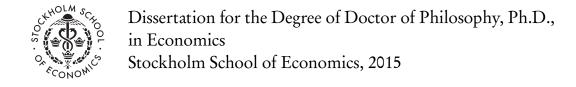
Public Debt, Business Cycles and Institutions

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Spyridon Sichlimiris





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Foreword

This volume is the result of a research project carried out at the Department of Economics at the Stockholm School of Economics (SSE).

This volume is submitted as a doctor's thesis at SSE. In keeping with the policies of SSE, the author has been entirely free to conduct and present his research in the manner of his choosing as an expression of his own ideas.

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Göran Lindqvist

Director of Research

Stockholm School of Economics

Richard Friberg

Professor and Head of the

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Chapter 1

Introduction

This Ph.D. thesis consists of four chapters. "Domestic and External Sovereign Debt" provides a model to explain the level and the composition of public debt in developing countries across two dimensions a) the business cycle and b) the level of financial development. "Composition of Sovereign Debt and Financial Development: A Dynamic Heterogeneous Panel Approach" empirically analyses the relationship between composition of public debt and financial development for a large sample of developing countries. "News Shocks and Structural Breaks" studies news shocks as a driving force of business cycle fluctuations. We build on the identification strategy for news shocks proposed by Beaudry and Portier (2006, AER) and propose improvements. "Social Norms and Authority: In Quest for Social Order" explores the interplay between authority and internalized social norms in achieving social order. We classify different types of authority (Conformist, Charismatic and Punitive) based on the support they receive and individuals' attitude towards social norms.

Domestic and External Sovereign Debt

We develop a theory of sovereign debt in the presence of limited enforcement, by analysing both domestic and external debt. In a financially repressed economy, a government that exploits its market power in the domestic asset market can increase its debt capacity in the international asset market. The reason is the additional endogenous default cost: a government in default loses the gains from trading across these segmented asset markets. We can account for the empirically observed composition of sovereign debt for developing coun-

tries. We obtain a higher share of external debt over domestic debt and higher default incentives in recessions than in booms. We also find a run up in external debt before default. After re-entering the markets, the external debt increases rapidly. Finally, the level of financial development affects the long-run domestic-to-total-debt ratio in a non-monotonic way. For low levels of financial development the effect is positive, for higher levels it is negative.

Composition of Sovereign Debt and Financial Development: A Dynamic Heterogeneous Panel Approach

This paper studies the long-run impact of financial development on the composition of sovereign debt in a large sample of developing countries. We use the dynamic heterogeneous panel model to distinguish between long-term and short-term effects and allow for cross-country heterogeneity in time-invariant features and dynamics. Moreover, we control for the presence of unknown common factors that can affect all countries. We find a non-monotonic long-term effect of financial development on the share of domestic debt over total debt. This effect is robust to different proxies of financial development and the inclusion of relevant macroeconomic variables. Inflation has a positive long-run effect on the domestic debt share, which is consistent with the presence of financial repression.

News Shocks and Structural Breaks

Do news shocks explain business cycle fluctuations? A positive answer is provided by Beaudry and Portier (2006), who develop an identification strategy for "news shocks" in a vector error correction model (VECM) with TFP and Stock Prices on US data. Refining their analysis, we find evidence of a structural break in the long-run relationship between Stock Prices and TFP in 1980, at the beginning of the Volcker Era. In the second part of the paper we extend the sample period and analyse the news shock before and after 1980. Our results support the news view of the business cycle only after 1980. The news shock explains the majority (65 to 80 percent) of business cycle fluctuations of output, consumption and investment at any horizon and generates strong comovement among them. Moreover, TFP movements are well explained at medium and long-term horizons.

Social Norms and Authority: In Quest for Social Order

An agent is said to have real authority when that agent's prescriptive messages affect others' behavior. An agent is said to have internalized a social

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norm if the agent suffers disutility from deviating from the norm's prescription. We study the interplay between authority and internalized social norms in achieving social order. We say that authority is Conformist if it supports the prevailing norm, Punitive when it entails a Pareto-worsening violation of the prevailing norm, and Charismatic if it entails a violation of the prevailing norm and the violation benefits some player. For any social situation we derive different social norms, depending on how society regards equality, justice and efficiency. We find that Charismatic authority requires less support to emerge in games with conflicting interests than in games with common interests. Conformist and Punitive authority are relevant when Rawlsian or Paretian norms generate a common interest game. Charismatic authority is relevant when an egalitarian norm generates a game with conflicting interests. We apply our theoretical framework to the context of media and politics to explain recent events, such as the role of Twitter messages in the "Arab Spring".

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