“Seniority Reversals and Endogenous Sudden Stops: Some Transfer Problem Dynamics”

1. What is the main question(s) raised in the paper (the issue)?

The paper analyzed the dynamic incentive effects of debt restructuring and changes in seniority among rivaling debt elements in a stochastic endowment economy with a risk-averse sovereign debtor. The author wanted to understand why Germany was able to accumulate large foreign debts in the interwar period despite punitive reparations that exceeded its capacity to pay

2. Why should we care about it (the significance)?

This topic is important because it can have significant economic implications. Seniority reversals refer to the phenomenon where junior creditors receive payment before senior creditors, which can lead to a loss of confidence in the financial system and increase the likelihood of sudden stops in capital flows. And when sudden stops occur, it can cause economic instability and financial crises.

3. What is the author’s answer (the findings)?

The author found out that the debtor country has an incentive to discriminate against legacy debt in favor of fresh money, making the legacy debt junior. This leads to a borrowing binge, often followed by sudden stop and default episodes in which the junior debt is defaulted on first.

4. How did the author get there (the strategy, empirical approach)?

By calibrating the model to interwar Germany under the Dawes Plan of 1924-1929 and found that their simulation results bear out the predictions of Keynes about the dim prospects of recovering reparations. The paper suggests that the relative strength of the incentives is determined by the size of the macroeconomic shock experienced by the debtor country.