

Maturity Structure and Debt Renegotiation in International Lending

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Abstract

This paper presents a model of sovereign default with multi-period debt contracts with endogenous maturity. The sovereign in the model chooses the most favorable combination of interest rate, loan size and maturity out of the contracts offered in equilibrium by international lenders. All three characteristics of the contract endogenously vary with the business cycle of the sovereign. Additionally, in contrast to existing theories, we explicitly model the debt overhang problem: that the market power of the lenders depends on the refinancing opportunities of the sovereign borrower. As a special case, we model how the debt is optimally restructured in case the sovereign decides to cease payments on outstanding debt. We explore the quantitative predictions of the calibrated model for debt, endogenous business cycle evolution of the debt contracts and the determination of the optimal debt relief when the sovereign is in default.