Renegotiation and the Maturity Structure of Sovereign Debt

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Abstract

Sovereign debt defaults are accompanied by debt restructurings that alter the quantity as well as the maturity structure of a country’s external debt. In a debt restructuring, the burden of repayment for a defaulting borrower can be reduced either by reducing the face value of debt or extending its maturity. Existing work on sovereign debt renegotiation focuses only on reduction of face value, while leaving the maturity structure constant. This paper builds a model of sovereign borrowing and renegotiation in which both the level of restructured debt and its maturity are outcomes of post-default renegotiation. A sovereign borrower borrows in international financial markets from competitive, risk-neutral lenders, and may default on debt at any time. After a default, the sovereign borrower and lenders bargain to choose both a new face value of debt and a new maturity structure. The paper quantitatively analyzes how the optimal restructuring agreement varies with the borrower’s income in default, and how the presence of renegotiation of maturity affects borrowing and default incentives ex ante.

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