Carmen Reinhart began with a response to the discussants. First, she noted that even rich countries can be serial defaulters. Reinhart provided the example of Spain, which was a serial defaulter while it was a world power. The country had very volatile revenue from the trade with the New World, which was frequently interrupted by pirates. However, she noted that this example is hard to reconcile with being a world power today and being in a serial default.

Second, she made three comments about the theoretical models that would be helpful in understanding the stylized facts presented in the paper. Her first comment was that standard models (e.g., Eaton and Gersovitz 1981) assume that a country is permanently excluded from the market after it defaults. However, one can observe that, in the real world, countries return to borrowing after they defaulted and sometimes default again. Her second comment addressed particular modeling features that could be helpful. These features include politicians and private lenders’ short planning horizon, public and private debt bias due to moral hazard, and cycles of behavioral optimism. Finally, Reinhart emphasized that the repeated cycles of defaults and banking crises are connected to credit cycles. Thus, models along the lines of Kiyotaki and Moore (1997) are also helpful in understanding the serial nature of defaults. Kenneth Rogoff added that Aguiar, Amador, and Gopinath (2009) advances the Eaton and Gersovitz framework by explaining endogenously why one might get the default cycles going on longer in developing countries.

Third, Reinhart mentioned that the end of the Bretton Woods system is an interesting period to look at right now. Emerging markets countries are operating much closer to full capacity than the advanced world and are importing monetary policy from advanced countries by fixing their exchange rates. Reinhart argued that it is possible that the next wave of inflation will occur in emerging markets.

Fourth, Reinhart pointed out that they did not consider the issue of sudden stops explicitly in the paper. However, since sudden stops occur
frequently with debt and banking crises, their paper captures a significant portion of sudden stop episodes.

Finally, Reinhart discussed the issue of clubs. She argued that if Greece was not treated as a developed country, its external debt would have never gotten to 160%–180% of GDP.

After acknowledging that the authors conducted a descriptive analysis, Daron Acemoglu suggested possible statistical interpretations of the graduation effect. First, the unobserved probability of default follows a duration-dependent process. Alternatively, the probability of default is affected by some other factors, and there is no duration dependence. He pointed out that it is hard to distinguish among these possibilities, and he referred to the literature started by Heckman (e.g., Heckman and Singer 1986). Acemoglu wondered if the authors can tell why the duration-dependent story seemed more plausible to them. Robert Hall reinforced Acemoglu’s point by giving an example of the classic Heckman labor market issue of quits. Then he suggested that it would be useful to set up the possible explanations as hypotheses and then to show which of the explanations is correct or establish that the data are not powerful enough to distinguish between them. He mentioned that the tools are well established in labor market econometrics, making this exercise a logical next step. Reinhart agreed with this suggestion. However, she pointed out that the issue of wars should be addressed before proceeding with duration analysis given that many defaults were associated with civil or cross-border wars.

Acemoglu joined Mark Aguiar by saying that political economy factors are important for understanding debt crises. However, he argued that it is not obvious that the frequency of power turnover is key because he thought it would be easy to develop models in which the turnover effect could go either way. He argued that the relevant political frictions have to do with the constraints that are imposed on governments. The different risk premia that countries face determine their different behavior.

Frederic Mishkin posited an equilibrium story of banking crises. If good regulation built a stable, well-functioning financial system, it will create a safer environment for doing business. It will encourage people to take on greater debts and higher leverage. This may ultimately lead to a crisis. In this context, one may want to restrict the growth of credit when there is a credit boom. Thus, the idea of avoiding financial crises completely is not a good way of regulating the economy because it leads to an inefficient financial sector. Given the difficulty of eliminating financial crises completely, it is better to find ways of making them less
likely and less severe. Lasse Pedersen joined Mishkin in citing the difficulty of eliminating banking crises. He added that a country must have a severely regulated financial market to avoid banking crises. Reinhart agreed with the idea. She noted that Schularick and Taylor (2009) make this point for bank credit and banking crises. In one of their recent papers, Reinhart and Rogoff come to similar conclusions in the case of external debt. She added that since one cannot do away entirely with the business cycles, one can think of financial crises as exaggerated business cycles.

Kristin Forbes highlighted two empirical facts that the authors presented in the paper. First, after a banking crisis, there is usually a sovereign debt default. Second, there are a number of countries that graduated from serial debt defaults and almost no countries that graduated from banking crises. She asked how these two facts are consistent with each other. She pointed to the existence of a group of countries that had the banking crises but then did not default on their debt, arguing that this may be due to the fact that these countries started with a low level of debt and could afford to pay for banking crises. But now with higher levels of debt these countries may no longer be able to finance another financial crisis. Reinhart replied by saying that banking crises may not lead to debt crises. However, banking crises almost always lead to an increase in government debt. She added that external versus domestic debt was a major determinant of whether countries suffered a debt default or not.

Gita Gopinath raised a question of empirical estimates of the costs of default for a country. She noted that from a theoretical point of view, default can result in reputation costs, costs of reentering the market, and other collateral damage. However, it is hard to empirically pin down the magnitude of these costs. There are countries that reenter financial markets fairly quickly with fairly low increases in the cost of borrowing. Moreover, sanctions are not very costly for them either. Reinhart replied that Reinhart and Rogoff (2009) documented that a country’s growth rate is smaller around default episodes, and the growth rate is even worse if it is a domestic default. She pointed out that more analysis is needed on the duration of credibility costs that defaulters suffer. She also noted that it has became easier for a defaulter to reenter the market since World War II.

Rong Qian agreed with Aguiar’s points that the political economy issues and volatility are important factors in explaining the frequency of defaults. She concluded by saying that it is possible that graduation from defaults takes a long time since institutional change is a slow process.