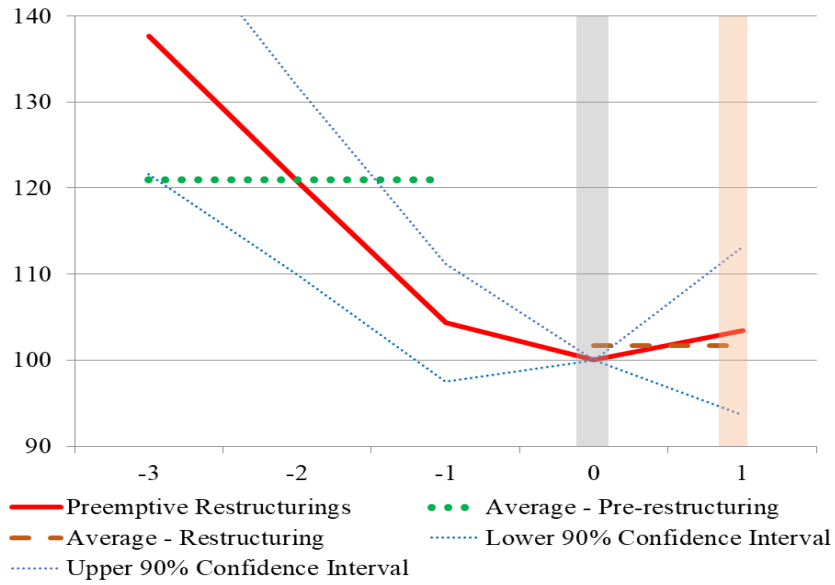
Stylized Facts on Expenditure Consolidation

- **Stylized Fact 2**: Public investment declines sharply ex ante in preemptive cases, while ex post in post-default cases
- **Stylized Fact 3**: Debt settlement takes place before recoveries in public investment in preemptive cases, while after in post-default cases

(a) Post-default Restructurings

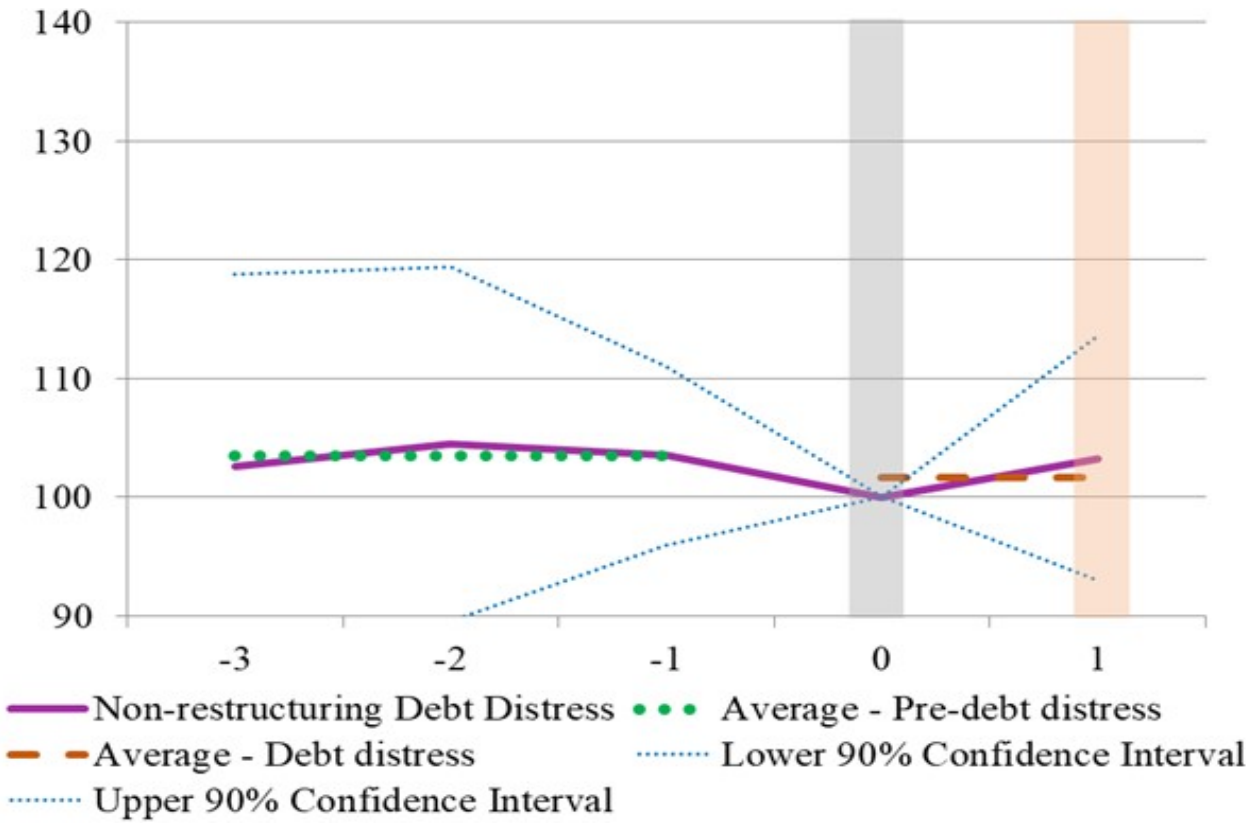


(b) Preemptive Restructurings



Stylized Facts on Expenditure Consolidation

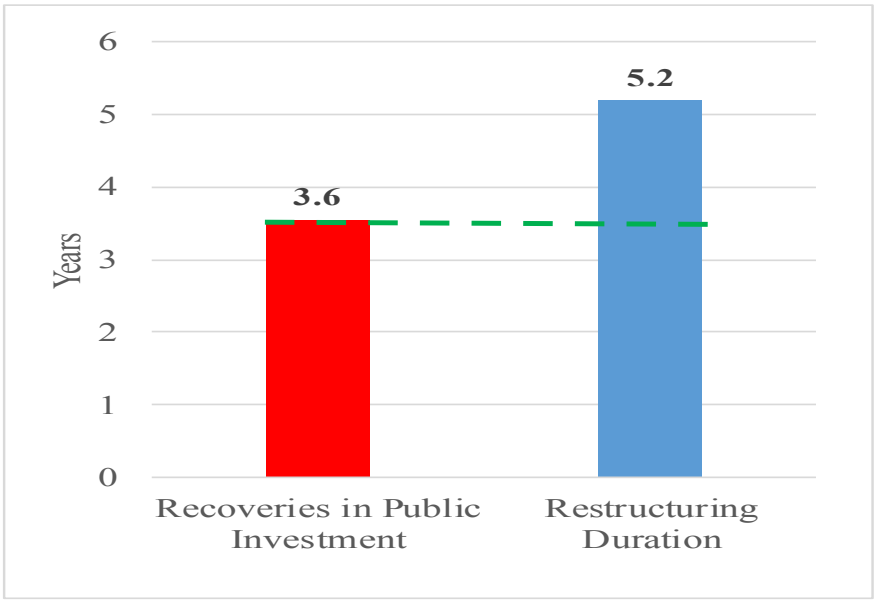
(c) Non-restructuring Debt Distress



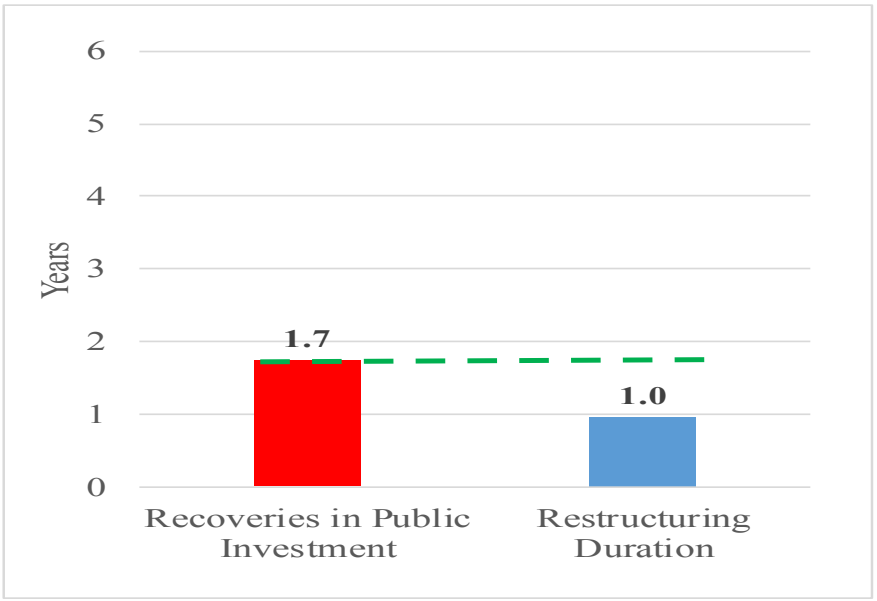
Stylized Facts on Expenditure Consolidation

- **Stylized Fact 4**: Recoveries in public investment are shorter in preemptive cases than in post-default cases

(a) Post-default restructurings



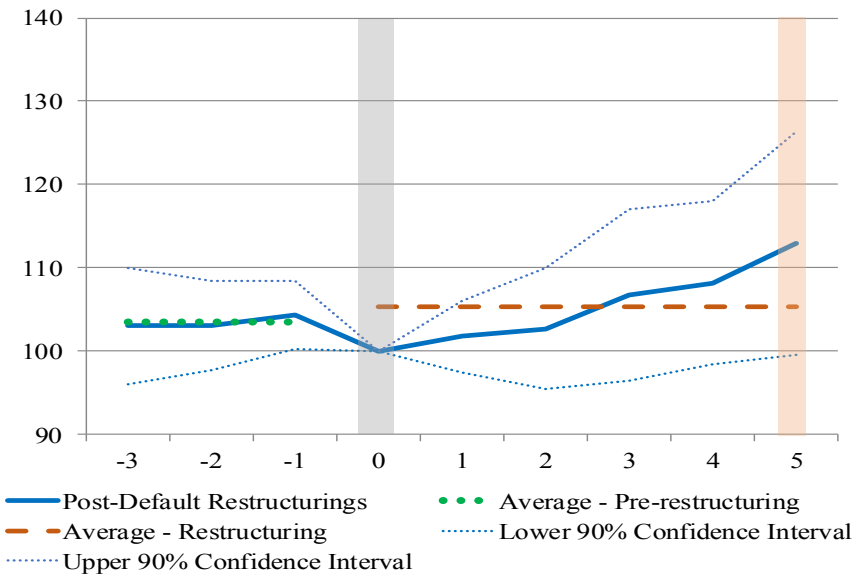
(b) Preemptive restructurings



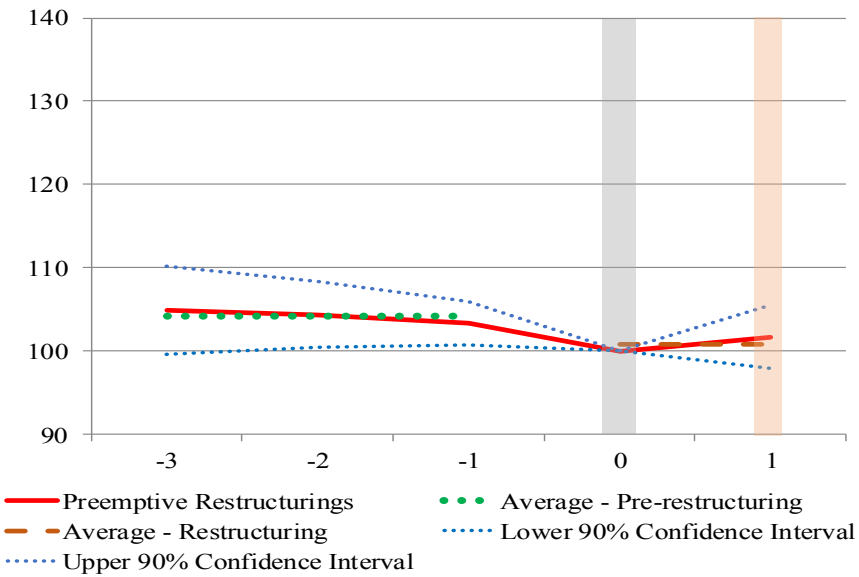
Stylized Facts on Expenditure Consolidation

- **Stylized Fact 5**: Public consumption and transfers decline temporarily ex post and recover quickly in both cases

(a) Post-default restructurings

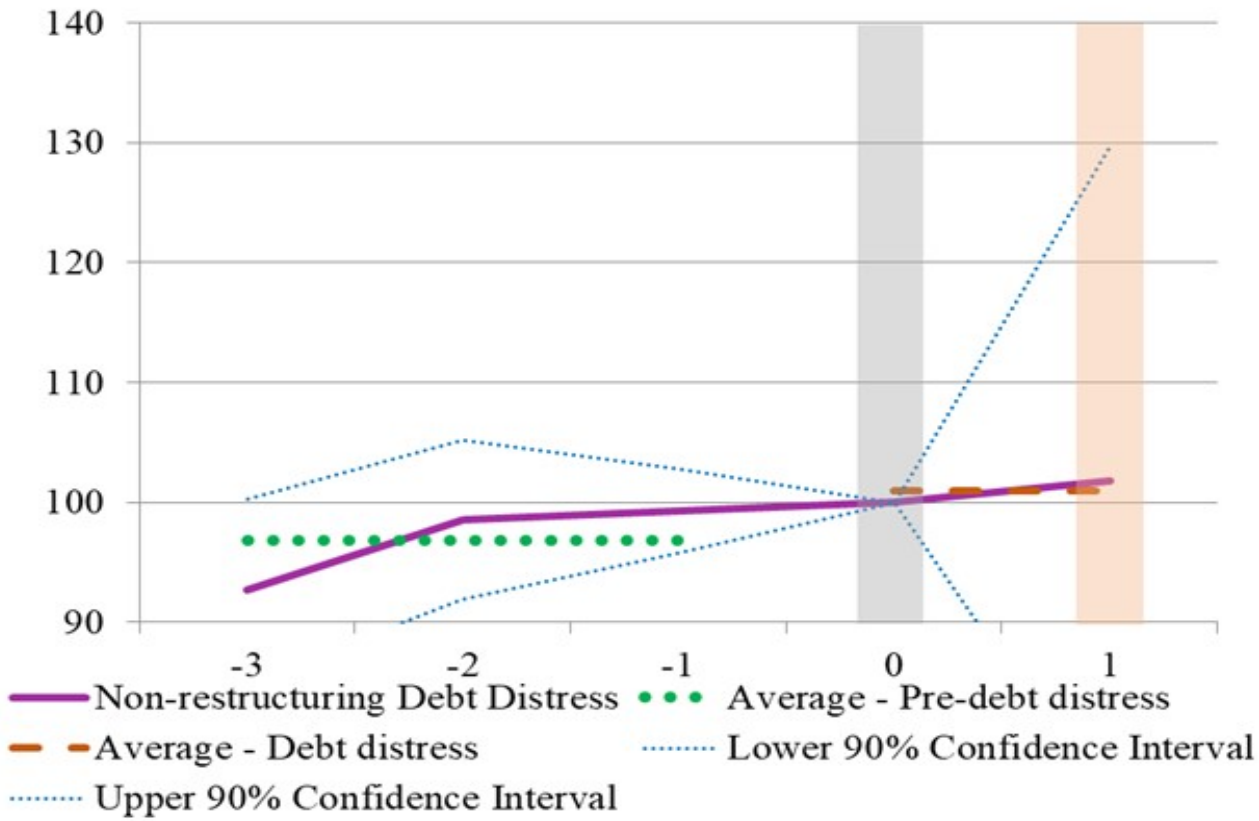


(b) Preemptive restructurings



Stylized Facts on Expenditure Consolidation

(c) Non-restructuring Debt Distress



Main Questions

- **Why is not more front-loaded consolidation if it is associated with preemptive restructuring** i.e., quicker debt resolution?
- **What is the mechanism of consequence of front- and back-loaded consolidation?** In particular, default / restructuring choice and crisis resolution.

Literature Review

- Fiscal austerity (consolidation)
  - Alesina et al. (2019), Vegh et al. (2019), Guajardo et al. (2014)
  - Ours: Outcomes of two types of expenditure consolidation
- Sovereign debt/default and fiscal policy
  - Cuadra et al. (2010), Arellano and Bai (2017), Hatchondo et al. (forthcoming), Bianchi et al. (2020)
  - Ours: Front-loaded expenditure consolidation (i.e., prior to debt crises)
- Different types of sovereign defaults/debt restructurings
  - Arellano et al. (2019), Hatchondo et al. (2014), Asonuma and Trebesch (2016)
  - Ours: Joint choice on expenditure consolidation and restructuring

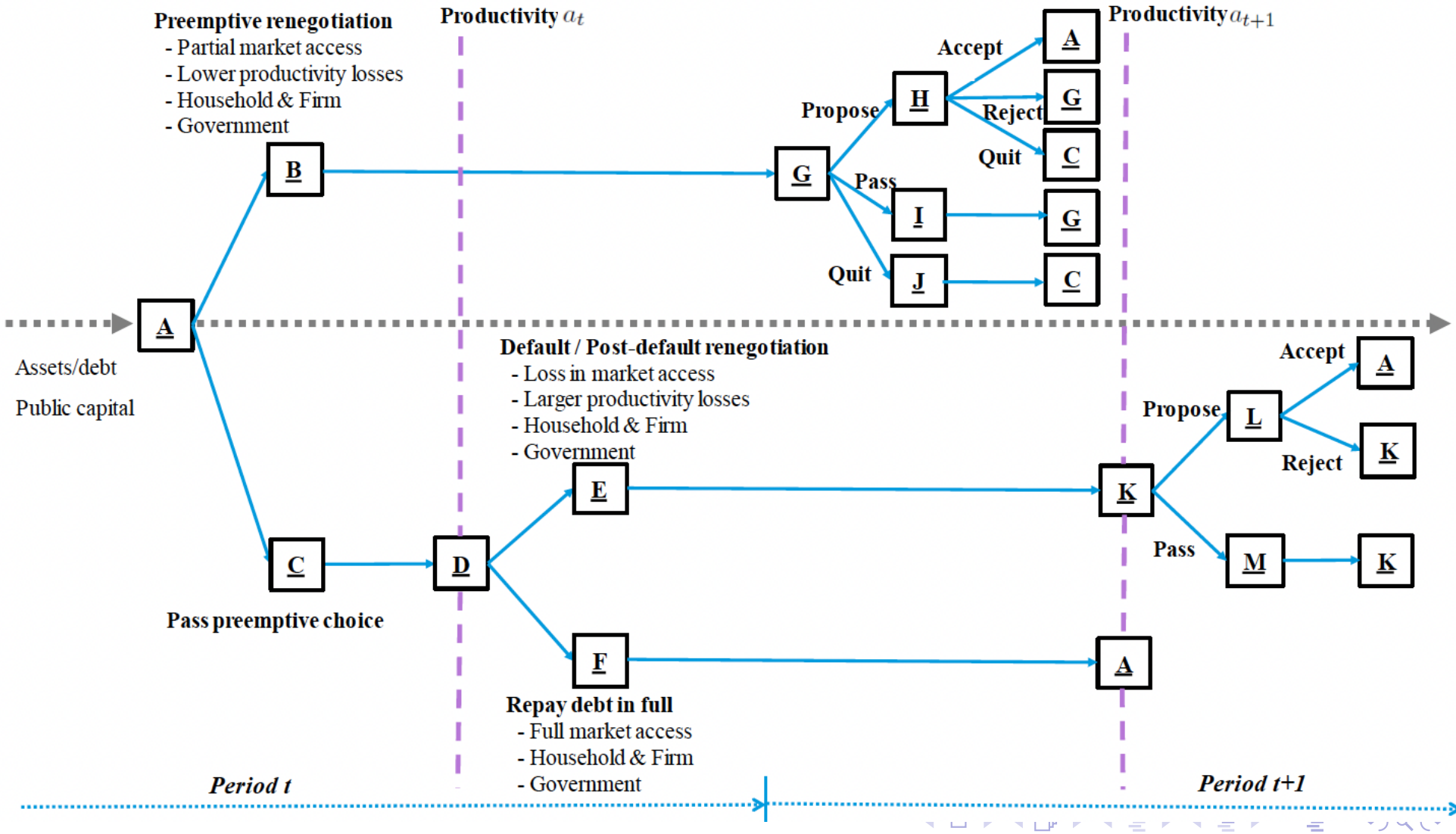
Theoretical Findings and Key Mechanisms

- **Choice between front- and back-loaded consolidation**: "Gambling for resurrection"
  - Ex ante choice between front-loaded and no consolidation
    - Front-load consolidation: Certain on likelihood of default
    - No consolidation: Expecting high TFP shocks (i.e., gambling)
  - Ex post choice: back-loaded consolidation up on low TFP shocks
- **Consequence of front- and back-loaded consolidation**: Endogenous fiscal constraint and public capital
  - Front-loaded (ex ante) consolidation
    - Preemptive: Hedging incentive under low public capital
    - Quick settlement: Relaxation of fiscal constraint
  - Back-loaded (ex post) consolidation
    - Default / post-default: Low TFP shocks
    - Delay: Fiscal constraint and slow capital accumulation

Model: General Features

- Sovereign debt in a dynamic small open economy model:
  - Endogenous ex ante choice of preemptive option and passing it
  - Endogenous ex post choice of default and repayment
  - Endogenous choice of settlement and delays conditional on preemptive option and default
  - Endogenous choice of public expenditure (i.e., consolidation)—public consumption, investment, transfers and debt repayments
  - Endogenous production with labor and public capital

Model: Timing



Model: Household's Problem

- Household maximization problem

$$\max_{c_t, l_t} E_0 \sum_{t=0}^{\infty} \beta^t U(c_t, l_t, g_t)$$

$$s.t. \quad (1+\tau)c_t = w_t l_t + \pi_t^F + T_t \tag{1}$$

  where $U(c_t, l_t, g_t) = (1-\omega)u(c_t, l_t) + \omega v(g_t)$

- Optimality condition of household

$$\frac{u_l(c_t, l_t)}{u_c(c_t, l_t)} = \frac{w_t}{1+\tau} \tag{2}$$

Model: Firm's Problem

- Production function

$$y_t = a_t (l_t)^{\alpha_l} (k_t^g)^{\alpha_k} (\bar{k^p})^{1-\alpha_l-\alpha_k} \tag{3}$$

- Private firm's profit maximization problem:

$$\max_{l_t} \pi_t^F = a_t (l_t)^{\alpha_l} (k_t^g)^{\alpha_k} (\bar{k^p})^{1-\alpha_l-\alpha_k} - w_t l_t \tag{4}$$

  - $\bar{k^p}$ is numeraire (Mendoza and Yue 2012)
- Optimality condition of the private firm

$$w_t = \alpha_l a_t (l_t)^{\alpha_l - 1} (k_t^g)^{\alpha_k} (\bar{k^p})^{1-\alpha_l-\alpha_k} \tag{5}$$

Model: Sovereign's Ex Ante Problem

- Ex ante value of sovereign

$$V^{EXANTE}(b_t, k_t^g, 0, a_{t-1}) = max[V^{PRE}(b_t, k_t^g, 0, a_{t-1}), V^{NON\_PRE}(b_t, k_t^g, 0, a_{t-1})] \quad (6)$$

- Ex ante value of taking a preemptive restructuring

$$V^{PRE}(b_t, k_t^g, 0, a_{t-1}) = \max_{g_t, k_{t+1}^g, T_t} \int_A [(1-\omega)u(c_t, l_t) + \omega v(g_t) + \beta\Psi(b_t, k_{t+1}^g, 1, a_t)]d\mu(a_t|a_{t-1}) \quad (7)$$

$$s.t. \quad g_t + k_{t+1}^g + T_t = \tau c_t + (1-\delta^k)k_t^g - \frac{\Omega}{2}(\frac{k_{t+1}^g - k_t^g}{k_t^g})^2 k_t^g \quad (8)$$

$$T_t \geq 0 \quad (9)$$

$$\frac{u_l(c_t, l_t)}{u_c(c_t, l_t)} = \frac{\alpha_l \hat{a}_t (l_t)^{\alpha_l - 1}(k_t^g)^{\alpha_k}(\bar{k^p})^{1-\alpha_l-\alpha_k}}{1+\tau} \quad (10)$$

$$(1+\tau)c_t = \hat{y}_t + T_t \quad (11)$$

Model: Sovereign's Ex Ante Problem

- Ex ante value of passing a preemptive option

$$V^{NON\_PRE}(b_t, k_t^g, 0, a_{t-1}) = \int_A V(b_t, k_t^g, 0, a_t) d\mu(a_t|a_{t-1}) \tag{12}$$

- Preemptive restructuring choice

$$PRE(b_t, k_t^g, 0) = \{a_{t-1} \in A : V^{PRE}(b_t, k_t^g, 0, a_{t-1}) \geq V^{NON\_PRE}(b_t, k_t^g, 0, a_{t-1})\} \tag{13}$$

Model: Sovereign's Ex Post Problem

- Ex post value of sovereign

$$V(b_t, k_t^g, 0, a_t) = max[V^R(b_t, k_t^g, 0, a_t), V^D(b_t, k_t^g, 0, a_t)] \tag{14}$$

- Ex post value of repayment

$$V^R(b_t, k_t^g, 0, a_t) = \max_{g_t, b_{t+1}, k_{t+1}^g, T_t} (1-\omega)u(c_t, l_t) + \omega v(g_t)$$
$$+\beta \int_A V(b_{t+1}, k_{t+1}^g, 0, a_{t+1}) d\mu(a_{t+1}|a_t) \tag{15}$$

$$s.t.\ g_t + k_{t+1}^g + T_t + q(b_{t+1}, k_{t+1}^g, 0, a_t)b_{t+1} = \tau c_t + (1-\delta^k)k_t^g - \frac{\Omega}{2}\left(\frac{k_{t+1}^g - k_t^g}{k_t^g}\right)^2 k_t^g + b_t \tag{8a}$$

$$T_t \geq 0 \tag{9}$$

$$\frac{u_l(c_t, l_t)}{u_c(c_t, l_t)} = \frac{\alpha_l a_t (l_t)^{\alpha_l - 1} (k_t^g)^{\alpha_k} (\bar{k^p})^{1-\alpha_l-\alpha_k}}{1+\tau} \tag{10a}$$

$$(1+\tau)c_t = y_t + T_t \tag{11a}$$

Model: Sovereign's Ex Post Problem

- Ex post value of default/post-default restructuring

$$V^D(b_t, k_t^g, 0, a_t) = \max_{g_t, k_{t+1}^g, T_t} (1-\omega)u(c_t, l_t) + \omega v(g_t)$$

$$+\beta \int_A V((1+r^*)b_t, k_{t+1}^g, 2, a_{t+1}) d\mu(a_{t+1}|a_t) \tag{16}$$

$$s.t. \quad g_t + k_{t+1}^g + T_t = \tau c_t + (1-\delta^k)k_t^g - \frac{\Omega}{2}\left(\frac{k_{t+1}^g - k_t^g}{k_t^g}\right)^2 k_t^g \tag{8}$$

$$T_t \geq 0 \tag{9}$$

$$\frac{u_l(c_t, l_t)}{u_c(c_t, l_t)} = \frac{\alpha_l \tilde{a}_t (l_t)^{\alpha_l - 1} (k_t^g)^{\alpha_k} (\bar{k^p})^{1-\alpha_l-\alpha_k}}{1+\tau} \tag{14a}$$

$$(1+\tau)c_t = \tilde{y}_t + T_t \tag{15a}$$

- Default/post-default restructuring choice

$$D(b_t, k_t^g, 0) = \{a_t \in A : V^R(b_t, k_t^g, 0, a_t) < V^D(b_t, k_t^g, 0, a_t)\} \tag{17}$$

Quantitative Analysis - Parameters

- TFP - AR(1) process:

$$\log(a_t) = \rho \log(a_{t-1}) + \epsilon_t, \tag{54}$$

- Household utility function - GHH, CRRA:

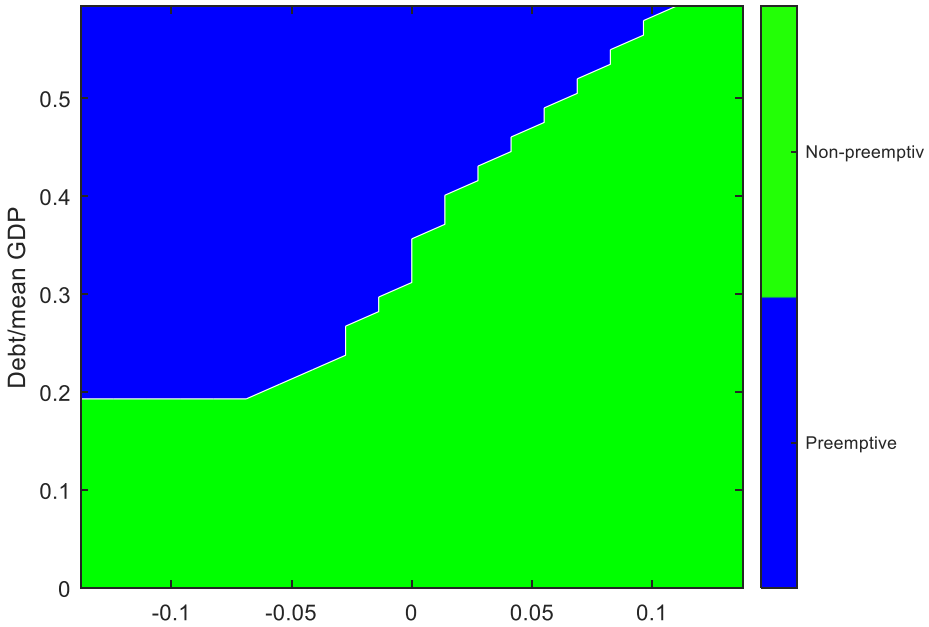
$$u(c_t, l_t) = \frac{(c_t - \frac{l_t^{1+\psi}}{1+\psi})^{1-\sigma}}{1-\sigma}, \qquad v(g_t) = \frac{g_t^{1-\sigma_g}}{1-\sigma_g} \tag{55}$$

Parameter	Value	Source
Risk aversion for private consumption	$\sigma = 3$	Hatchondo et al. (forthcoming)
Risk aversion for public consumption	$\sigma_g = 3$	Hatchondo et al. (forthcoming)
Labor elasticity	$\psi = 0.48$	Mendoza (1991)
Risk-free interest rate	$r^* = 0.01$	Aguiar et al. (2016), Yue (2010) - US Treasury bill rate
Public capital depreciation rate	$\delta^k = 0.04$	US BEA (1999)
Direct productivity loss (post-default)	$\lambda_d = 0.05$	Asonuma and Trebesch (2016) - Computed (ARG)
Direct productivity loss (preemptive)	$\lambda_p = 0.04$	Asonuma and Trebesch (2016) - Computed (URY)
Country-specific parameters		
Weight on public consumption	$\omega = 0.80$ (ARG)/0.80 (URY)	Computed (ARG/URY)
Labor income share	$\alpha^l = 0.64$ (ARG)/0.58 (URY)	Gordon and Guerron-Quintana (ARG)/Computed (URY)
Public capital income share	$\alpha^k = 0.058$ (ARG)/0.11 (URY)	Computed (ARG/URY)
Effective consumption tax rate	$\tau = 0.33$ (ARG)/0.33 (URY)	Computed - IMF WEO (ARG/URY)
Public capital adjustment costs	$\Omega = 10$ (ARG)/10 (URY)	Computed (ARG/URY)
Auto-correlation of productivity shock	$\rho = 0.85$ (ARG) /0.90 (URY)	Computed - MECON (ARG)/ BCU (URY)
Standard deviation of productivity shock	$\sigma^a = 0.017$ (ARG) /0.015 (URY)	Computed - MECON (ARG)/ BCU (URY)
Bargaining power	$\phi = 0.93$ (ARG)/0.70 (URY)	Computed (ARG/URY)
Discount rate	$\beta = 0.80$ (ARG)/0.80 (URY)	Computed (ARG/URY)

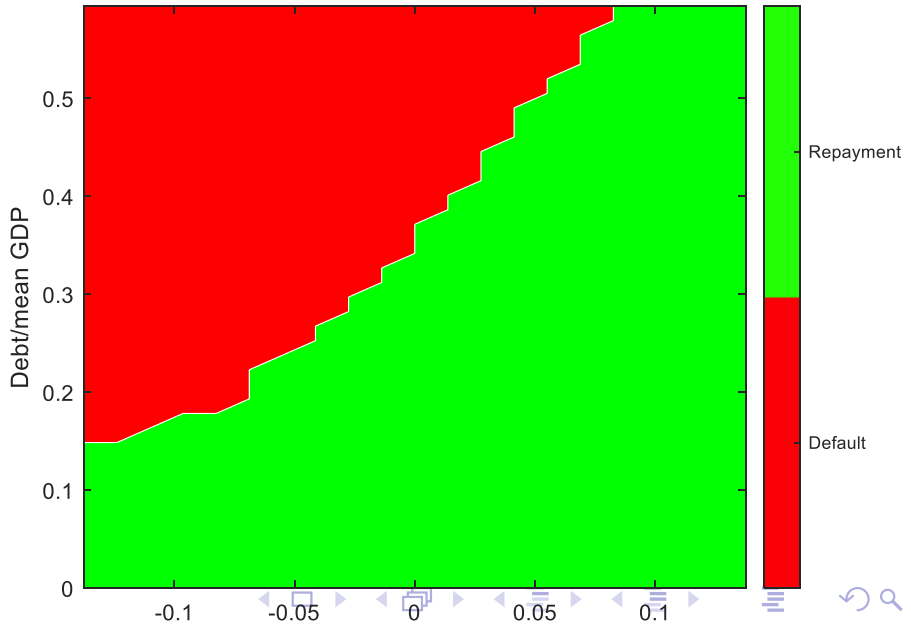
Quantitative Analysis - Ergodic dist.

- Debtor's choice between preemptive and non-preemptive and between repayment and default - Mean public capital
  - Preemptive - when debt is high and previous TFP is low
  - Default - when debt is high and current TFP is low

(a) Choice for Preemptive Restructuring (ex-ante, Uruguay)



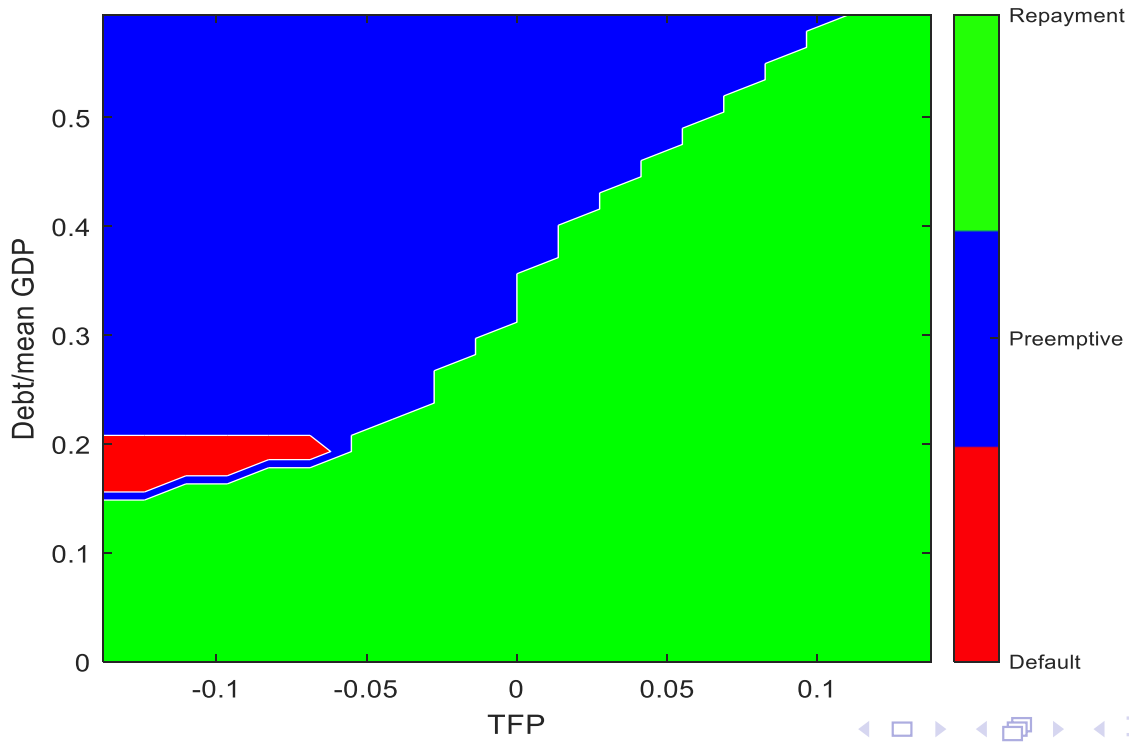
(b) Choice for Default and Repayment (ex post, Uruguay)



Quantitative Analysis - Ergodic dist.

- Debtor's choice among preemptive, default and repayment - Mean public capital
  - Replication of Asonuma and Trebesch (2016)

(c) Choice for Preemptive Restructuring, Default and Repayment (Uruguay)

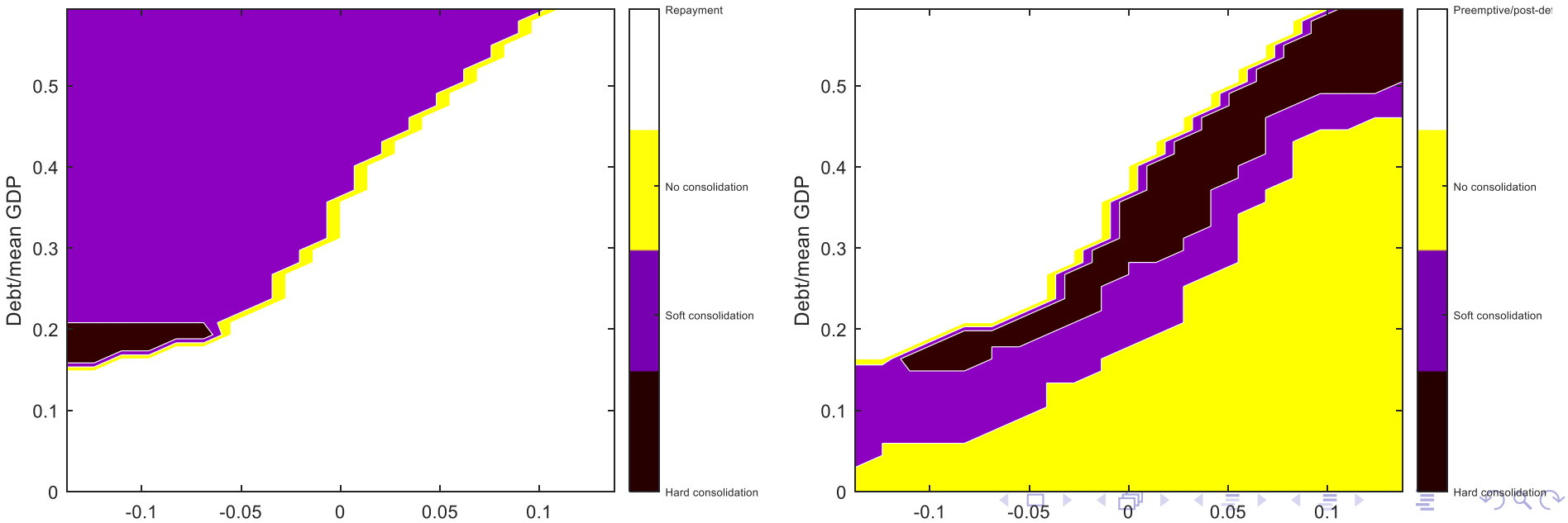


Quantitative Analysis - Ergodic dist.

- Debtor's choice among hard, soft and no expenditure consolidation - Mean public capital
  - Hard consolidation under post-default, soft under preemptive
  - Hard, soft and no consolidation under repayment

(a) Under Intermediate and Bad Credit Records (preemptive/post-default, Uruguay)

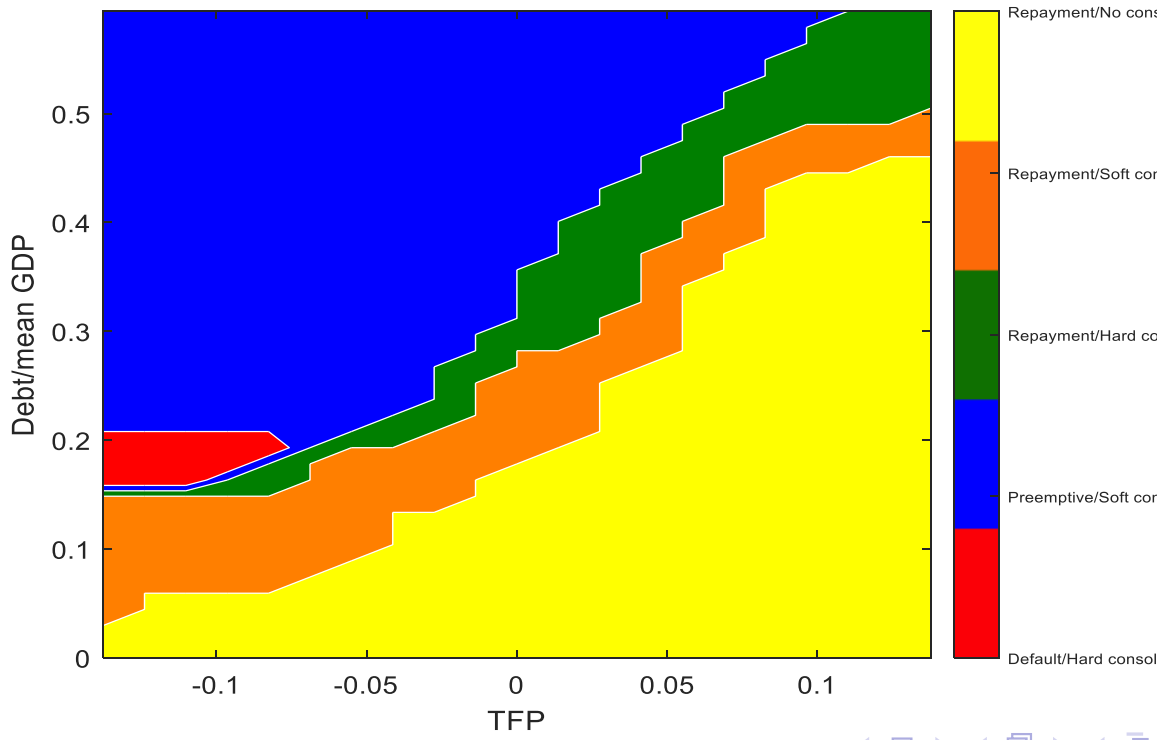
(b) Under Good Credit Record (repayment, Uruguay)



Quantitative Analysis - Ergodic dist.

- Front-loaded (hard) expenditure consolidation & no restructuring (green)
- Back-loaded (hard) expenditure consolidation & post-default (red)

(c) Choice among strategies of expenditure consolidation and restructuring (Uruguay)



Quantitative Analysis - Simulation

(i) Business Cycle Statistics

	Uruguay 2003		Argentina 2001-2005	
	Data	Baseline Model	Data	Baseline Model
Target statistics				
Pre-restructuring period				
Average public consumption & transfers/GDP ratio (%)	19.4	20.5	20.0	22.9
Public investment (std. dev.)/output (std. dev.)	5.8	3.04	5.1	5.9
Restructuring period				
Average output deviation during debt renegotiations (%)	-2.28	-3.0	-3.47	-4.50
Non-target statistics				
Pre-restructuring period				
Public sector				
Public consumption & transfers (std. dev.)/output (std. dev.)	1.09	1.00	1.26	1.23
Corr.(public consumption & transfers, output)	0.35	0.74	0.52	0.85
Average public investment/GDP ratio (%)	4.18	3.70	1.31	1.60
Average public expenditure/GDP ratio (%)	23.5	24.2	21.3	23.5
Average public investment/public expenditure ratio (%)	16.9	14.7	6.2	6.4
Restructuring period				
Public sector				
Public consumption & transfers (std. dev.)/output (std. dev.)	2.0[1/]	0.78	0.99	2.36
Corr.(public consumption & transfers, output)	1.0[1/]	0.89	0.99	0.77
Average public consumption & transfers/GDP ratio (%)	25.2	20.7	20.2	23.3
Average public investment/GDP ratio (%)	3.20	3.25	1.19	1.47
Average public expenditure/GDP ratio (%)	28.4	23.9	21.3	24.7
Average public investment/public expenditure ratio (%)	11.2	15.8	5.7	5.9
Expenditure consolidation choice	front-loaded	front-loaded	back-loaded	back-loaded

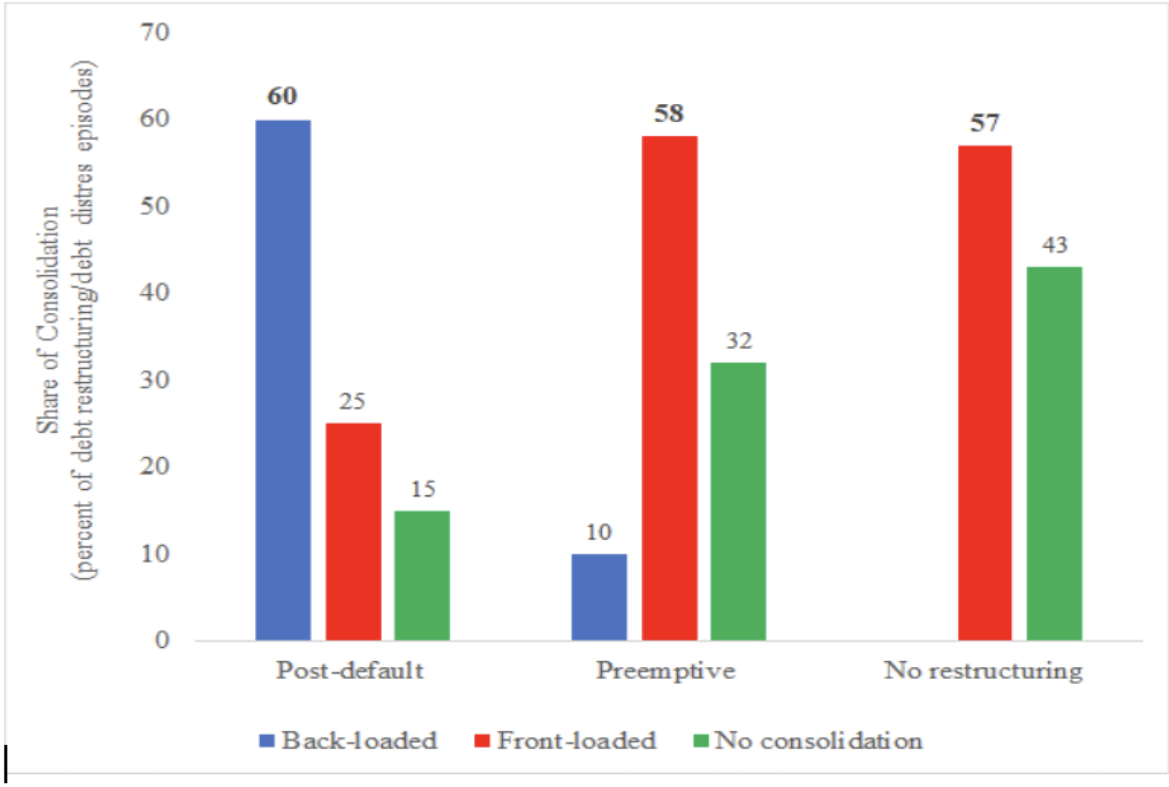
Quantitative Analysis - Simulation

(ii) Non-business Cycle Statistics

	Uruguay 2003		Argentina 2001-2005	
	Data	Baseline Model	Data	Baseline Model
Target statistics				
Default probability (%)	3.26	3.03	3.26	3.05
Average recovery rate (%)	87.1	83.0	25.0	27.1
Pre-restructuring period				
Average debt/GDP ratio (%)	59.1	48.0	45.4	44.7
Bond spreads: average (%)	7.7	1.03	9.4	1.65
Bond spreads: std. dev. (%)	5.1	1.50	7.6	2.25
Corr.(debt/GDP, spreads)	1.00	0.11	0.92	0.18
Restructuring period				
Restructuring strategy	preemptive	preemptive	post-default	post-default
Average debt/GDP ratio (%)	130.5	51.6	130.5	50.7
Duration of renegotiations/ exclusion (quarters)	1.0	4.3	14.0	11.2
Average public investment recovery (quarterly) from t-1 to pre-restructuring level	10.3	7.5	12.0	8.5

Quantitative Analysis - Simulation

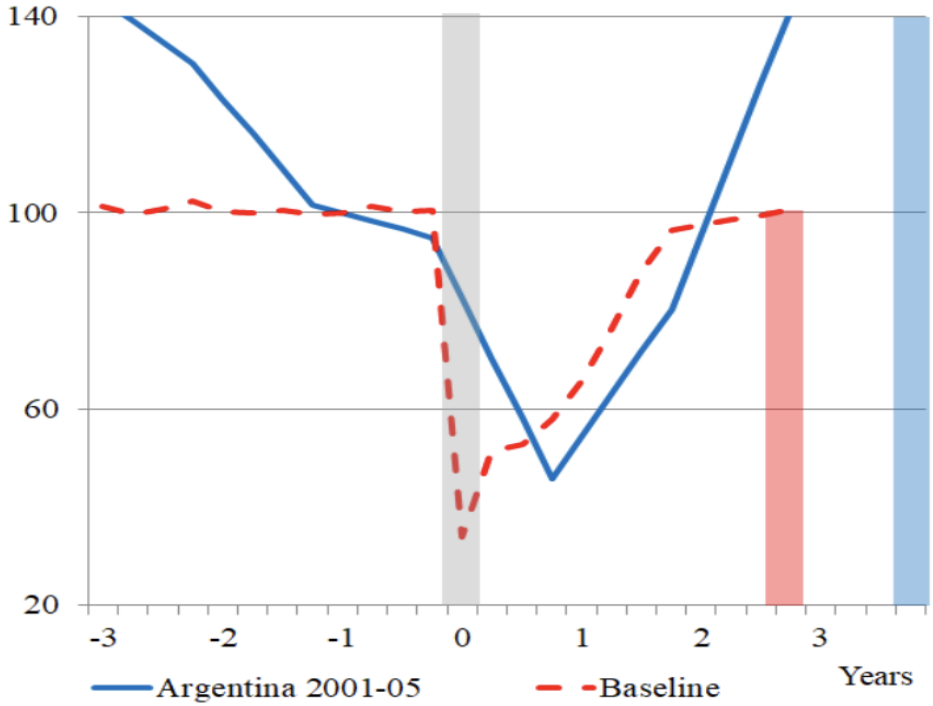
- Strategies of expenditure consolidation and debt restructuring



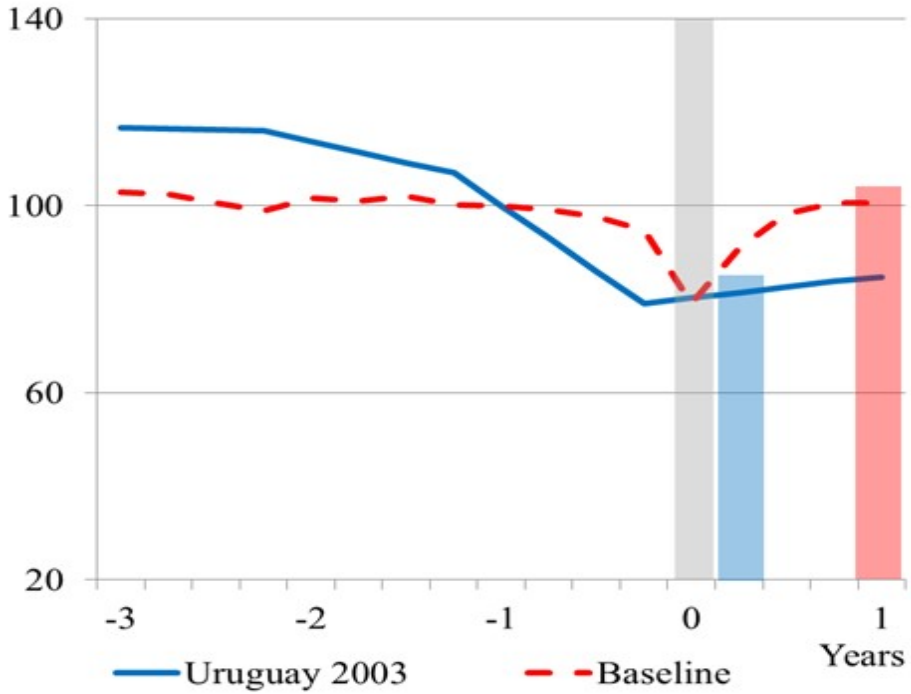
Quantitative Analysis - Simulation

- Public investment around debt restructuring and debt distress

(a) Post-default Restructuring (Argentina)



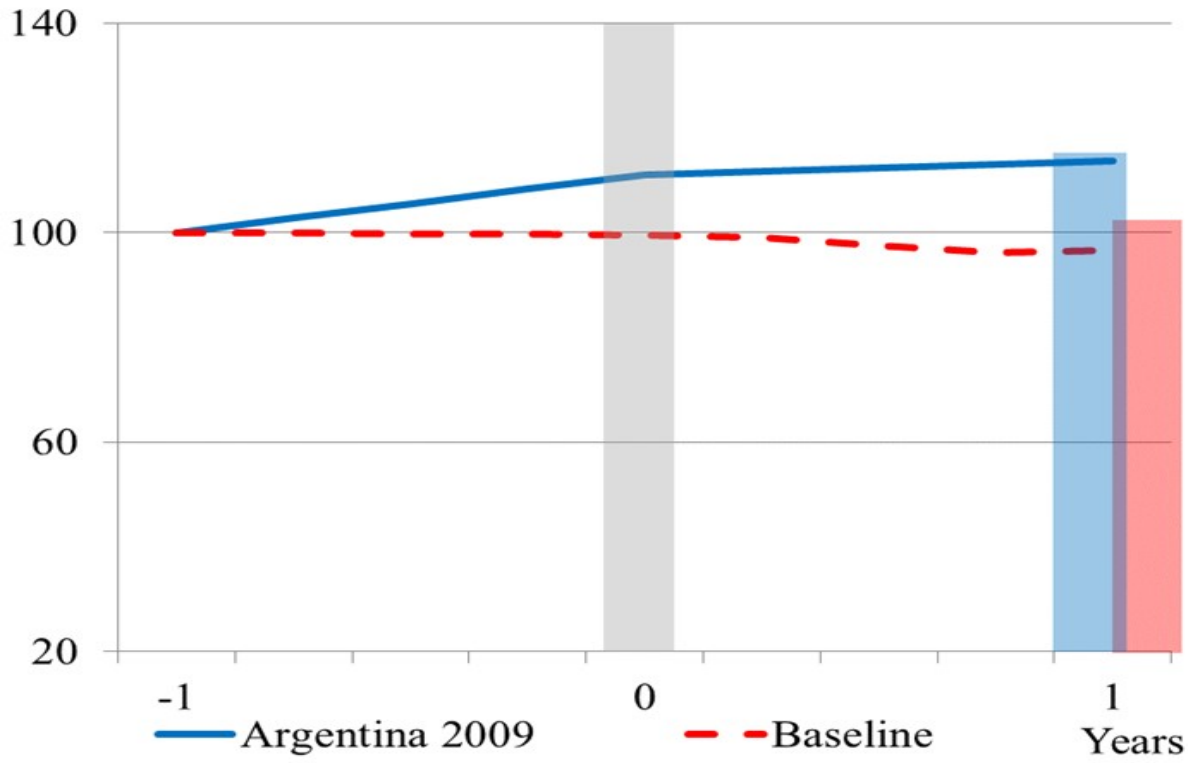
(b) Preemptive Restructuring (Uruguay)



Quantitative Analysis - Simulation

- Public investment around debt restructuring and debt distress

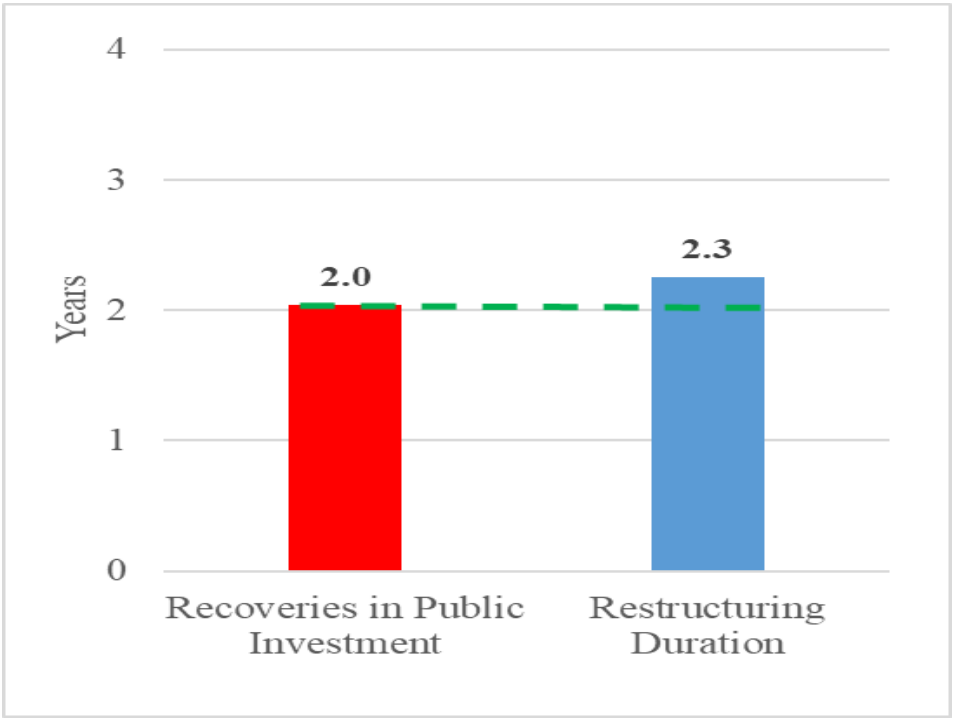
(c) Non-restructuring Debt Distress (Argentina)



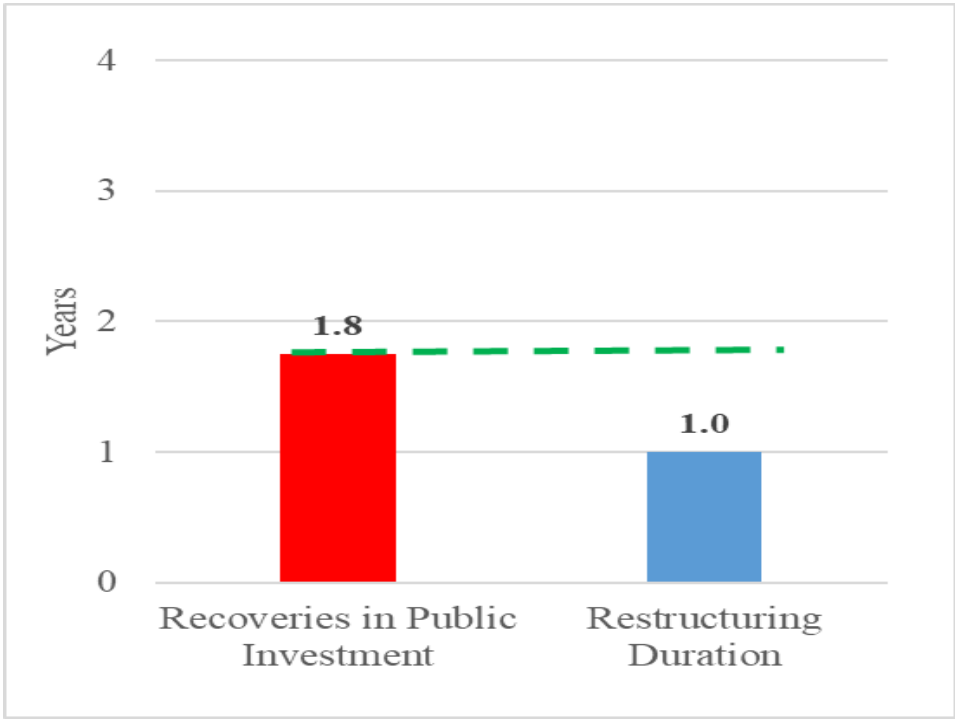
Quantitative Analysis - Simulation

- Recoveries in public investment and restructuring duration

(a) Post-default Restructuring (Argentina)



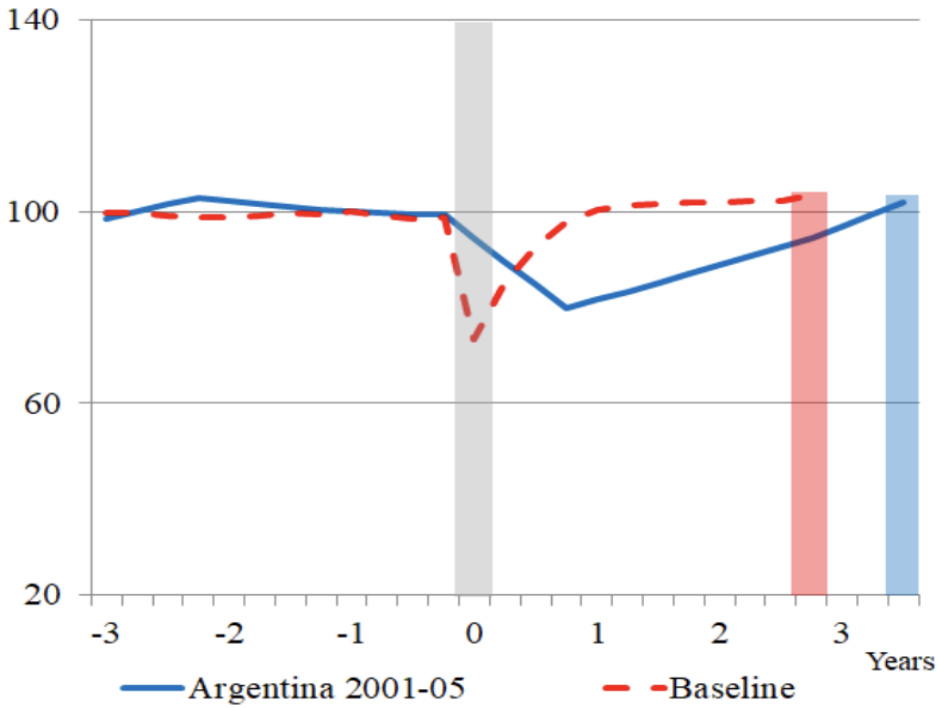
(b) Preemptive Restructurings (Uruguay)



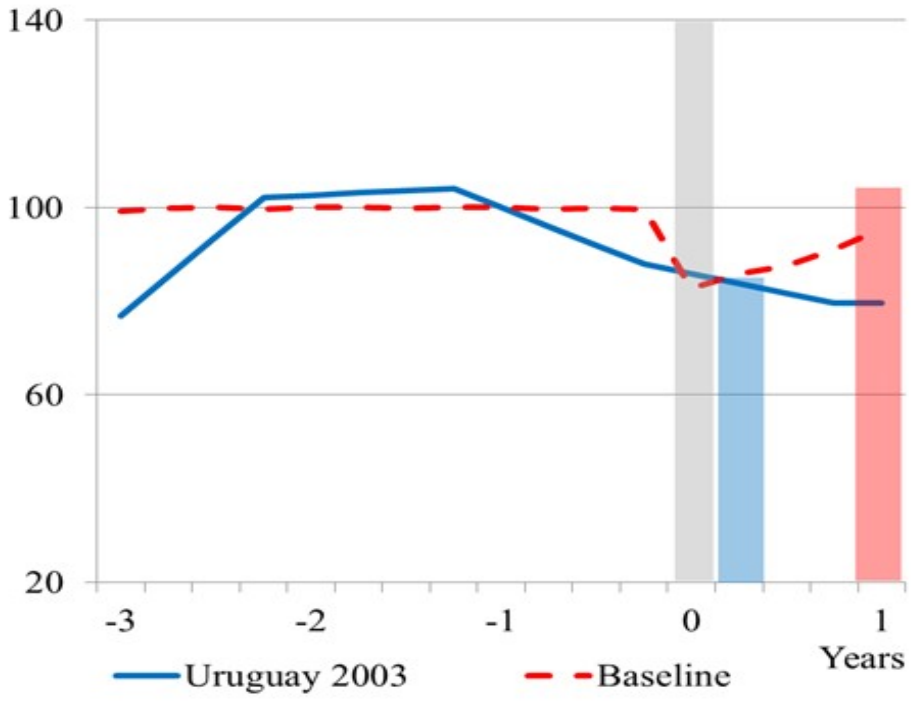
Quantitative Analysis - Simulation

- Public Consumption and Transfers around Restructurings and Debt Distress

(a) Post-default Restructuring (Argentina)



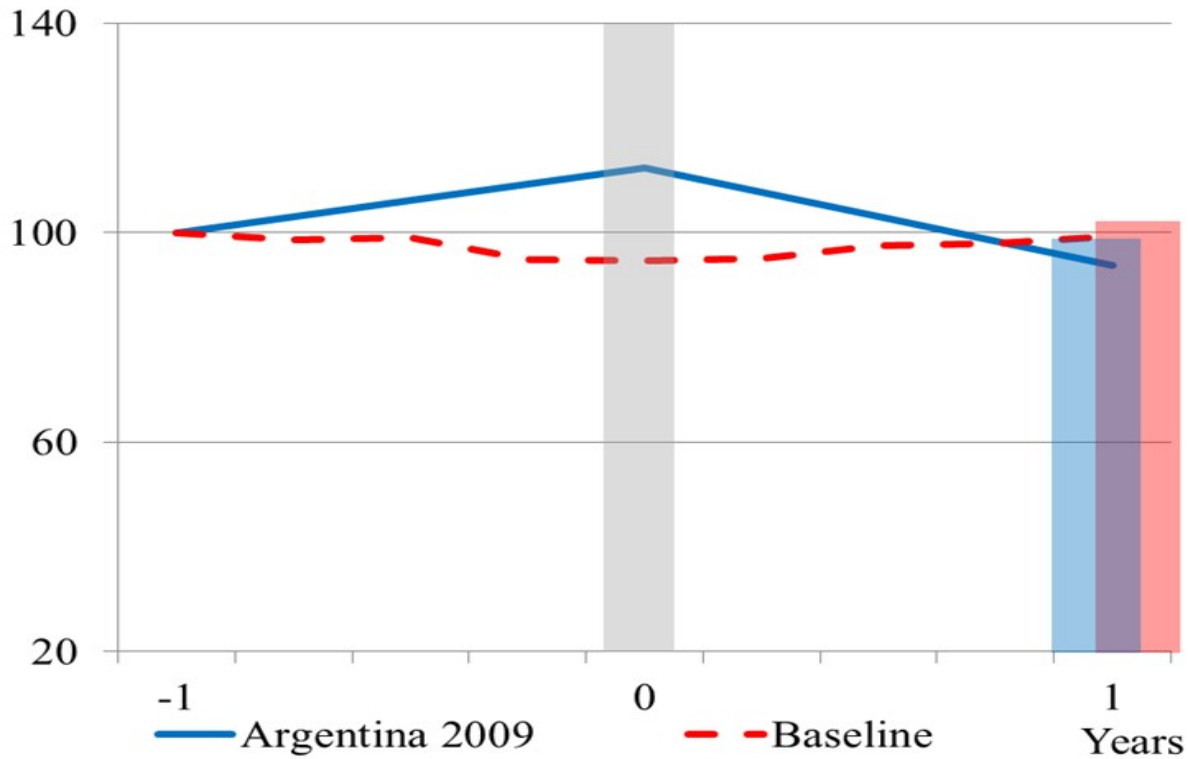
(b) Preemptive Restructuring (Uruguay)



Quantitative Analysis - Simulation

- Public Consumption and Transfers around Restructurings and Debt Distress

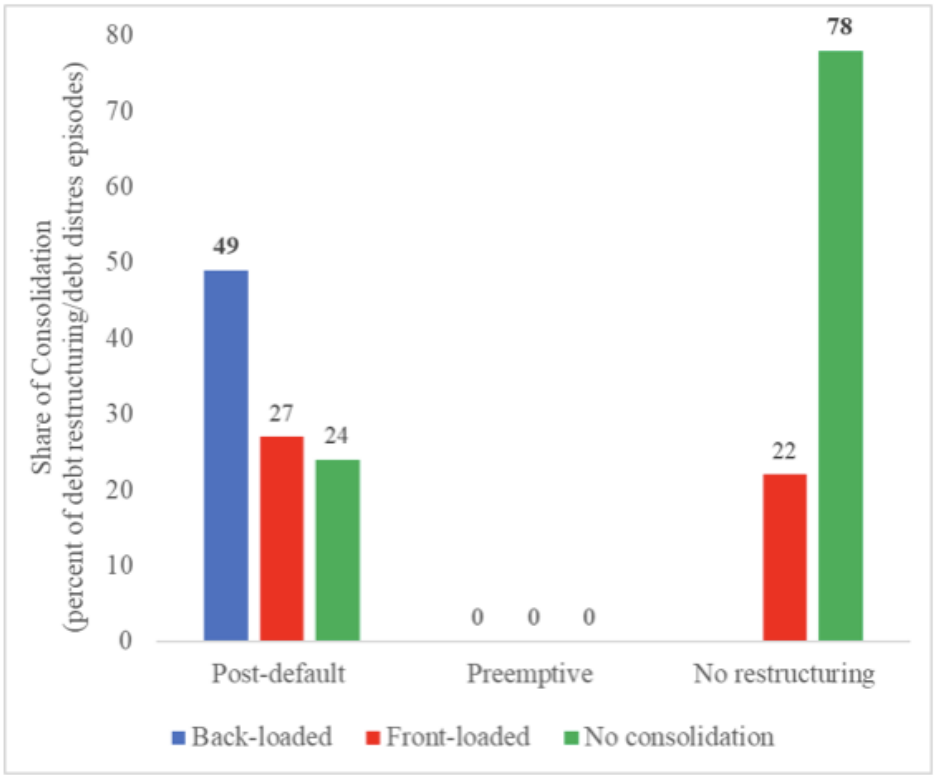
(c) Non-restructuring Debt Distress (Argentina)



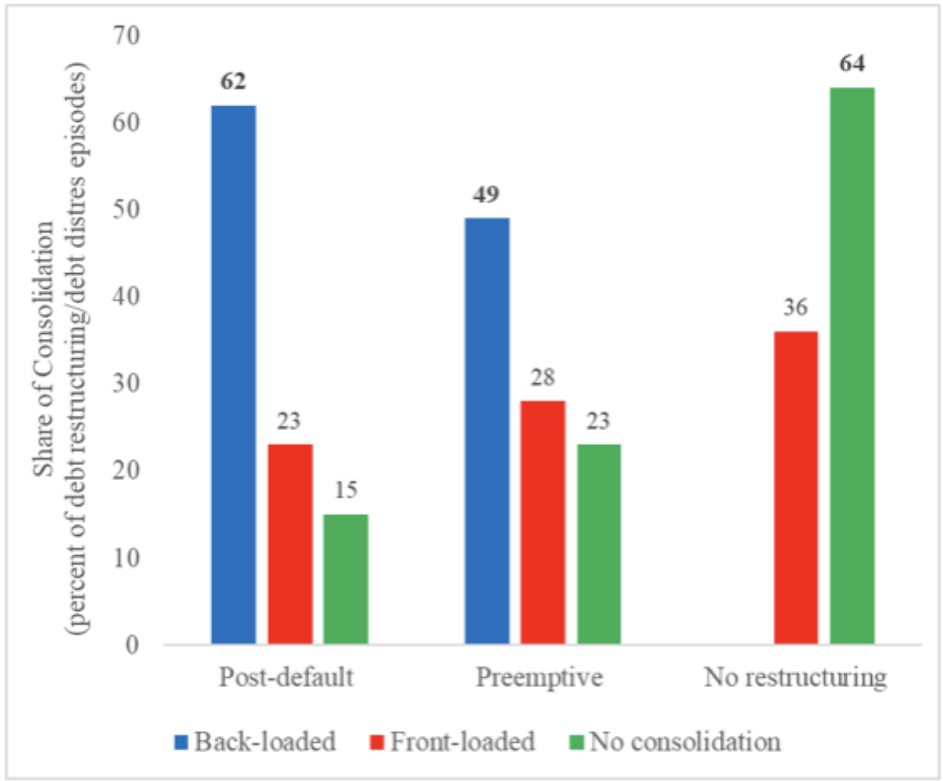
Quantitative Analysis - Simulation

- Role of preemptive restructuring choice and public capital

(i) No Preemptive Restructuring Choice



(ii) Fixed Public Capital



Conclusion

- New data and stylized facts on expenditure consolidation and debt restructurings
- New theoretical explanation on sovereign debt crises and resolution
  - Choice between front- and back-loaded consolidation
  - Role of two types of expenditure consolidation in sovereign debt crises and resolution
- Quantitative analysis of model rationalizes the stylized facts