Can Democracy Prevent Default?

Sebastian M. Saiegh

1. Introduction

Argentina's default by the end of 2001 put the problem of sovereign debt repayment back in the spotlight. Between 1999 and 2001, in spite of the country's deteriorating macroeconomic conditions, the incumbent president, Fernando de la Rua, pursued a battery of fiscal austerity policies to avoid default on the foreign debt. After his resignation on December 20, 2001, though, it took just a few days for the new authorities to officially declare a moratorium on the sovereign debt.

Arguments about the role of political factors in determining a country's willingness to repay its sovereign debt are pervasive in the literature. Yet the politics of debt repudiation is rarely subjected to rigorous empirical analysis. In this article, I focus on the domestic politics of default and on what theory and experience tell us about the link between democratic politics and debt repudiation. According to the "democratic advantage" argument, electoral accountability makes democracies more likely to honor their debts than nondemocratic countries. This claim does not hold in the case of developing countries, however, as they tend to borrow abroad, and lenders are seldom agents in the domestic economy. Moreover, a country's decision to repudiate its sovereign debt has distributional consequences for its residents. Hence, democracy alone does not create a credible commitment to debt repayment. What matters is representation of debt-holders' interests, which democratic regimes provide only when those groups with a stake in debt repayment are electorally relevant.

I argue that debt repudiation may bring temporary relief to a country's public finances but would not necessarily enhance its long-term growth prospects. In fact, once a country has declared a moratorium on its sovereign debt, it may respond to credit constraints by running down its productive assets in order to keep its consumption path unchanged.

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Given that productive assets are not distributed equally in society, the decision to default may entail a distributive conflict between those individuals who do not own productive assets and those who own them. I argue that in a pure two-party contest, the parties would rather repudiate their commitments to international creditors than implement the domestic policies necessary to honor their sovereign debt. By contrast, when political competition takes place between coalitions of parties, where each party represents a single interest, democracy can provide guarantees for those who have a stake in debt repayment. The empirical evidence presented in this article supports this claim, showing that multiparty coalition governments are less likely than single-party governments to reschedule their debts.

The remainder of the article is organized as follows. Section 2 discusses the distributive consequences of default. Section 3 introduces the relationship between government coalitions and sovereign debt repudiation. In Section 4, I present some empirical tests. First, I estimate a model of debt rescheduling for a cross-section of debtor countries, taking into account the government's partisan composition. Second, I provide a brief discussion of the Argentine default in light of my argument. Conclusions follow in Section 5.

2. The Distributive Consequences of Default

The Problem of Sovereign Borrowing

Why is it that sovereign debt is so different from ordinary debt owned by nongovernment entities? The literature points to two key factors: willingness to repay and enforcement problems.

First, repayment is not necessarily connected to the ability to repay. As Drazen notes, a country may have the technical ability to repay the debt but still adopt a political decision not to do so (2000, 587). This fact is connected to the second element of sovereign borrowing: limited enforcement mechanisms. The main reason is that, as Bulow and Rogoff (1989) put it, collateral in the strict sense used in domestic contracts is "irrelevant." The assets of debtor countries that a creditor could seize in the event of default are usually worth only a small fraction of the outstanding debt. This is because countries keep very limited assets abroad and domestic assets cannot be seized by creditors (Drazen 2000, 587). Taken together, these two factors imply that debtor countries may behave opportunistically, balancing the costs of defaulting against the benefits of repudiation (Cohen and Sachs 1986; Eaton, Gersovitz, and Stiglitz 1986; Bulow and Rogoff 1989; Kehoe and Levine 1993; Alvarez and

Jermann 2000). The question, then, is how can creditors induce repayment? The literature discusses several incentive mechanisms, such as punishment strategies and exclusion from borrowing markets. These mechanisms tend to fail, however, under a wide array of conditions (for a summary of these arguments, see Drazen 2000).

Indeed, since debt repudiation constitutes an attractive option for debtor countries, lenders may respond by refusing credit altogether or by charging very high interest rates on new loans. Note that borrowing countries are the ones facing a problem. Thus, to secure good credit conditions, a country may benefit from precommitting not to repudiate its debt, but there are not many ways to do this. Again, the opportunity to repudiate debts and the lack of adequate enforcement mechanisms create a credibility problem for borrowing countries.

Although some authors argue that certain features of the borrowing country's political institutions alleviate or exacerbate this commitment problem (North and Weingast 1989; Root 1989; Barzel 1992), the role of domestic political institutions in determining a country's borrowing abilities is not clear. Since the publication of North and Weingast's seminal article on public borrowing in seventeenth-century England, the argument that governments bound by the rule of law alleviate the commitment problem has been a pervasive theoretical claim. Along these lines, Schultz and Weingast (2003) argue that "representative institutions enhance a state's borrowing power." According to them, the commitment technology provided by representative institutions means that states possessing them have an advantage. Because "the constraints on liberal government increase the likelihood that the state will honor its debts, these states typically have superior access to credit than their nondemocratic rivals" (p. 36). Although this is an interesting hypothesis, it rests on very restrictive assumptions. In particular, lenders may not be agents in the domestic economy, or they may not carry much electoral weight. If this is the case, democracy alone does not create credibility.

In the case of developing countries, governments tend not to raise much of their capital domestically. Hence, the "democratic advantage" argument should be weaker in the case of LDCs. There is a way to get around this problem, though. One may postulate that a majority of voters may have preferences for debt repayment (Schultz and Weingast 2003, 13).

Maybe so, but as Tomz (2002) points out, it could also be the case that a majority of voters regard debt repudiation as the best way to promote the national interest or their personal welfare. Honoring the sovereign debt has distributional consequences, creating winners and

losers. Thus, we should expect part of the population to consider debt repudiation as the optimal policy (Tomz 2002, 2). Drazen (1998) presents a model incorporating both foreign and domestic borrowing. The differential ability of domestic and foreign residents to "punish" a government that takes actions detrimental to the value of their holdings implies that the effective cost of borrowing at home and abroad may differ substantially. He shows that the lower the effective cost of foreign borrowing, the higher will be the desired government spending. In Drazen' s model, if the median voter favors a low domestic interest rate, she will certainly prefer to finance government expenditure with lower effective foreign borrowing costs, namely, by not repaying its foreign debts in full (Drazen 1998).

Political competition need not lead to outright default. But whether electoral competition leads policymakers to act on the lenders' behalf or not depends on who stands to win and lose from a policy of debt repudiation.

Debt Repudiation, Consumption, and Income

Following Easterly (1999), I focus now on the long-run effects of debt repudiation on consumption and income. Producers-consumers accumulate total assets A with rate of return r. The country accumulates foreign liabilities L, with an interest rate equal to r. The country's net worth can be defined as $W = A - L$, and its GNP expressed as rW. The change in W is equal to saving, the change in A to investment, and the change in L to the current account deficit.

All households are the same. Each has utility function

$$U(C) = \frac{C^{1-\sigma}}{1-\sigma}, \sigma \neq 1. \qquad (1)$$

They maximize the present value of their consumption,

$$U = \int e^{-\rho t} U(C)\, dt, \qquad (2)$$

subject to

$$C = rW - \dot{W}. \qquad (3)$$

The optimal path of consumption must satisfy

$$\frac{\dot{C}}{C} = \frac{r-\rho}{\sigma}. \qquad (4)$$

The ratio of consumption to wealth in the *steady state* is where W and C grow at the same rate, which implies

$$\frac{C}{W} = r[1 - \tfrac{1}{\sigma}] + \tfrac{\rho}{\sigma}. \qquad (5)$$

We can also express the ratio of wealth to consumption as the inverse of (5). And in flow terms we can solve for the ratio of saving to consumption as follows:

$$\frac{\dot{A} - \dot{L}}{C} = \frac{r - \rho}{r(\sigma - 1) + \rho}. \qquad (6)$$

Saving is positive as long as $r > \rho$ and $\sigma > 1$. Note, though, that if $r > \rho$, the higher the discount rate, and the lower is the intertemporal elasticity of substitution (that is, a high σ), the higher is the propensity to consume out of wealth. We can safely assume that a country on the verge of default is one with a high discount rate against the future. Also, as it has been argued in the literature, less developed countries tend to have a low intertemporal elasticity of substitution (Ogaki, Ostry, and Reinhart 1995; Easterly 1999). Note also that lower saving implies some combination of a higher current account deficit $\frac{\dot{L}}{C}$ and lower domestic investment $\frac{\dot{A}}{C}$.

Suppose a country decides to stop making its debt payments. We can take this as a onetime lump sum transfer that reduces L. The decision to default, however, will not necessarily affect the ratio of saving to consumption. If the parameters r, ρ, and σ remain the same, in the long run the national net worth as a ratio to consumption is unchanged before and after a default takes place at the value given by (6). Moreover, suppose that after a default takes place, the external creditors impose credit constraints. We can see from (6) that any constraint on $\frac{\dot{L}}{C}$ is not necessarily binding. The country can adjust $\frac{\dot{A}}{C}$ one for one to leave the path of net worth and consumption unchanged. As Easterly (1999) notes, being prevented from running up as much debt as previously to finance consumption, the country will compensate by running down assets instead.

Winners and Losers

Sovereign debt repayment is indeed a political issue. Policymakers in debtor countries may behave opportunistically, balancing the costs of default against the benefits of repudiation. In terms of the prospective costs, these may include the inability to borrow in the future, the interruption of international trade, or some other form of punishment from

the international financial community. Alternatively, default may bring an immediate benefit. As payments of interest and principals to creditors are suspended, the government need not match its receipts from taxes and money creation to its debt service expenditures.

Therefore, under bad macroeconomic conditions (after a prolonged recession, and/or when external financing has dried up) the temptation to repudiate the country's sovereign debt may become particularly attractive to the authorities. However, the government always has the option of doing the opposite: forcing the country's macroeconomic conditions to meet its foreign obligations. The authorities can make an effort to service the country's debt by cutting public spending and/or raising taxes.

Political conditions determine the range of policy options available to the government. For example, budget cuts required for debt repayment will certainly affect public sector employees, the unemployed, and poor citizens. In some cases it may be politically feasible to force the reduction of public spending. In other instances, such a strategy would quickly be reversed by active opposition. Whether the domestic economy is forced into conformity with the external conditions or vice versa depends on how intensely the government's constituents feel about the issue and on the power of the relevant constituents.

Suppose that the government decides to repudiate its sovereign debt. This decision may bring temporary relief to the country's public finances, but as stated above, it will not enhance the country's long-term growth prospects. In fact, the country may actually end up running down its assets instead. Notice, though, that assets are not distributed equally in society.

Let us consider the situation in the most general terms. Say there are two individuals (or types of individuals) in this economy. Suppose that at time $t - 1$ individuals of type 1 own k_t and can use it to produce income, y_{t-1}, using technology f. The other types do not own any productive assets. Let $s(\cdot)$ be the saving rate. To facilitate the analysis, I assume that $s(\cdot)$ is given exogenously and that it is a constant, $s(\cdot) = s > 0$. At time t, the default takes place. Keeping the national net worth as a ratio to consumption unchanged according to (6) implies that producers will transfer a share $0 < \delta \leq 1$ of their income to the individuals who do not have any productive assets. The producers' problem then becomes

$$\max_{s} \sum \rho^{t} U(c_t), \qquad (7)$$

given that

$$c_t = y_t(1 - s - \delta). \qquad (8)$$

The solution to this problem is some $s^*(\delta)$, which declines as δ increases. The implied redistribution, though, will be constrained. The types who do not own any productive assets solve the following problem,

$$\max_{\delta} \sum \rho^t U(\delta y_t), \qquad (9)$$

given that

$$s = s^*(\delta). \qquad (10)$$

Those who do not own productive assets will seek to keep their long-run consumption level unchanged after the default is declared. These individuals would certainly like to increase their share of consumption at time t. This course of action is particularly appealing, given that the suspended payments of interest and principals to creditors creates a temporary revenue surplus. However, it is not the optimal "rate of extraction." On the one hand, the more they extract in increased consumption at time t, the more they will consume at this time. On the other hand, the more they extract at time t, the less the producers will invest and the less there will be to extract in the future. Hence, the optimal rate of extraction must be the one that leaves unchanged over the long run the ratio of national net worth to consumption.

This very simple and schematic analysis gives us some insight into the distributional effects of debt repudiation. Pressures to declare a moratorium on the sovereign debt or to honor a country's commitments to international creditors will emanate both from very broad popular demands and from more concentrated social groups. Those who care profoundly about the value of their productive assets will certainly try to make their concerns known to politicians. How successful this "special interest" group could be, though, depends on the nature of the political system.

3. Coalition Governments and Default

It is time to ask again whether democratic leaders would implement domestic policies necessary to honor their sovereign debt or would rather decide to repudiate their commitments to international creditors.

This decision depends on the domestic constellation of political forces and the government's position within it. Hence, democracy alone does not create credibility. What matters is representation of debt-holder interests, which democracy provides only when those with a stake in the repayment of debt are electorally pivotal.

Given the distributive consequences of default, when would the political process reward those who favor sovereign debt repudiation and when would it be responsive to those who have a stake in debt repayment? In other words, what determines whether the specific concerns of the latter social group are taken into account?

Dixit and Londregan (1998) develop a model in which sovereign debt repayment is decided through a competitive election. They show that when politically powerful groups are also more likely investors in government debt, the repayment promise is more credible. Dixit and Londregan (1996) also provide a key insight to understand the politics of debt repudiation. In this case, political competition takes place between two parties that vie for voters' electoral support by offering group-specific transfers. Voters are heterogeneous in their ideological affinities and also care about particularistic benefits. The authors find that differences in the parties' abilities to deliver such benefits to different groups generate different redistributive outcomes (Dixit and Londregan 1996).

In terms of the discussion presented in the previous section, suppose there are two parties, D and R, and that the voting population consists of G identifiable groups, distinguished by their ownership of productive assets. As in Dixit and Londregan (1996), individuals within each group are heterogeneous in their ideological affinities, and the groups differ in their willingness to compromise their political preferences in return for economic benefits. More importantly, the parties can target their redistributive policies to the membership of one of these groups. An individual who belongs to group$i$ has the following utility function

$$U_i(C) = \kappa_i \frac{C^{1-\sigma}}{1-\sigma}, \sigma \neq 1, \qquad (11)$$

where the parameter κ_i measures the relative importance of consumption against the individual's ideological position. For example, nationalistic sentiments might lead some individuals to favor default on the sovereign debt. Thus, if party D promises to deliver an extra dollar to each member of group$i$ it will affect each of these individuals' propensity to support D by

$$U_i'(C_{iD}) = \kappa_i (C_{iD})^{-\sigma}. \qquad (12)$$

A higher κ_i means that group i is more responsive to promises of economic benefits. Dixit and Londregan (1996) find that when is large (that is, $\frac{1}{\sigma}$ is small), such as the environment described in section 2, the political-economic equilibrium is that everyone gets equal consumption. Low-income groups receive transfers, and high-income ones pay taxes. In terms of the discussion presented above, this can be interpreted as a decision to repudiate the sovereign debt. That is, in a pure two-party contest, the parties would rather repudiate their commitments to international creditors than to implement the domestic policies necessary to honor their sovereign debt.

Suppose now that instead of governments being formed by a single party that represents a coalition of interests, political competition takes place between coalitions of parties, where each party represents a single interest. Would this make a difference? Bawn and Rosenbluth (2003) argue that it does—that difference stems from the nature of electoral accountability. According to them, a single party in government is electorally accountable for all policy decisions it makes. Parties that participate in coalition governments, by contrast, " are held primarily responsible only for a subset of policy dimensions, for the policy areas in which they have the biggest stake, and the biggest impact" (Bawn and Rosenbluth 2003, 1).

We can extend this logic to Dixit and Londregan's model in the following way. These authors find that when parties have an advantage at conveying benefits to, or taxing, a "core" support group, the outcomes of redistributive politics will differ. Suppose now, say, that party D is a coalition of two parties: d_1, which is closer to the interests of those who have no productive assets; and d_2, representing the interests of asset holders. According to Dixit and Londregan, given two groups, if both of them are close to the "core" of a party and both have very similar "clout," then the party will refrain from redistributive transfers (Dixit and Londregan 1996, 1154).

If groups have party affinities and parties have to favor different core support groups, then democracy can provide guarantees for those who have a stake in debt repayment. Regardless of their electoral size, coalition partners can become electorally pivotal as they can potentially "make or break" governments. Thus, multiparty coalition governments may generate a positive correlation between political power and the desire to hold bonds. And, by empowering bondholders, multiparty coalitions should make governments' promises of debt repayment more credible (Dixit and Londregan 1998). In other words, the probability of debt

repudiation should be lower when there is a multiparty coalition rather than a single-party government in power.

4. Empirical Evidence

In this section I estimate a model of debt rescheduling for a cross-section of debtor countries, taking into account the government's partisan composition. The sample consists of 531 observations on 48 countries for the 1971–97 period, including 346 debt rescheduling cases, covering 43 countries.

The dependent variable (RESDBT) is defined broadly to include rescheduling or restructuring of debt, including arrears on either principal or interests.. This is a dichotomous variable that takes the value of 1 if such events are observed and 0 otherwise. I constructed this variable from data available in the World Bank's 1999 global development finance report.

I consider a government to be a multiparty (portfolio) coalition if members of different political parties that are represented in the national legislature hold cabinet posts. These are different from legislative (policy) coalitions. If parties are disciplined, then every government coalition is a legislative coalition. Legislative coalitions may vary from one issue to another. Such variations may arise from the fact that parties may vote together on some but not all issues or from lack of party discipline among members. Moreover, the two types of coalitions need not be coextensive. A party may not be a member of a portfolio coalition and yet vote with the government (or at least not vote against it) on some or all issues. Thus, the variable GOVCOAL takes the value of 1 if the government is a multiparty coalition, and 0 otherwise. This variable was constructed with data from Cheibub, Przeworski, and Saiegh (2004). Regarding the economic determinants of the probability of default, the following explanatory variables are considered:

1. Debt-output ratio (DEBTGNP). In most theoretical models of foreign borrowing the debt-output ratio plays a crucial role. This variable can be considered to be an indicator of the degree of solvency of a particular country (Edwards 1984).
2. Debt-service ratio (DEBTXGS). This variable is computed as the ratio of debt service to exports. As Edwards (1984) notes, it measures possible liquidity (as opposed to solvency) problems faced by a particular country.
3. Ratio of the current account to GNP (ACCGNP). This variable measures the quantity of investment financed through borrowing

from abroad. According to some authors, this variable should capture a country's perspectives for future growth and, hence, should be negatively related to rescheduling probabilities (Cohen and Sachs 1986; Edwards 1984).

4. Ratio of international reserves to total debt (RESDBT). This variable measures the level of international liquidity held by a country.
5. Change in gross national product (CHGNP). The literature suggest that higher output will enhance a country's creditworthiness.
6. Ratio of short-term debt to total debt (SHRTDBT). This variable seeks to capture the fact that many countries are able to avoid a rescheduling of their sovereign debt by borrowing short-term funds in the international markets. This variable should be negatively correlated to rescheduling probability.
7. Sum of past reschedulings (SUMPDEF). The past history of a country can be seen as an indicator of how good or bad a risk that country is. Hence, this variable measures how countries' rescheduling probabilities are affected by their past behavior.

Table 1 provides descriptive statistics for these variables. Note that multiparty coalition governments reschedule their debts less often than do single-party governments. The observed differences across these types of governments with respect to their solvency and liquidity are mostly due to four outlier observations (Nicaragua in 1989 and 1992; and Malta in 1974–75). If we compare the solvency and liquidity indicators excluding these observations, there are no significant differences between multiparty coalitions and single-party governments.

With respect to the econometric specification, I estimate a binomial probit model. The results are presented in Table 2. In the second column, the results of the model without including the government coalition variable are presented. The third column reports the model including the type of government among the independent variables.

The first item of interest from Table 2 is that the expanded specification including the government type does predict better that the initial model. The probability of a greater χ^2, with one degree of freedom, is low enough (0.0001) to reject the null hypothesis so the coalitional nature of the government does have a significant effect.

The model performs fairly well in predicting debt rescheduling. If we take the mean of the dependent variable (.65) as the cutoff probability, the model correctly predicts that debt rescheduling will not occur below that threshold in 68 percent of the cases, whereas a "false positive" is reported only in 9.6 percent of the cases.

TABLE 1

Descriptive Statistics for Country-Year Observations

	All	Multiparty Coalition	Single-Party
DEFAULT	0.65	0.56	0.73
	(0.48)	(0.50)	(0.45)
DBTGNP	63.74	50.12	74.81
	(107.45)	(27.36)	(141.68)
DBTXGS	234.69	187.33	273.16
	(356.58)	(118.09)	(464.93)
ACCGNP	-0.03	-0.03	-0.03
	(0.07)	(0.05)	(0.08)
RESDBT	70.25	31.97	101.35
	(207.35)	(29.27)	(274.19)
CHGNP	0.05	0.06	0.04
	(0.18)	(0.12)	(0.21)
SHRTDBT	17.53	16.54	18.34
	(14.76)	(11.81)	(16.75)
SUMPDEF	7.65	8.03	7.34
	(6.55)	(7.43)	(5.73)
N	531	238	293

As Table 1 shows, the frequency of debt rescheduling amounts to 56 percent in the case of multiparty coalition governments and 75 percent in the case of single-party governments. Column 3 of Table 2 shows that this difference is robust to the inclusion of the economic controls. Multiparty coalition governments are less likely to reschedule their debts.

Most remaining results are consistent with the existing literature. The coefficient for the debt-output ratio is positive and statistically significant. This suggests that a higher level of indebtedness will be associated

TABLE 2

Binary Probit Estimates of Debt Rescheduling

	Initial Model	Model with Gov. Type
Constant	-1.017	-0.585
	(0.241)	(0.263)
GOVCOAL		-0.734***
		(0.150)
DBTGNP	0.008*	0.010*
	(0.003)	(0.004)
DBTXGS	0.002**	0.002*
	(0.001)	(0.001)
ACCGNP	-1.209	-2.141
	(1.418)	(1.479)
RESDBT	0.001	-0.001
	(0.001)	(0.001)
CHGNP	-0.566	-0.362
	(0.562)	(0.593)
SHRTDBT	-0.010*	-0.012*
	(0.005)	(0.005)
SUMPDEF	0.125***	0.129***
	(0.014)	(0.015)
Log-L0	-343.265	-343.265
Log-L	-219.4436	-206.9638
Estrella	0.43923	0.48012
N=531		

Standard errors are in parentheses. ***p<.001, **p<.01, *p<.05 two-tailed

with a higher probability of debt rescheduling. With respect to the debt-service ratio, the coefficient is also statistically significant. The coefficient of the current account ratio is negative, but it is not statistically significant. This differs from Edwards's results. This variable measures the quantity of investment financed through borrowing from abroad. Thus, if investment programs involve returns that are inadequate to repay their financing costs, creditors might consider that a country lacks the economic control necessary to generate the revenue for debt service (McFadden et al. 1985). The coefficient of the ratio of reserves to total debt is, as expected, negative but not statistically significant. The coefficients on short-term debt and past defaults are significant and have the expected signs, whereas the coefficient of GNP change is not statistically significant, just as in the original Edwards model.

Sensitivity and Robustness

Pooled cross-sectional time-series samples such as this one inevitably raise concerns about time and country effects. To address these potential problems, I estimate a binomial probit model including fixed effects for each country. I also employ a transition model to account for possible problems caused by temporal correlation of the observations.. This model is based on analyzing the transitions from a lagged value of the dependent variable of zero or one to a current value of the dependent variable of zero or one (based on simple first-order Markov assumptions), allowing for different processes based on the lagged value of the dependent variable (Amemiya 1985; Przeworski et al. 2000; Beck, Epstein, Jackman, and O'Halloran 2002).

The results are presented in Table 3 below. In the second column, the results of the fixed effects model including the government type variable are presented. The last column in Table 3 reports the results from the transition model including government type among the independent variables.

Table 3 shows the robustness of the findings regarding government type across the different models. Thus, the discussion below focuses on the results obtained from the model reported in column 3 of Table 2. To further interpret the coefficients, I calculate marginal effects. For government type, they are calculated as the change in the probability of debt rescheduling given a country's coalition status, while keeping all the other independent variables at their means. Having a multiparty coalition government diminishes the probability of debt rescheduling by 19 percent. For the remaining covariates, I calculate the expected change in the probability of debt rescheduling given an increase of one

TABLE 3

Fixed Effects and "Transition"

Binary Probit Estimates of Debt Rescheduling

	FE Model	Transition[a]
Constant		-0.674
		(0.511)
GOVCOAL	-0.622*	-0.499*
	(0.376)	(0.286)
DBTGNP	0.001	0.009
	(0.011)	(0.007)
DBTXGS	0.013***	-0.003
	(0.003)	(0.002)
ACCGNP	0.183	-3.235
	(2.465)	(2.488)
RESDBT	0.001	-0.001
	(0.001)	(0.001)
CHGNP	-1.192	0.908
	(1.027)	(1.294)
SHRTDBT	0.001	-0.009
	(0.013)	(0.008)
SUMPDEF	0.098**	
	(0.032)	
DEFAULT (Lagged)		1.558*
		(0.670)
Log-L0		-311.4285
Log-L	-113.6701	-134.5010
Estrella		.66 32
N	531	483

Standard errors are in parentheses. ***p<.001, **p<.01, *p<.05 two-tailed

[a] In the transition model the independent variables are lagged by one year.

standard deviation in that variable while keeping all the other independent variables at their means. A one-standard deviation increase in the debt-output ratio raises the probability of debt rescheduling by 27 percent. Liquidity problems, measured by an increase of one standard deviation in a country's debt-service ratio, tend to increase the probability of default by 15 percent, while the ability of borrowing short-term funds (an increase of one standard deviation in short-term debt) decreases the probability of debt rescheduling by more than 4 percent.

The empirical evidence supports the theoretical claims made in the previous section: the probability that a country will repudiate its sovereign debt is lower in the case of multiparty coalition governments. This is consistent with the idea that democracy can prevent default as long as the political process gives a say to those who have a stake in debt repayment.

A Tale of Two Elections: Argentina 1999 and 2001

Argentina's road to default is an excellent illustration of how declaring a moratorium on the sovereign debt depends on the nature of the political system. Argentina's access to international credit was effectively cut off by the end of 2001, as international investors speculated that the country would be unable to make loan payments on its public debt. The consensus that the country was on the brink of default proved right when its government decided to swap bonds for securities with lower value by the end of 2001.

On December 24, Adolfo Rodriguez Saa was sworn in as Argentina's interim president and officially announced that he would halt payment on government debt. Some days later, on January 3, 2002, the administration of Eduardo Duhalde (the country's fifth president in two weeks) decided to uphold his predecessor's decision and missed a $28 million interest payment due on an Italian lira bond. After de la Rua' s fall, it took just a few days for the new authorities to officially declare the moratorium on the sovereign debt. However, the country's path to default was not that unwavering.

In the presidential campaign of 1999 debt repayment took center stage, as the two leading contenders took opposite sides on the issue. On June 25 the Peronist Party candidate, Eduardo Duhalde, complained that debt payments were "bleeding" the country. He stated that "with current levels of debt servicing there would be no possible recovery" for Argentina, and demanded that foreign creditors cancel debt (quoted in Tomz 2002, 10). Conversely, Fernando de la Rua, the candidate of the

multiparty coalition called the Alianza, declared on the same day that the country should uphold its commitments. To reinforce the differences with Duhalde, de la Rua' s running mate, Carlos Chacho Alvarez, said that talk of default would hurt the country. As the months progressed, Duhalde insisted on the need for debt forgiveness. Meanwhile, de la Rua continued to assert that he would honor the sovereign debt, even if it meant austerity at home (Tomz 2002, 11). The candidate of the multiparty coalition clearly behaved differently from the single-party candidate with respect to debt repudiation. In fact, his position was consistent with the redistributive politics argument presented above.

De la Rua won the 1999 election. However, the coalition government almost broke up after being in office less than a year, when Alvarez resigned as vice president. De la Rua managed to stay in power after that incident, but internal divisions within the coalition became more common and were even further aggravated when Domingo Cavallo joined the cabinet. The fate of de la Rua's presidency was definitively sealed on the night of October 14, 2001. After almost two years in power, his administration lost control of the two houses of Congress to the Peronist Party. As Tomz (2003) notes, the 2001 legislative elections had become a referendum on the austerity needed to meet IMF targets and remain current with creditors.

The de la Rua administration had implemented a series of budget cuts required for debt repayment. These included the "zero deficit" plan and the reduction in salaries for public sector employees. As the 2001 congressional elections approached, the disintegration of the Alianza was becoming more and more apparent. In the final months of the campaign, even members of de la Rua's party, the UCR, decided to break with the president over the issue of debt. Meanwhile, the Peronist party candidates openly campaigned using prodefault rhetoric (Tomz 2002, 15).

The election outcome was clearly a victory for those who did not want to repay the sovereign debt (Tomz 2002, 2003) In terms of de la Rua' s legislative support, the Alianza saw its seat total fall to 87 from a near majority of 125 seats two years earlier. What followed is well known: without popular support, increasingly isolated within its own coalition and lacking majority backing in the legislature, de la Rua soon discovered that his ability to govern was deteriorating even further. Two months later, on December 19, 2001, thousands of people banging pots and pans marched on the Casa Rosada and led Fernando de la Rua to resign the presidency.

Concluding Remarks

Debt repudiation may bring temporary relief to a country's public finances. As payments of interest and principals to creditors are suspended, the government need not match its receipts from taxes and money creation to its expenditures on debt service. Such debt repudiation would not necessarily enhance a country's long-term growth prospects, however. Less developed countries, especially those on the verge of default, tend to have high discount rates against the future and a low intertemporal elasticity of substitution. Once a country has declared a moratorium on its sovereign debt, it may respond to credit constraints by running down its productive assets in order to keep its consumption path unchanged. Debt repudiation may lead to a higher ratio of net worth to consumption, however, if there are changes in the interest rate, the discount factor, and the savings rate.

Governments in developing countries tend to use their foreign credit to finance their general deficits. In addition, the posture of less developed countries toward consumption has another important consequence. It provides a strong incentive for political parties to repudiate the sovereign debt in order to benefit those individuals who do not own productive assets at the expense of those who do. While pressures to honor a country's commitments to international creditors will emanate from more concentrated social groups, there will be very popular demands to declare a moratorium on the sovereign debt. Tomz (2003), for example, found that in Argentina public sector employees and unemployed individuals favored sovereign debt repudiation, whereas those employed in the private sector had a stronger preference for debt repayment.

The answer to the question of which group will prevail depends on the nature of the political system. In this article I have analyzed the relationship between democratic politics and debt repudiation. My main conclusion is that in developing countries, democracy alone does not create a credible commitment to debt repayment. What matters is how the interests of debt holders are represented. Multiparty coalition governments include "partners" that are held responsible for those policy areas in which they have the biggest stake. As such, they may provide a vehicle to represent the view of those groups and individuals with a stake in debt repayment.

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