

Discussion on "Domestic Policies and Sovereign Default"

by Emilio Espino, Julian Kozlowski, Fernando M. Martin, Juan M. Sanchez

Minjie Deng

Simon Fraser University

July 2022, TWID International Finance Conference

One-page summary

- ▶ Standard trade-off for debt holding: impatience v.s. default risk (thus borrowing cost)
- ▶ This paper: **domestic policies** also affect the incentives to accumulate debt
 - ▶ Domestic policies focus on tax, money growth (in eqm: inflation, currency depreciation)
- ▶ Incorporates fiscal and monetary policy into a sovereign default model
- ▶ Importance of **distortionary tax** and **default risk** to reproduce business cycle statistics of fiscal and monetary policy in emerging markets

This Discussion

Very nice paper, advances sovereign default literature

- ▶ Standard sovereign default literature, government chooses B' (if not default) and D .
- ▶ Taxation and sovereign default: e.g. Pouzo and Presno (2014), Karantounias (2019), Cuadra et al. (2010), Deng (2019)
- ▶ Monetary policy and sovereign default: e.g. Arellano et al. (2020), Sunder-Plassmann (2020), Hurtado et al. (2022)

This Paper: distortionary tax τ , money growth μ , interacting with B' and D

A Particularly Useful Decomposition

How much debt to hold?

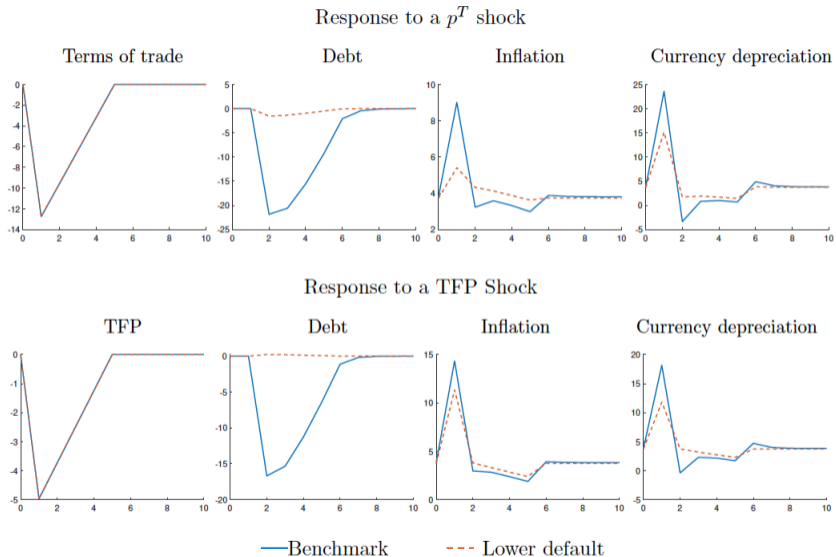
$$\beta \frac{\partial \mathbb{E} [\mathcal{V}(B', s') \mid s]}{\partial B'} + \xi \frac{[\partial Q(B', s) B']}{\partial B'} + \lambda \beta \frac{\partial \mathbb{E} [u'_N c^{N'} \mid P, s]}{\partial B'} = 0$$

- ▶ Distortionary-policies channel (further derived with an explicit form in the paper):
more debt tomorrow \Rightarrow larger distortions and larger default risk \Rightarrow affect household money demand today \Rightarrow affect govt budget constraint today
- ▶ Theoretically, can be positive or negative, depending on curvature of u
- ▶ Quantitatively: negative in calibration

Remark #1: Role of Default Risk

- ▶ One key conclusion: distortionary tax and default risk to reproduce business cycle statistics of fiscal and monetary policy in emerging markets
- ▶ Authors compare the "benchmark" and a "lower default" model (Figure next page)
- ▶ Would be helpful to further quantify the role of default risk
- ▶ Authors could evaluate the importance of default risk by shutting down default risk:
 - ▶ Option 1: a reduced-form debt elastic interest rate
 - ▶ Option 2: calibrate such that no default in the eqm

Figure 8: Evolution of Inflation and Depreciation after a shock



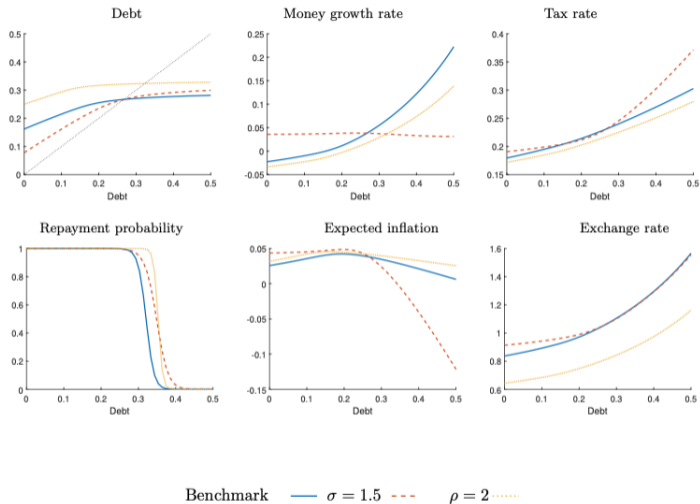
Remark #2: Discipline on σ_N

- ▶ Recall

$$\beta \frac{\partial \mathbb{E}[\mathcal{V}(B', s') \mid s]}{\partial B'} + \xi \frac{[\partial Q(B', s) B']}{\partial B'} + \lambda \beta \frac{\partial \mathbb{E}[u'_N c^{N'} \mid P, s]}{\partial B'} = 0$$

- ▶ $u(c^N, c^T) = \alpha^N \frac{(c^N)^{1-\sigma^N}}{1-\sigma^N} + \alpha^T \frac{(c^T)^{1-\sigma^T}}{1-\sigma^T}$
- ▶ $\sigma_N < 1$ implies the distortionary-policies channel has a negative sign, mitigating the incentives to accumulate debt
- ▶ Paper sets $\sigma_N = 0.5$ (exogenous parameter) \Rightarrow mitigating debt
- ▶ Key for the sign of the mechanism. Can it be a key empirical target in the analysis?

Figure 12: Policies as functions of debt, alternative calibrations

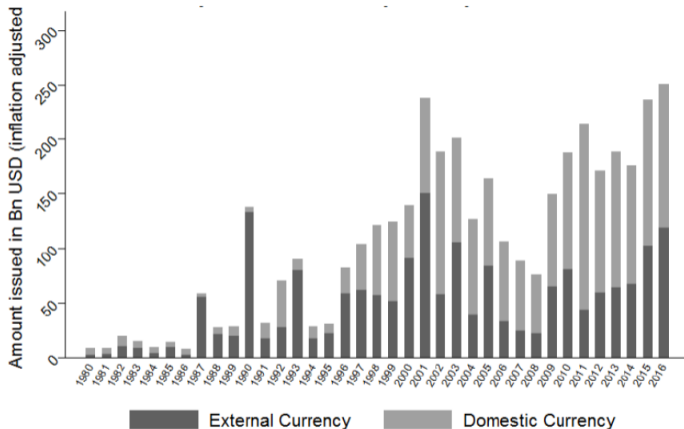


Maybe $corr(\text{money supply}, \text{debt})$ in the data can identify σ_N ?

Remark #3: Domestic Currency Debt

- ▶ Foreign currency debt
- ▶ Could add nominal debt?
 - ▶ Data shows growing dominance of debt issued in domestic currency (Figure next page)
 - ▶ A high share of nominal debt provides extra inflation incentives. Affects the key mechanism in the decomposition mentioned earlier. Affects optimal borrowing.

A Global Phenomenon: Rise of Domestic Currency Debt



Source: Mitchener, K.J. and Trebesch, C., 2021. Sovereign debt in the 21st century: looking backward, looking forward

Conclusion

- ▶ Very nice paper on an important research agenda!
 - ▶ Interactions among fiscal policy, monetary policy, and debt and default
 - ▶ Could be relevant for advanced economies too
- ▶ Suggestions/comments for future steps and research
 - ▶ Quantify the role of default risk
 - ▶ More discipline on key parameter σ_N
 - ▶ Integrate domestic currency debt in the framework