

Discussion of

# Political Economy of Sovereign Debt: A Theory of Cycles of Populism and Austerity

by DAVIS, Golosov, and Shourideh

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IMF

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its Executive Board, or its management.

# The *want* operator

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## Model delivers

- Cyclical behavior
- “**Populist**” phase: low inequality, external borrowing
- “**Austerity**” phase: high inequality, debt deleveraging

## What to like

- Elegant theory
- **Overshooting** component — rare with fully rational, optimizing agents
- Makes sense of seemingly **inefficient** behavior

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## How it works

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## Ingredients

- Productivity types + labor income taxes + endogenous labor supply
  - ... Tax revenues lower earnings inequality but depress output
  - ... Efficiency / equity tradeoff
- Sovereign borrowing + no shocks and/or complete markets
  - ... Can borrow to finance transfers
  - ... Can default ex-post: risk-free subject to debt limit
  - ... Time inconsistency: debt limit is endogenous (+ state-dependent)
- Overlapping generations + financial income taxes + save in government bonds
  - ... Can tax old people's savings (aka domestic default): reduce inequality with no distortion
  - ... Domestic debt + transfers reduces consumption inequality when income inequality is high
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# The key: two interacting sources of time inconsistency

- Need for both debt repayments gives rise to **sustainability constraint**

$$H(Y) \leq \frac{\hat{\beta}}{\beta} (W(B') - \underline{W})$$

- Choice of debt and inequality are both time-inconsistent
- Key: *tradeoff* is **time-inconsistent**: Overdoing one adjustment = cheap incentives

	Benefits	Costs
Debt	$t$	$t + 1$
Inequality	$t$	$t$ and $t + 1$

- When foreign debt is high
  - ... Need high output  $\implies$  high inequality
  - ... Issue domestic debt to finance transfers
  - ... Repayment of domestic debt costly tomorrow



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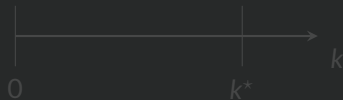
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## Two Comparisons

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## Phelan and Stacchetti (2001)

- Similar model with
  - Endogenous labor supply
  - Savings
  - Time-inconsistent taxes
- Time inconsistency: **capital** accumulation
  - Want tax capital ex-post, promise low taxes ex-ante
- No cycles? — Example with  $k_0 > k^*$  overshoots initial capital reduction
  - Only **link** between  $t$  and  $t + 1$  is the capital stock
  - To induce savings, can subsidize labor today or 'promise' low taxes
  - ... Same result



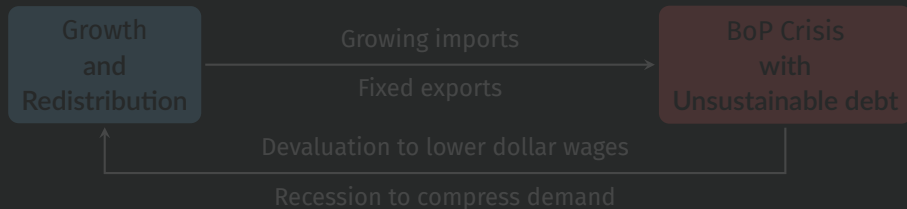
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# Stop & Go Dynamics

- Phenomenon also studied by Latin American **structuralists**
  - ... Díaz-Alejandro, Ferrer, Braun and Joy, etc...
  - ... More about shocks/imperfect planning than purposeful overshooting
- Also two phases (but with different names)



- **Testable** differences:
  - Growth in 'Go' phase v. low labor and output in 'populist' phase
  - REER depreciation in 'Stop' phase v. high after-tax wages in 'austerity'?

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# Concluding Remarks

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- Excellent theoretical exercise
  - ... All assumptions needed, sharp characterization, basic idea applies to many setups
- Last comments
  - ... Quantitative performance?
    - ... Baseline is a little underwhelming
    - ... Three-period model seems to have larger effects
    - ... Would a full life-cycle give more traction?
  - ... How to think about best SPE?
    - ... Harsh punishments: better model for US / Advanced Europe?
    - ... Eurozone crisis, LatAm coups fit more with shocks than planning?
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