Discussion of:

"Taking a Big Bath upon a Sovereign Downgrade"

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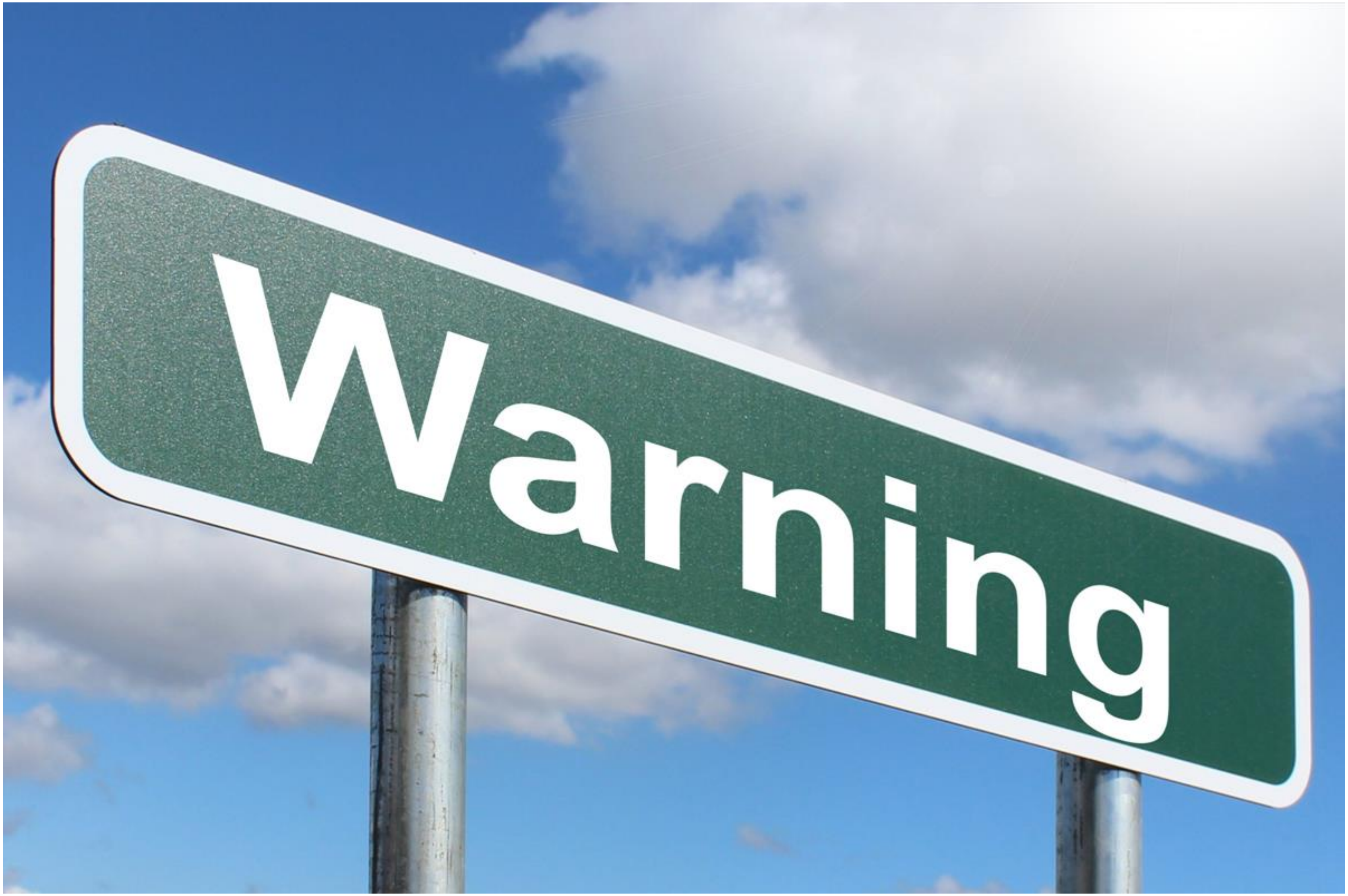
Warning

Brief Summary

- Firms whose credit rating is equal to or above the sovereign rating of their country (bound firms) are more likely to be downgraded.
- Bound firms reduce discretionary accruals after sovereign downgrades, and experience a reversal of earnings subsequent to the accrual reduction.
- The effect is more significant in countries with higher accounting transparency, stronger shareholder protection, and high regulatory quality.
- Bound firms increase various provisions after a sovereign downgrade.

Empirical Issues

An Issue of Interest

GEORGETOWN UNIVERSITY
McDonough School of Business

The New York Times

The Issue of 'Big Bath' Write-offs

By DEBORAH RANKIN JAN. 31, 1978

The New York Times

Professor Pastena studied the movements in stock prices of 58 companies that had filed 8-K statements (to explain any unusual charges or credits to income) with the Securities and Exchange Commission over the period 1972 to 1974. He found that prices fell a month or so before the actual announcement as well as on the day of

the news, but tended to rise thereafter. This indicates that investors "are unduly pessimistic at the time of a write-off, but subsequently make an upward adjustment about the company and its future prospects." he said.

Why Do They Do It ?

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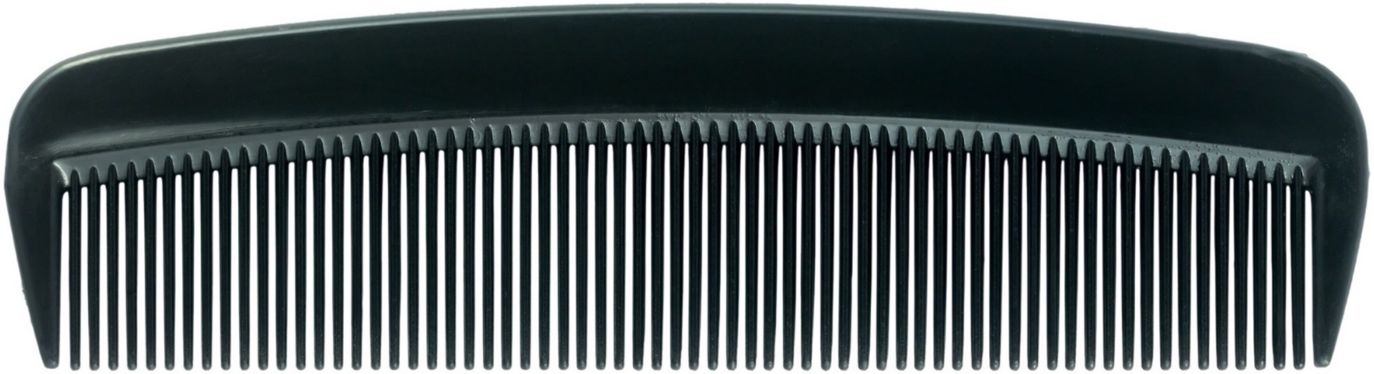

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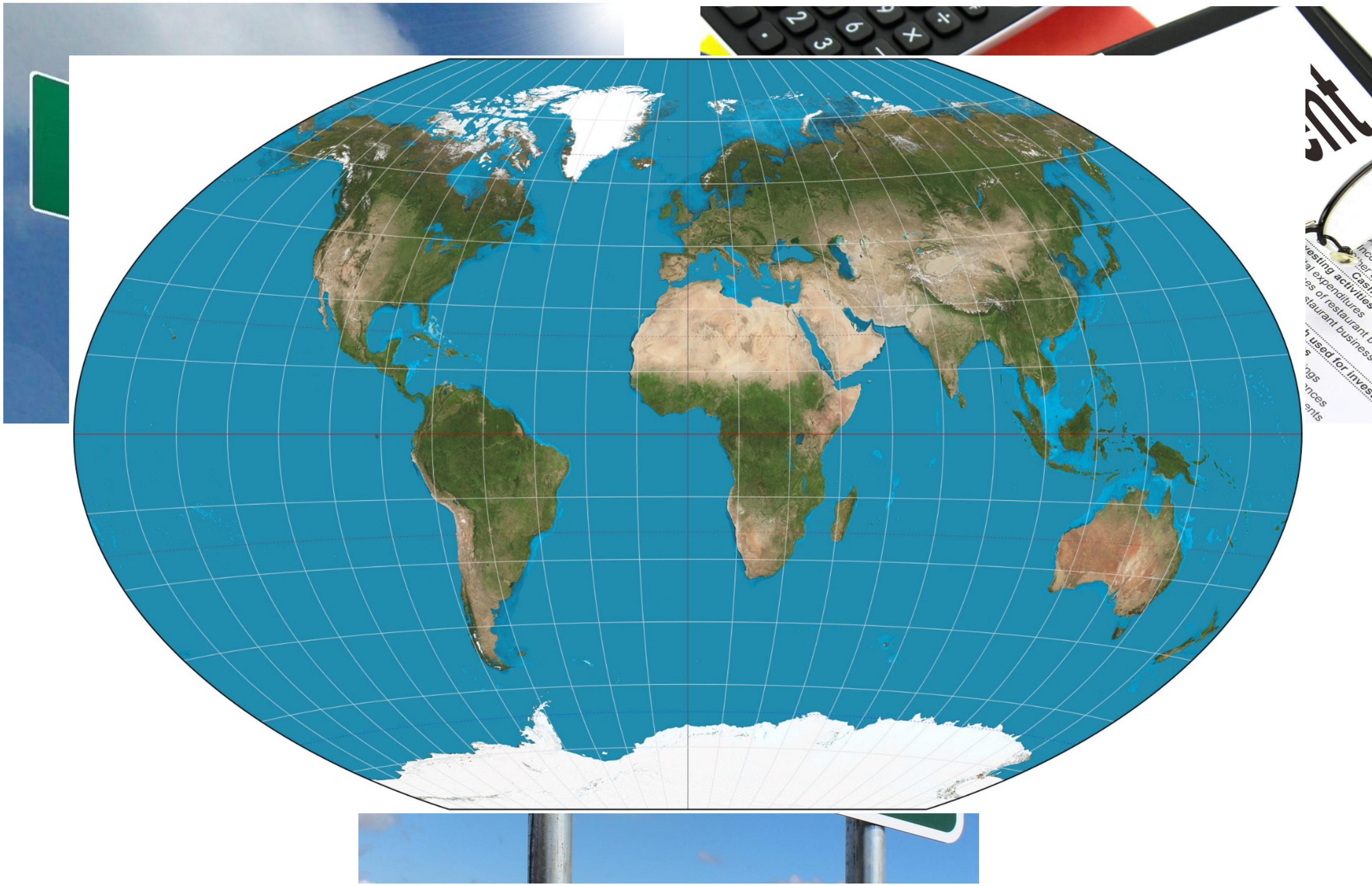
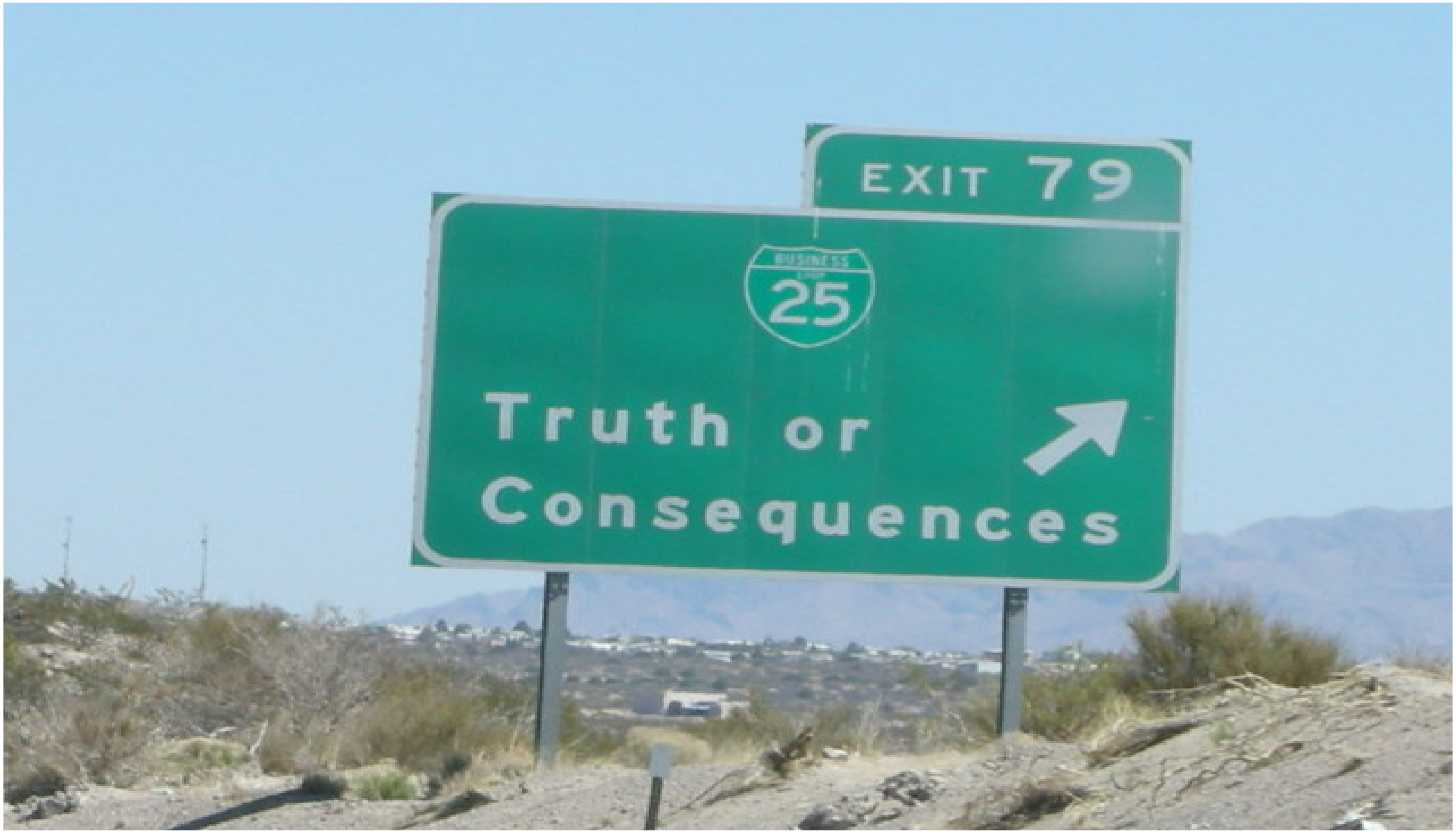


Real Consequences



Kiyotaki and Moore (JPE, 1997)

- Loans must be backed by collateral.
  - For example, land plays two distinct roles:
    - (i) it is a productive input, and
    - (ii) it also serves as collateral for debt.

- If for any reason the value of real estate declines, so does the amount of debt they can acquire.

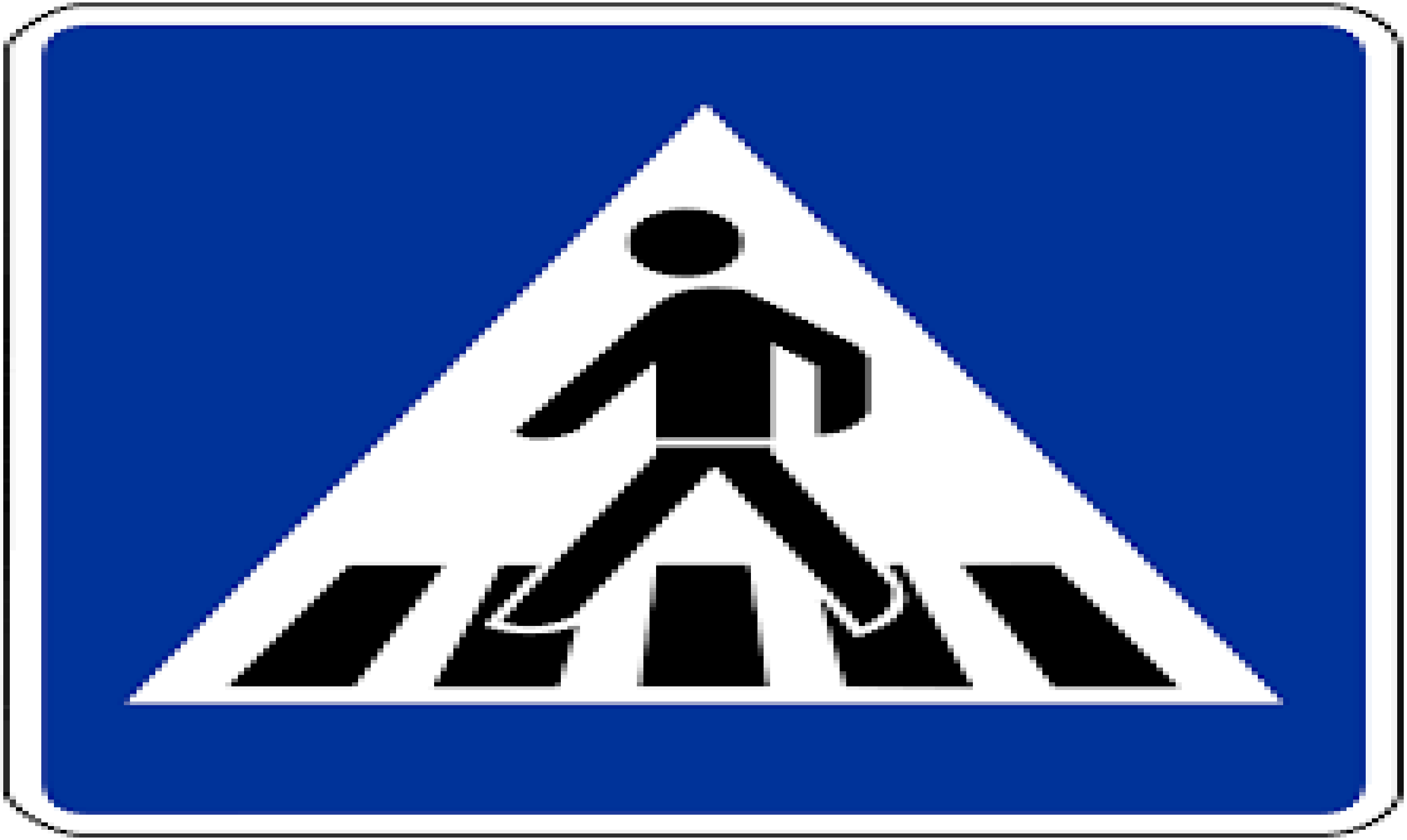
- This feeds back into the real estate market, driving the price of land down further (thus, the borrowing decisions of the entrepreneurs are strategic complements).
  - This positive feedback is what amplifies economic fluctuations.

Guerrieri and Lacoviello (JME, 2017)

- The authors estimate a general equilibrium model where occasionally binding collateral constraints drive the link between housing prices and economic activity.
- As collateral constraints became slack during the housing boom of 2001–2006, expanding housing wealth made a small contribution to consumption growth.
- By contrast, the housing collapse that followed tightened the constraints and sharply exacerbated the recession of 2007–2009.

A New Approach ?

Conclusion



Thank You!