Reputational Effects in Sovereign Default: Role of Information Acquisition*

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Abstract

Why do countries tolerate prolonged periods of high interest rates without defaulting? Why do spikes in interest rates tend to decline from recession to recession if the country does not default? Why some developed countries had to go through a period of high interest rates in the past before they could "graduate from default"? We document these empirical regularities and build a sovereign default model with reputation that, unlike the existing literature, explains these facts. Governments could be of different types based on their level of responsibility (cost of default as perceived by the politicians). Only the governments observe their level of responsibility. International investors try to infer the unobserved types based on the history of all observable actions, which gives irresponsible politicians an incentive to choose the same actions as responsible ones would. Governments could tolerate periods of high interest rates without defaulting to signal that they are of better type and to gain good reputation. This leads to lower interest rates during future recessions. For the same reason, even responsible governments should pay at first high interest rates in order to signal their type and thus "graduate from default" afterwards. In addition to explaining these empirical regularities and matching standard business cycle moments, our model delivers a more realistic default rate in equilibrium, with the same parameter values as in the existing literature.

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