

**Discussion of
“Institutions and Sovereign Default”**

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The views expressed herein are those of the presenter and not necessarily those of the Inter-American Development Bank.

The paper

- Quantitative model of sovereign default with political friction.
- Coalition controls the government and distribute “favors” among themselves.
- They solve a different problem than a planner would.
- Lower representation induces borrowing and default.
- Degree of representation explains difference among developed and emerging economies.
- Motivation: Argentina vs Chile vs developed economies.

Contribution

- Typical ingredients in quantitative sovereign debt models:
 - Lack of commitment.
 - Impatient sovereign: low β .
 - Output fluctuations.
 - (Asymmetric) default costs.
- Default costs and degree of impatience used to match spreads and debt levels.
- But why countries differ in their degree of impatience (β)?
- **This paper: due to different institutional environments (representation and control of corruption).**

Incentive for borrowing

Intuition from a simple model

- Deterministic 2-period model.
- n groups, each has constant endowment $y_{i0} = y_{i1} = y$.
- Utility:

$$U_i = u(c_{i0}) + \beta u(c_{i1})$$

- Budget constraint in each period:

$$c_{i0} = y + \frac{t_0}{n},$$

$$c_{i1} = y + \frac{t_1}{n}.$$

- Transfers need to be equal across groups (representation).

Incentive for borrowing

Intuition from a simple model

- Government budget constraint:

$$\begin{aligned}t_0 &= qb, \\t_1 &= -b.\end{aligned}$$

- In this case, it does not matter which or how many groups “control” the government:

$$\max_b u\left(y + \frac{qb}{n}\right) + \beta u\left(y - \frac{b}{n}\right).$$

- First-order condition:

$$u'(c_0) \frac{q}{n} = \frac{\beta}{n} u'(c_1).$$

- It follows that $c_0 > c_1$ if and only if $\beta < q$.

Incentive for borrowing

Intuition from a simple model

- Now, let's assume a subgroup $m < n$ controls the government and distribute “favors” among themselves in the first period:

$$c_{i0} = y + \frac{t_0}{n} + \frac{f_0}{\theta m},$$
$$t_0 + \underbrace{f_0}_{\text{favors}} = qb.$$

- θ captures control of or preference for corruption (isomorphic).
- Assuming $\theta m < n$, we have that $t_0 = 0$:

$$\max_b u \left(y + \frac{qb}{\theta m} \right) + \beta u \left(y - \frac{b}{n} \right).$$

Incentive for borrowing

Intuition from a simple model

- First-order condition:

$$u'(c_0) q = \beta \frac{\theta m}{n} u'(c_1).$$

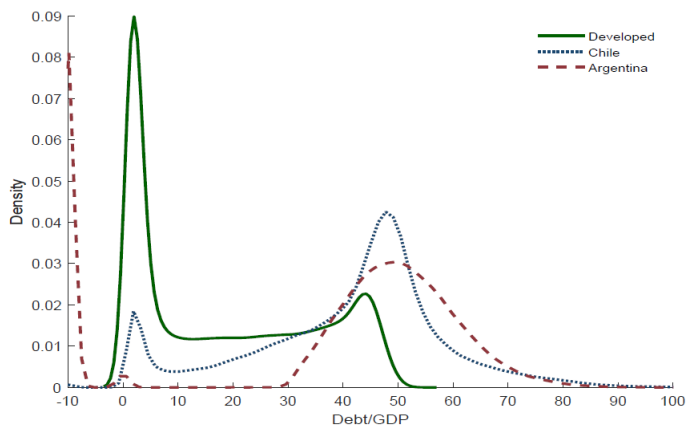
- Let's define:

$$\tilde{\beta} \equiv \beta \frac{\theta m}{n}.$$

- It follows that $\tilde{\beta} < \beta$.
- New condition: $c_0 > c_1$ if and only if $\tilde{\beta} < q$.
- **Equivalent to making the government more impatient.**
- **θ and m play a similar role.**

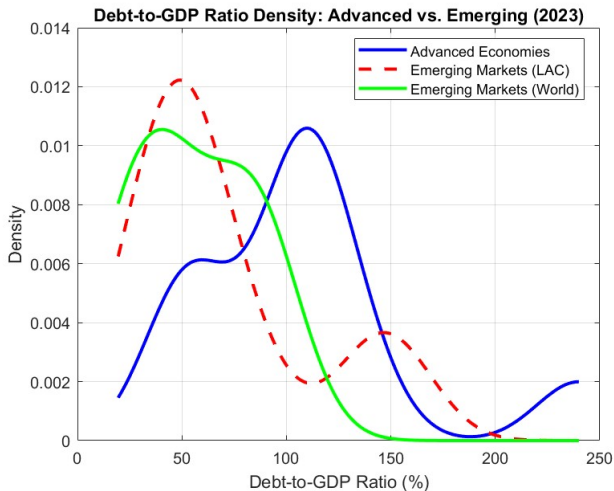
Developed economies more patient in the model

Figure: Less debt in developed economies



Data shows more debt in developed economies

Not really a problem



Rich quantitative setting

- Government solves the following problem:

$$V(z, m, \Omega, b) = \max_{\tau, g, d, b', f} u(\cdot) + \alpha v(g) + \frac{f}{\theta m} + \beta EV(\cdot),$$

with

$$u(\cdot) = \kappa((1 - \tau)h(z, \Omega, d))^{(1+\gamma)(1-\sigma)/\gamma},$$

$$f \leq Rev(\tau) - g + (1 - d)(q(b')b' - b),$$

$$Rev(\tau) = n \frac{\tau}{1 - \tau} ((1 - \tau)h(z, \Omega, d))^{(1+\gamma)/\gamma}.$$

- First-step: choose τ, g, f for given (b', d) .
- Utility is linear in favors \rightarrow are favors more volatile?
- m/n also represents the probability of remaining in the coalition (turnover).

How to interpret m and n ?

- m can represent the political group as a whole, and $m - n$ the rest of the population.

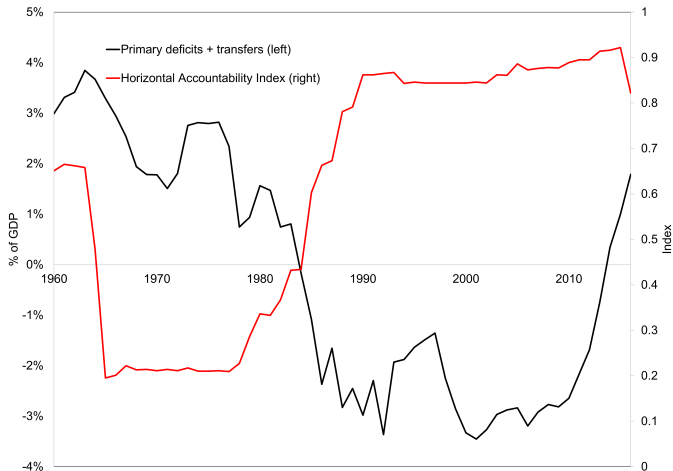
Or,

- m can represent a coalition, and $m - n$ the rest of groups with political power.
- Do we need to stick to one interpretation?

The case of Brazil

Ayres, Garcia, Guillen, Kehoe (2022)

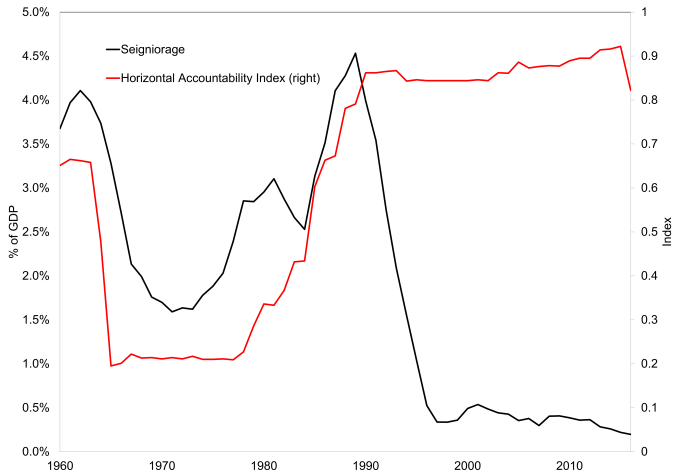
Figure: Accountability and deficits in Brazil (1960-2016)



The case of Brazil

Ayres, Garcia, Guillen, Kehoe (2022)

Figure: Accountability and seigniorage in Brazil (1960-2016)



The case of Brazil

Ayres, Garcia, Guillen, Kehoe (2022)

Figure: Lack of control over monetary aggregates

