

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

XXV Workshop in International Economics and Finance  
UTDT, August 2023

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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

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- Elegant theory
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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
- Overlapping generations + financial income taxes + save in government bonds
  - ... Can tax old people's savings (aka domestic default): reduce inequality with no distortion
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# The key: two interacting sources of time inconsistency

- All choices subject to sustainability constraint

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

- When constraint binds
  - To sustain more debt issuance
    - ... Need to provide incentives to repay tomorrow — Decrease  $H(Y)$  and  $Y$
  - To sustain more output
    - ... Need to tolerate more inequality tomorrow — Increase  $W(B')$ , decrease  $B'$
- Key: *tradeoff* is time-inconsistent

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



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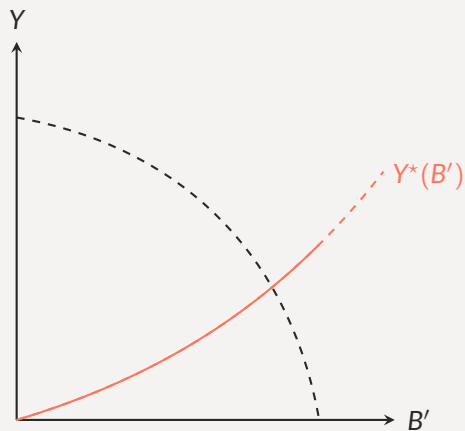
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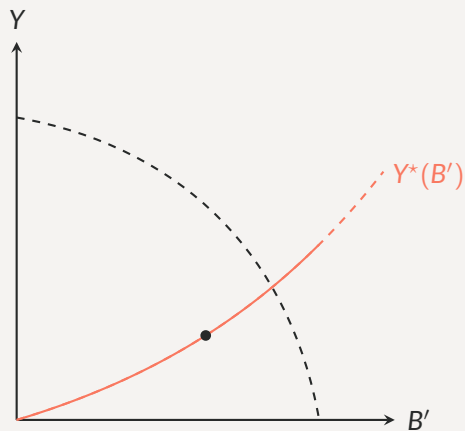


- For low  $B$ , low choice of  $B'$   
 $\Rightarrow$  constraint does not bind

- But  $B'(B)$  increasing...

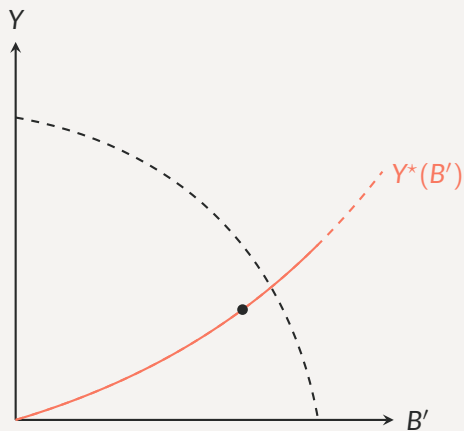
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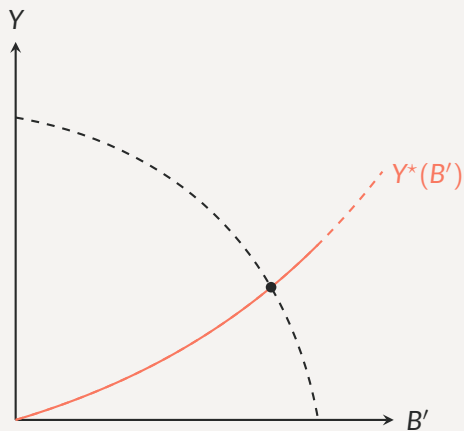
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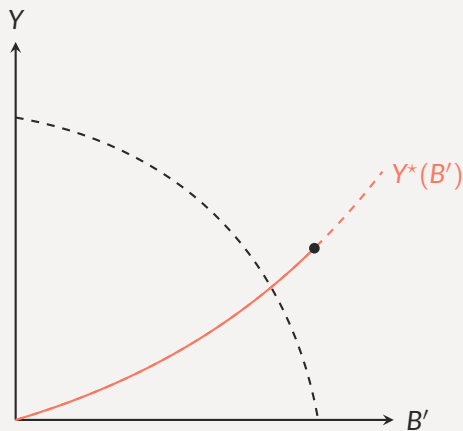
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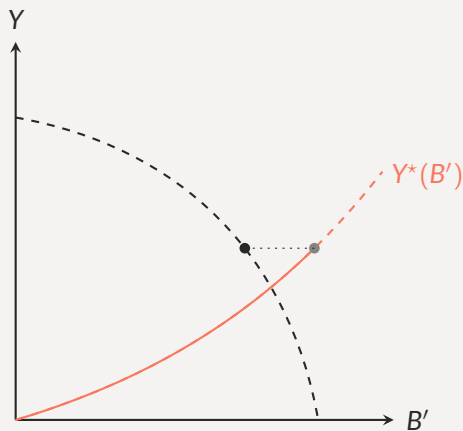
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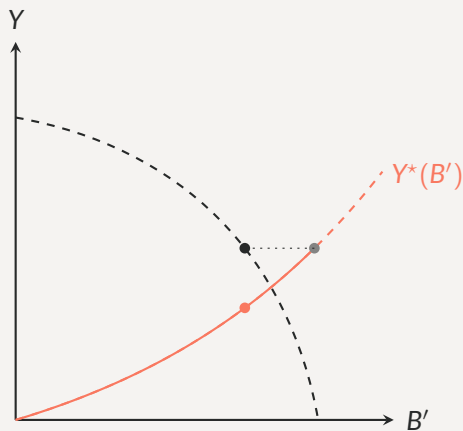
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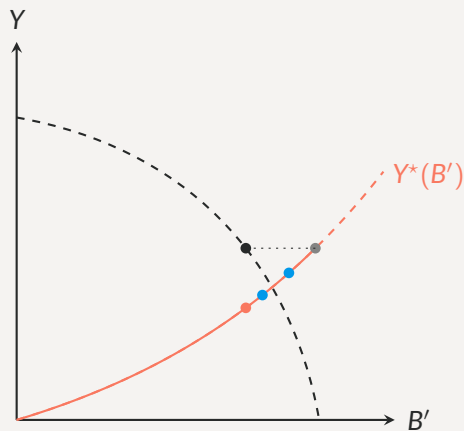
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• The constraint binds *intermittently*

The debt-money growth rate is time-varying



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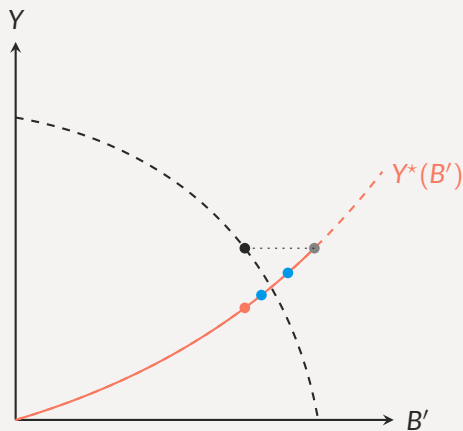


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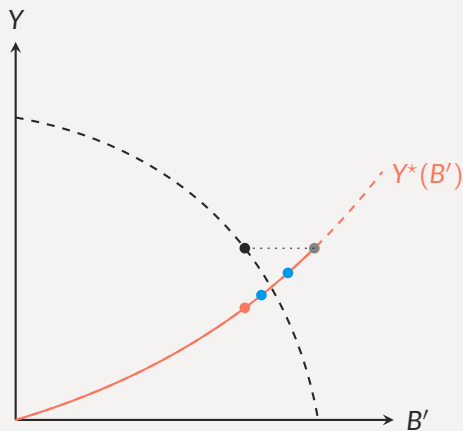


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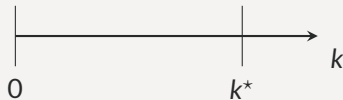
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## Two Comparisons

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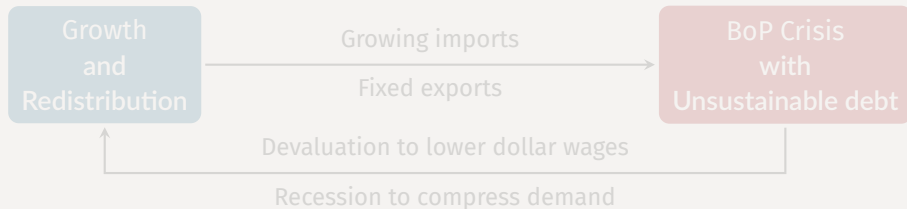
- Similar model with
  - Endogenous labor supply
  - Savings
  - Time-inconsistent taxes
- Time inconsistency: **capital** accumulation
  - Want tax capital ex-post, promise low taxes ex-ante
- No cycles? — Example with  $k_0 > k^*$  overshoots initial capital reduction
  - Only **link** between  $t$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



# 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
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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?
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