Discussion of

"Renegotiation Policies in Sovereign Defaults"

by Cristina Arellano and Yan Bai

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Overview

- Wide discontent with architecture of sovereign debt restructuring:
  - "Debt restructuring have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way", IMF 2013

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  - "Debt restructuring have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way", IMF 2013
- **This paper:** focus on sovereign debt restructuring policies when multiple countries default simultaneously
- Very interesting and policy relevant paper!

Summary

- Static Model (one-period version of Arellano-Bai 2013)
- Linear utility (unlike AB 2013)
- One lender, two borrowing countries
- Countries start with an initial exogenous level of debt
- If countries default, parties renegotiate over recovery rates

Summary (ctd)

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- Paper considers a social planner:
  - Sets directly the recovery rate in renegotiation and parties borrowers choose whether to default and renegotiate
  - No lump sum transfer (redistribution only via default)
- Key results:
  - Centralized solution entails less defaults for given rec. rate
  - Recovery rates should be indep. of default of other borrower

Comments

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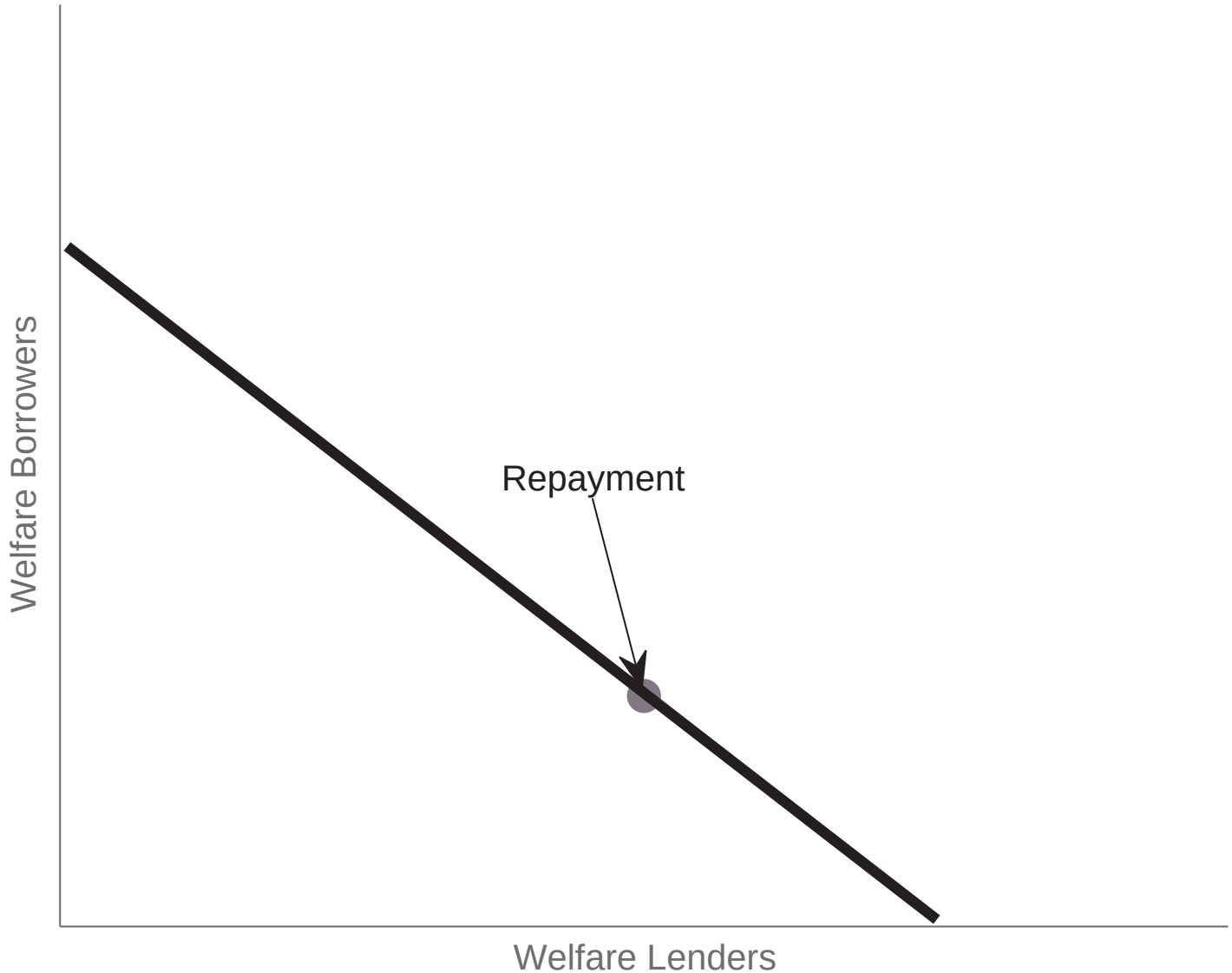
- If planner reduces recovery rate, this leaves the lender strictly worse off
- But polices do predict average welfare gains
- Stochastic model with risk averse lenders would be interesting as intervention would affect risk-sharing (Arellano-Bai, 2013)
- A dynamic model would also produce gains in terms of commitment (better borrowing terms)

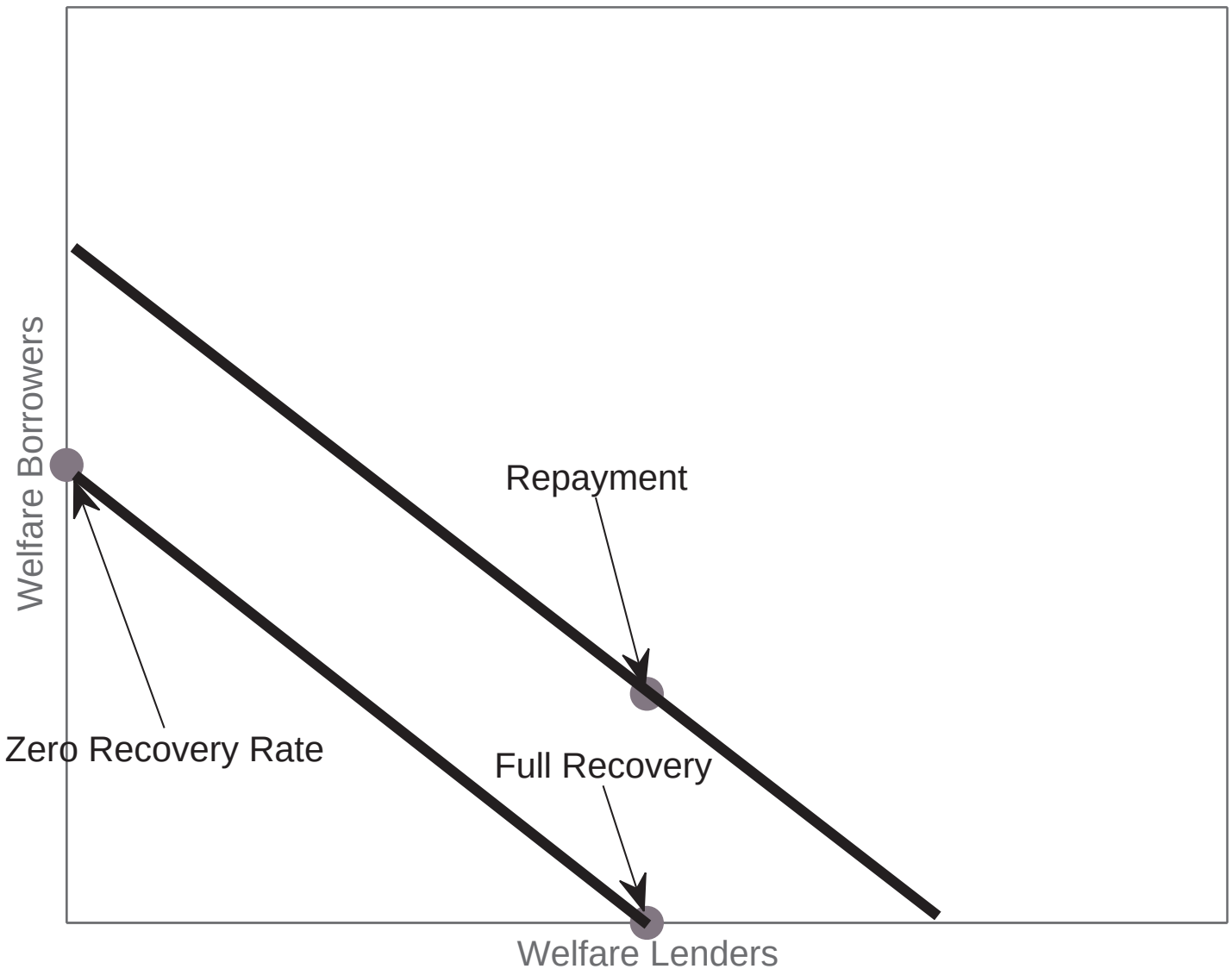
Pareto Frontier

With lump-sum transfers



Pareto Frontier

Without lump-sum transfers + Default



Alternative Renegotiation Protocol

- Instead of renegotiating three parties together, consider simultaneous and independent decentralized renegotiations

$$\begin{aligned}
\phi_1^* &= \arg\max_{\phi_1}\{[(y^d - \phi_1) - y^{NR}]^{\lambda}[(\phi_1 + \phi_2^*) - \phi_2^*]^{1-\lambda}\} \\
\phi_2^* &= \arg\max_{\phi_2}\{[(y^d - \phi_2) - y^{NR}]^{\lambda}[(\phi_2 + \phi_1^*) - \phi_1^*]^{1-\lambda}\}
\end{aligned}$$

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- Each recovery rate becomes **independent** of other country's recovery rate, **as in centralized solution**

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- Each recovery rate becomes **independent** of other country's recovery rate, **as in centralized solution**
- This would not be the case without linear utility for lenders
- ...BUT for the planner, recovery rates would also be linked

Other comments/questions

- Paper assumes that lenders collude. What prevents free-riding problem in practice?
- What about collusion on borrowers (Paris club)?
- Implications for restrictions on borrowing (Maastricht treaty)? Should they be restrictions on gross/net borrowing?
- Asymmetric countries seem to be inessential

Final Remarks

- Thoughtful and timely paper!
- Clarify sensitivity of some of the policy conclusions to modelling choices