Discussion of
Sovereign Default and Government Reputation
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Fiscal Policy in an Era of High Debt
IMF, November 2023

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

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
  ... $0 < \underline{\pi} \leq Reputation \leq \bar{\pi} < 1$

- Preference shocks everywhere, no observation is perfectly revealing
  ... Reputation is a continuous variable
  ... Cannot fully separate, cannot fully pool

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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 β with higher cost of default
  $\implies$ debt paths do not cross
  $\implies$ debt choice reveals type

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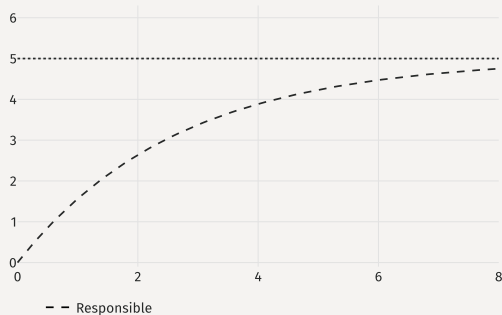Evidence on spreads after countries recover market access

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- - Responsible

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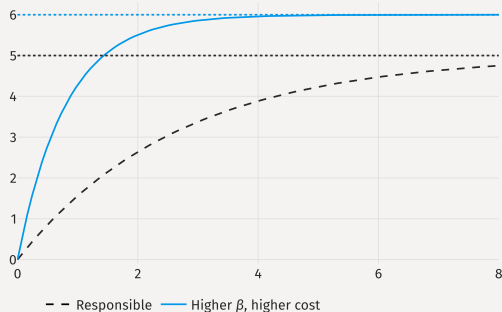

Legend: - - - Responsible — Higher β, higher cost
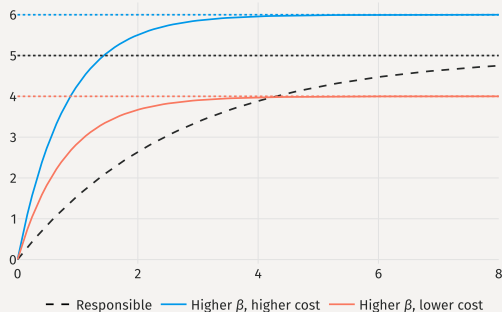
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Reputation

Theory

Models with types

Rational expectations

- If I want to convince you that I am of type τ, type τ 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?
    - ... lower types to separate
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Applications

- 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?

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

- 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?