Crisis costs and debtor discipline: the efficacy of public policy in sovereign debt crises

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Recent financial crises have generated much debate in policy circles. Although there has been some progress on crisis prevention measures—for example, greater emphasis on managing the national financial balance sheet—a consensus on the role of the official sector in crisis management is yet to be achieved. In particular, views vary on the likely impact of crisis management policies on lending by private creditors and the consequent welfare of sovereign borrowers.

In this paper, it is taken as given that the motivation for public intervention in crisis management stems from a coordination problem among creditors. The lack of coordination can be costly: in the event of a sovereign default, disorder in the workout process can lead to the premature scrapping of longer-term investment projects and a protracted exclusion from international capital markets. Much of the policy debate has therefore focused on reducing the costs of crisis.

But this may not be as benign an objective as it sounds. Dooley (2000) argues that the threat of substantial output costs in the event of non-payment provides the incentive for sovereign debtors to repay—crisis costs encourage debtor discipline. On this view, any move to reduce these costs will worsen the debtor moral hazard problem, and the supply of credit will be curtailed.

More generally, there is a trade-off between ensuring that sovereign borrowers adhere to debt contracts when they have the means to repay (termed '*ex ante* efficiency'), and the avoidance of large output losses following a bad-luck default ('*ex post* efficiency'). This trade-off is characterised in the paper. In particular, three key questions are addressed: (i) what are the main factors influencing the trade-off between *ex ante* and *ex post* efficiency? (ii) what is the role of the official sector in crisis management? and (iii) what impact might official sector involvement have on lending and welfare?

A simple model is presented in which the optimal level of lending and expected output are derived under two scenarios. In the first, creditors rely on high costs of crisis to ensure a debtor's willingness to pay (ie to deter strategic default). In the second, a representative of the international official sector—labelled the 'IMF'—receives a noisy signal on whether a default is strategic or arises from bad luck. If a default is perceived to be the result of bad luck, policies are implemented to alleviate the output disruption that would otherwise ensue. The official sector therefore acts in a dual capacity as 'firefighter' (trying to reduce crisis costs) and 'whistle-blower' (monitoring the debtor's ability to repay). In this second scenario, policy measures that alleviate crisis costs might include IMF lending (known in official circles as 'lending into arrears'), or measures to make the debt workout process more orderly (eg stays on litigation, mediation in the debt workout process, and oversight of best-practice guidelines for sovereign debt workouts).

Although the public policy framework described in the model leads to lower levels of lending, it confers *ex post* benefits and so can be welfare-improving. Whether this happens depends on two factors. The first is the quality of public monitoring. The better able is the 'IMF' to distinguish between bad-luck and strategic defaults, the greater the discipline on the debtor and the higher the level of lending extended by private creditors. The second factor is the efficacy with which the 'IMF' can reduce the costs of crisis. If the 'IMF' is a reasonably effective monitor, welfare is increasing in the degree to which crisis costs are alleviated. But beyond some point, the lower level of discipline that arises from the reduction in crisis costs offsets the extra discipline from 'IMF' monitoring. There is therefore a balancing act between the whistle-blowing and the fire-fighting functions: strategic behaviour is discouraged by better monitoring, but policy measures that lower the costs of crisis increase the incentive to behave strategically. Some analysis of a 'case-by-case' approach to public intervention is also presented, and it is shown to fall between full public intervention and no intervention.