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What determines debt intolerance? The role of political and monetary institutions

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ABSTRACT

Why do some States default on their debt more often than others? We argue that sovereign default is the outcome of a political struggle among different groups of citizens. It is less likely to happen if domestic debt-holders are politically strong and/or the costs of the financial turmoil typically triggered by a sovereign bankruptcy are large. We show that these conditions are in turn more likely to be present if a country has a strong middle class and/or a sufficiently independent central bank.

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1. Introduction

Reinhart and Rogoff (2008, 2009) show that some governments are systematically more likely to default than others. Moreover, most of their default episodes happened at relatively low levels of debt. On the contrary, other governments are able to sustain much higher borrowing levels without precipitating a crisis. In this paper we propose an explanation for this stylized fact, arguing that some sovereign borrowers are more prone to default than others due to features of their political and monetary institutions.

Faced with a large amount of public debt obligations, governments either re-absorb them through fiscal consolidation (by cutting expenditure and/or increasing taxes), or cancel them out with a sovereign default.[1] These two options entail different macroeconomic results, as well as different redistributive consequences. We propose a model in which the government takes into account these consequences when deciding whether to fulfill or default on its promises, and chooses default if and only if the implied costs for its constituency are lower than the benefits.

In our model, the poorest part of the population holds its wealth in the form of cash, the middle class invests in government bonds – a relatively safe and low-return financial asset – and the rich have most of their wealth invested in high-return, risky financial instruments (indeed, it is a well documented fact that portfolio composition depends on wealth, and in particular that

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[1] This dilemma is particularly compelling for countries in which inflating the debt away is not a viable option, either because debt is short-term or because it is denominated in a foreign currency.

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stock market participation is in most countries limited to the richest part of the population; see Guiso et al., 2003).[2] Therefore, the presence of a politically influent middle class improves debt sustainability. Moreover, this effect is enhanced if democratic institutions are in place, to the extent that these are more likely to protect the interests of the middle class while limiting the influence of people at the extremes.

Furthermore, our paper emphasizes the role played by the Central Bank (CB) in a sovereign debt crisis.[3] In our model, the CB has some degree of freedom in setting and pursuing its own objectives. Indeed, even if in the middle of a debt crisis the pressures of the government on the CB can be very strong, in some countries there are constitutional rules that protect the latter from the pressure of the former. More importantly, even if CB independence is not enshrined in the constitution, the existence of checks and balances in the political process limits the power of the government to override the monetary authority (Moser, 1999).[4] In addition, there are groups in society which might stand ready to defend CB's independence (e.g. the financial community, as in Posen, 1995). Our second assumption concerning the CB is that its objectives are less partisan than those of the government. Assigning middle-of-the-road objectives to the CB can be justified by the fact that the appointment of CB officials typically involves other actors besides the executive, such as the Parliament, or local governments as in Lohmann (1998). Alesina and Gatti (1995) also show that competing parties with extreme political preferences might reach an agreement and jointly appoint a moderate CB if they are uncertain about election outcomes.

The CB acts in the double role of guardian of price stability and responsible for the smooth functioning of the financial system. If the default puts the financial system in jeopardy (e.g. if it triggers bankruptcies of important financial institutions or induces a wave of panic selling), it will harm not only the debt-holders, but also the citizens who invested in risky high-return assets. In such circumstances, the latter will pressure the CB to inject liquidity to sustain the financial system, even if this policy will result in excessive inflation. Symmetrically, the poor will stand to lose from the bailout of the financial system because – due to the composition of their portfolio – they are very exposed to its inflationary consequences. Thus, the CB will oppose both the demand for an excessively loose monetary policy coming from the rich and that for an excessively tight policy coming from the poor, as both policies benefit a minority at the expense of overall social welfare. Provided the CB is sufficiently independent, it will effectively resist these pressures. This will in turn increase debt sustainability, by ensuring that both the rich and the poor will bear at least part of the costs of a sovereign default. In other words, even in the presence of a small or politically weak middle class the government has an incentive to honor its debt, if there is a sufficiently independent CB.

To sum up, we argue that countries that lack the proper political and monetary institutions are not able to sustain debt levels that are instead sustainable for others. According to the definition introduced by Reinhart et al. (2003), they suffer from "debt intolerance". In particular, we show that there is a country-specific debt threshold above which default occurs, and that this threshold increases as the middle class increases its political power and the CB gains greater independence.

Our contribution builds on the seminal paper by Calvo (1988). As in his paper, our policy-maker equates the marginal costs of servicing the public debt with the marginal costs associated with debt repudiation. Calvo assumes that the government is benevolent and that agents are homogeneous. Both hypotheses are relaxed by Beetsma (1996).[5] In his model, agents differ in their holdings of public debt, and the government does not necessarily maximize social welfare. Beetsma argues that in this framework the policy-maker will be more tempted to default if its constituency holds relatively few government bonds. The intuition that debt will be repaid if debtholders are politically more influent than the rest of the citizens is also present in Dixit and Londregan (2000). While we take this insight as our starting point, we make a step forward by introducing the CB into the picture.

We also contribute to the stream of literature which endogenizes the costs associated with a sovereign default. In previous papers, default costs have been traced back to the exclusion of the defaulting sovereign from the debt market (Eaton and Gersovitz, 1981) and to broader reputational concerns (Cole and Kehoe, 1998).[6] To our knowledge, we are the first to formally model the idea that financial market disruption and/or high inflation might be part of the costs of a sovereign default. In the real world defaults do tend to be associated with such unpleasant consequences (see Kaminsky and Reinhart, 1999, and the survey by De Paoli et al., 2006).

Our paper also relates to the literature that highlights the costs of economic inequality and political polarization (see e.g. Glaeser et al., 2003), and to the literature that studies the economic consequences of democracy (see e.g. Klomp and de Haan, 2009).

The paper is organized as follows: Section 2 presents some preliminary evidence concerning the link between institutions and debt intolerance; Section 3 spells out the model; Sections 4 and 5 describe its equilibria; and Section 6 concludes.

2. Empirical motivation

In this section we provide some evidence for our thesis that the degree of democracy, the degree of central bank independence and the size of the middle class all play a role in determining the degree of public debt "intolerance" of a country.[7]

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[2] Both the propensity and the possibility to buy risky assets increase with wealth: the poor exhibit a higher risk aversion (Guiso and Paiella, 2008), a reduced awareness of the diversification possibilities offered by financial markets (Guiso and Jappelli, 2005), and are more than proportionally harmed by the existence of fixed transaction costs. A thorough review of the related empirical literature is provided by Allen and Gale (2007).

[3] Several authors (e.g. Alesina, 1988) argued that in a sovereign default the behavior of monetary authorities is often crucial. Our model provides to our knowledge the first formalization of how the CB can influence the outcome of the debt end-game.

[4] North and Weingast (1989) argue that the introduction in the constitution of such checks and balances is optimal from an ex-ante point of view.

[5] See also Beetsma and van der Ploeg (1996).

[6] Surveys of this literature can be found in Eaton and Fernandez (1995) and in Sturzenegger and Zettelmeyer (2006).

[7] Some related – and loosely supportive – evidence already exists, showing that default is less likely if the government is responsive to the needs a wider set of citizens and political actors. For example, default seems less frequent if institutional checks and balances to the power of the executive are in place (van Rijckegem and Weder, 2004; Kohlscheen, 2007).

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