

Discussion of  
**Sovereign Default and Government Reputation**  
by S. Fourakis

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# The *want* operator

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## A **theory** that

- **reminds** you of how people outside the model *talk* about sovereign risk
  - ... Reinhart, Rogoff & Savastano (2003): countries differ in their 'debt tolerance'
- features information and **inference** about sovereign default
  - ... Hamilton: assume the states' debts and pay them to *ensure* better terms
- does not rely on failures of **rationality** or optimization
  - ... Discipline: agents apply Bayes' rule on equilibrium strategies

# Reputation and sovereign risk

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## Standard model of sovereign debt, default, renegotiation

- Two **types** for the government
  - One of them will face better borrowing terms ...call it a *responsible* type
    - ... Signalling target for the other type
  - Both types optimize
    - ... Responsible wants to **separate**, Irresponsible wants to **pool**
  - **Reputation** is the *investors'* belief that the government is responsible
- Types alternate, information never revealed
  - ...  $0 < \underline{\pi} \leq \text{Reputation} \leq \bar{\pi} < 1$
- Preference shocks everywhere, no observation is perfectly revealing
  - ... Reputation is a continuous variable
  - ... Cannot fully separate, cannot fully pool

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## Choosing the types

Who pretends to be which type?

Evidence on **spreads** after countries recover market access

- Size of past **haircut**
  - ... does not affect spreads in first three years
  - ... correlates with higher spreads later on
- Higher  $\beta$  with higher **cost** of default
  - ⇒ debt paths do not cross
  - ⇒ debt choice reveals **type**

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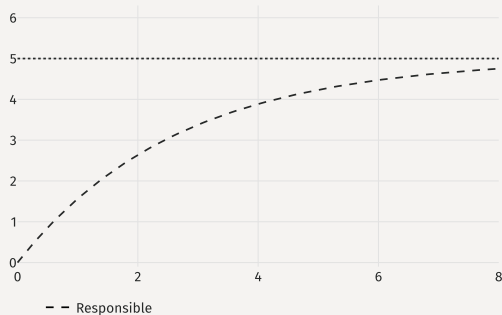
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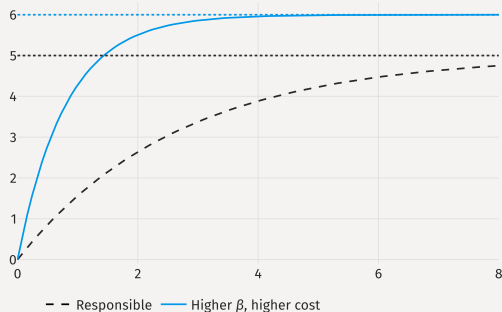


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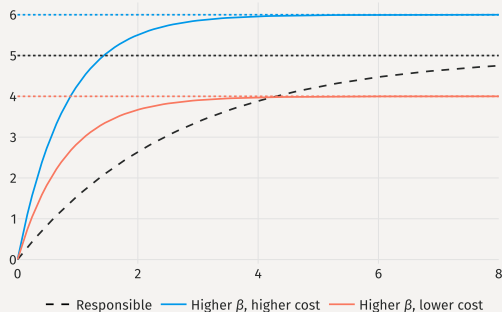


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## Theory

# Models with types

## Rational expectations

- If I want to **convince** you that I am of type  $\tau$ , type  $\tau$  must have a prior probability
- Need to think about each type's **behavior**
- Signalling style is a **hybrid** of two polar styles

### Political economy

- Alternating protagonists
- Full information
- Observe when the type changes
  - Elections natural counterpart
- Evaluate other type's strategy with own preferences

### Game theory

- Multitude of *behavioral* types
- Prior  $> 0$  but do not try to separate
- One rational type (protagonist)
- Often rely on announcements
- Who to include?
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## Applications

# How to do transparency?

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- Evaluation of **transparency** initiatives
  - ... through making the types common knowledge
- **Both** types worse off!
  - No confusion between types  $\implies$  Irresponsible cannot enjoy low spreads
  - Debt **dilution** with perfect info  $\implies$  separation curbs overborrowing
- Model has a more direct way to do this
  - Just reduce the **variance** of preference shocks
  - Lower cover means:
    - ... actions are more revealing
    - ... higher incentives to mimic
  - Often reputation models have a **discontinuity** at zero reputation
    - ... Here  $Reputation \geq \underline{\pi} > 0...$

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## How to do fiscal rules?

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If fiscal rules disrupt **signalling** motives, they could lead to *higher borrowing!*

- Different angle for the reputationally-minded

**Game Theory** style (blueprint from Kostadinov & Roldán, 2023)

- Conceptualize fiscal rules as  $b'(b, z)$ , proliferate **behavioral** types
- Add preference or control shocks
- Announce optimally one type/rule. Take **limit** as probability of rational to 1
- How closely does the rational type mimic the rule? – measure of **credibility**
- Tradeoff between literal promise and credibility

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## Concluding remarks

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- Fantastic work pushing the boundary on a first-order question
  - ... Should there be an extra state in sovereign debt models?
- Smart reinterpretation of elements in the literature
  - ... Especially on the data front to determine the types
- Nascent literature on applications of reputation in macro
  - ... many open questions:
    - ... Loose reputations?
    - ... Global reputations?