The dynamics of sovereign default risk and political turnover

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ABSTRACT

This paper develops a stochastic dynamic politico-economic model of sovereign debt to analyze the interaction of sovereign default risk and political turnover. Two parties differ in their preferred size of unproductive public spending which is financed by taxes and external debt. Electoral outcomes are characterized by the economic benefits from the incumbent's policies and stochastic idiosyncratic ideological aspects. Quantitative findings suggest that endogenous political turnover increases the discrepancies between the optimal borrowing and default policies of the two parties. Prior to a debt crisis, the incumbent government accumulates external debt to foster the probability of remaining in power. The dynamic interaction of electoral outcomes, external debt, and sovereign default supports arguments for imposing institutional constraints on incumbent governments.

1. Introduction

The large-scale sovereign default of Argentina in 2001/2002 was associated with substantial political instability. Hatchondo and Martinez (2010) argue that while the incumbent president Fernando de la Rua imposed severe austerity policies to fulfill the external debt obligations, his opponents campaigned for higher public spending. Having lost political support, de la Rua resigned in December 2001, and the interim president Adolfo Rodriguez Saa immediately declared a sovereign default. More recently, the political and economic situation in Greece indicates a strong interaction between sovereign debt crises and political turnovers. This anecdotal evidence is supported by econometric studies suggesting that the possibility of a political turnover increases default risk (Manasse and Roubini, 2009; Goretti, 2005; Vaaler et al., 2005; Block and Vaaler, 2004). Moreover, Herrera et al. (2014) provide econometric evidence that politico-economic factors are important predictors of financial crises in emerging market economies.

To analyze the underlying economic mechanisms behind the empirical interaction of sovereign default risk and political turnover, this paper develops a stochastic dynamic politico-economic model of sovereign debt. The theoretical framework features endogenous default risk as well as endogenous electoral outcomes and allows to study several important questions. Specifically, how does the risk of losing office affect the current government's policy choices between external borrowing, taxation, and public spending? Do incumbents make use of strategic defaults to influence their election probability? How do the dynamic interactions of sovereign spreads and election probabilities affect debt policies and macroeconomic outcomes?

The model builds on the politico-economic theory of public debt surveyed in Persson and Tabellini (2000) and the recent quantitative macroeconomic models of sovereign debt and default initiated by Aguiar and Gopinath (2006) and Arellano (2008). Hatchondo et al. (2009) and Cuadra and Sapriza (2008) employ the basic framework of Arellano (2008) and introduce two parties that exogenously alternate in power. While these studies allow to study the quantitative impact of exogenous political uncertainty on sovereign default risk, they abstract from the dynamic interaction between fiscal policy and endogenous political turnover. This paper attempts to fill this gap and analyzes the impact of endogenous electoral outcomes on the incumbent's policy choices between public spending, taxation, external borrowing, and default.

The theoretical framework considers a small open economy that is inhabited by infinitely-lived households. Individuals belong to two groups that differ in their preferred size of unproductive public spending, but have identical preferences for private consumption and leisure. There is a two-party system in which each party cares
about the welfare of one of the two groups. The government finances public spending by raising distortionary taxes and by issuing external debt. International financial markets are incomplete and debt contracts are not enforceable. In each period, conditional on being in a good credit standing, the government has the option to either fulfill the external debt obligations or to default. The party that is characterized by a greater preference for public spending raises higher taxes with distortionary effects on production and has higher incentives to default.

Political turnover is defined as the alternation in power of the two parties and is an endogenous outcome of the electoral process. I follow the probabilistic voting approach commonly used in the politico-economic literature and assume that the individual voting behavior is determined by the economic benefits from the incumbent’s and opponent’s policies as well as stochastic idiosyncratic non-economic ideological aspects. The endogenous election probability of a party turns out to be a function of the productivity state and the borrowing and default decision. An incumbent party can use its debt policy to increase the probability of remaining in power. Risk-neutral foreign creditors incorporate the endogenous electoral outcome as well as the default risk when maximizing expected profits.

In a quantitative exercise, the theoretical framework is applied to the Argentine economy. To highlight the importance of endogenous political turnover, I relate the policy outcomes to the ones that would occur in the absence of political uncertainty and in the presence of exogenous political turnover. Similar to Hatchondo et al. (2009), in comparison with no political uncertainty, exogenous political turnover reduces the discrepancies between the parties’ debt and default policies. In contrast, endogenous electoral outcomes increase the disparities between the optimal borrowing and default decisions of the two parties. The party which prefers lower unproductive public spending borrows more and defaults less often in order to raise its election probability. The party with a preference for higher spending is borrowing constrained because of greater credit costs and is more willing to default in order to enhance its probability of being elected.

The model predicts that the party with a preference for lower public spending has an electoral advantage since it faces lower credit costs and is less borrowing constrained than its opponent. Therefore, in the simulations, the party preferring lower public spending is more often in power and the sovereign premium is positively correlated with the probability that the left-wing opponent takes over. This finding is in line with the empirical correlation of political stability and sovereign interest spreads observed in Argentina and other emerging market economies. Econometric evidence suggests that in emerging market economies sovereign interest spreads indeed increase before elections in which a right-wing incumbent is expected to default constrained by greater credit costs and is more willing to default in order to enhance its probability of being elected.

While the aforementioned papers consider stylized two-period frameworks, this paper analyzes the link between political turnover and public debt in closed economy setups, see, e.g., Alesina and Tabellini (1990), Persson and Svensson (1989), and the excellent overview in Persson and Tabellini (2000). In particular, Persson and Svensson (1989) show that a right-wing government may borrow more when it knows that a left-wing party comes into power next period. Several studies extend the theoretical framework to open economy setups with external debt and default. While Alesina and Tabellini (1989) assume that two government types randomly alternate in office, Aghion and Bolton (1990) allow for endogenous political turnovers and show that the right-wing government affects the electoral outcome in its favor if it accumulates large levels of external debt since the left-wing party is expected to default. Related to the politico-economic literature on public debt, Chang (2007) and Chang (2010) study the interaction between political crises and financial crises and focus on the role of self-fulfilling expectations of foreign lenders. In particular, Chang (2010) develops an economy in which entrepreneurs seek funding from international financial markets to finance investment projects. Employing the probabilistic voting approach and assuming a “pro labor” and a “pro business” electoral candidate, Chang (2010) finds that the politico-economic interplay generates an increased macroeconomic and financial sensitivity to exogenous shocks during electoral periods. Similar to Chang (2010), this paper studies the interaction between electoral outcomes and international lending, however, Chang (2010) abstracts from public debt and sovereign default which are the focus here.

While the aforementioned papers consider stylized two-period frameworks, this paper analyzes the link between political turnover and sovereign default risk in a fully dynamic quantitative framework. Related studies are Battaglini and Coate (2008), Yared (2010), Song et al. (2012), and Müller et al. (2016) who develop dynamic politico-economic theories of public debt but abstract from sovereign default risk.
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