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Recovery Before Redemption

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Author

Listed:
- David Benjamin
(University of Southampton)

Registered:
- David Benjamin

Abstract

We present a model where default occurs because of a country's limited commitment to repay. In this model, default is costly to the country as it leads to a loss of income and a denial of access to markets. If a country's debt is high and income is persistently low, the country defaults on its debts in order to negotiate a smaller future obligation. Alternatively a country may default if bargaining power shifts away from the creditors towards the debtor. Once in default the country faces a formal bargaining procedure. In each period either the debtor country or the creditors are chosen randomly to make new offers which can consist of either current consumption or future debt. Neither side can commit to offers in any period during the bargaining. We show this model generates substantial delays in equilibrium. By doing so, we are able to explain delays without coordination problems or imperfect information. We also provide detailed quantitative implications of the model. We are able to match a wide variety of features of the data for recent sovereign debt renegotiations. These features include long delays, the correlation between income and both the beginning and end of sovereign default and the correlation between the size of the length of the default.

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