

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

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
- 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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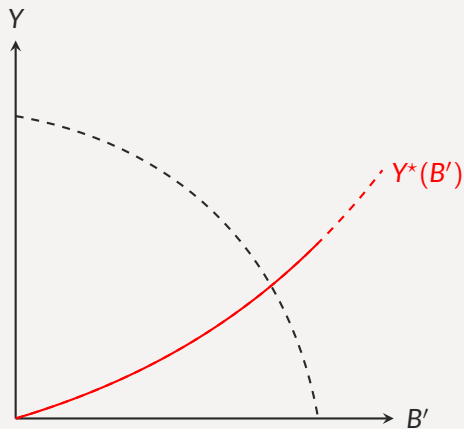
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The Debt/Output Frontier

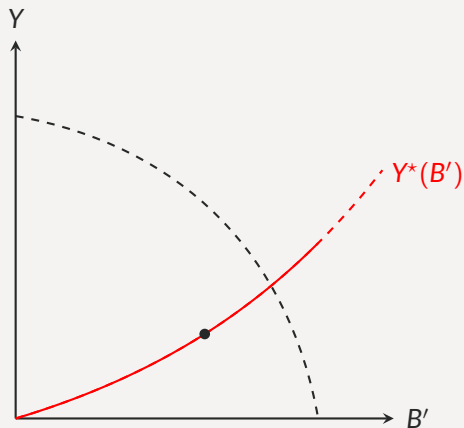


- For low B , low choice of B'
 \implies constraint does not bind

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

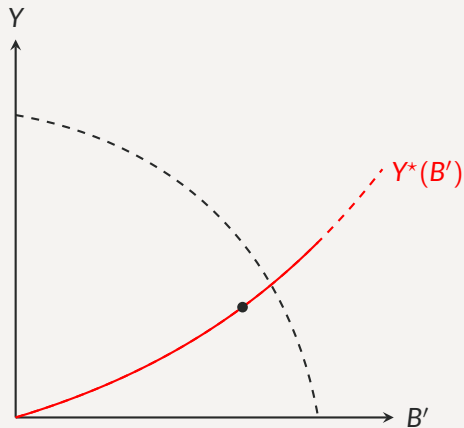
At some point the constraint binds

The Debt/Output Frontier



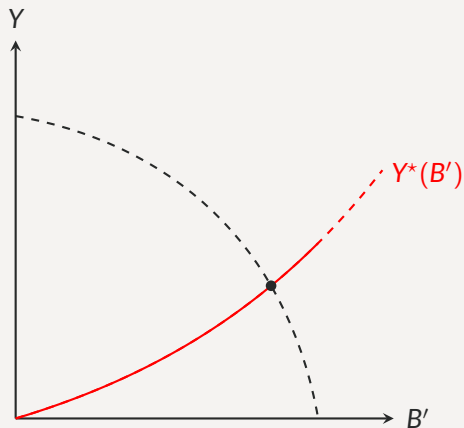
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- When constraint binds, replace B'

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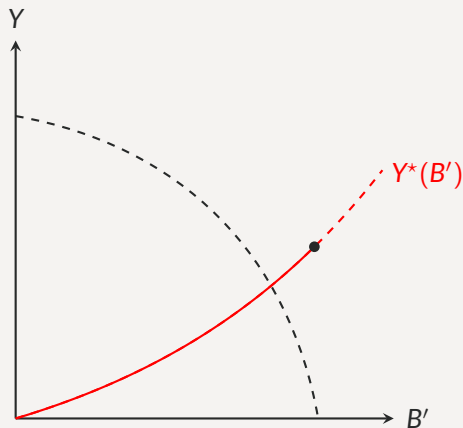
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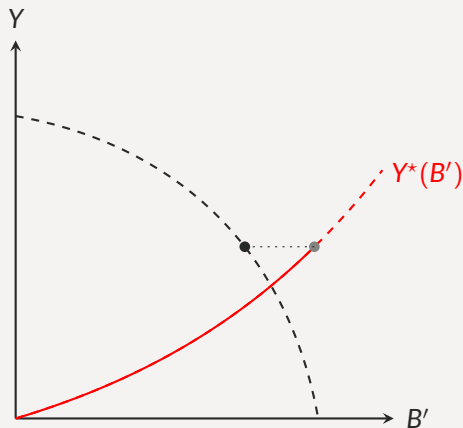
But why would the government choose to increase B' ?

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- But $\exists B_0$ with the same B' unconstrained

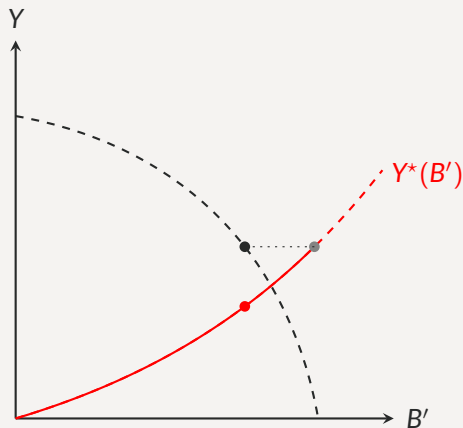
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Source: <https://www.fitchratings.com/web-content/2017/07/14/Debt%20Frontier%20-%20Fitch.pdf>

The Debt/Output Frontier

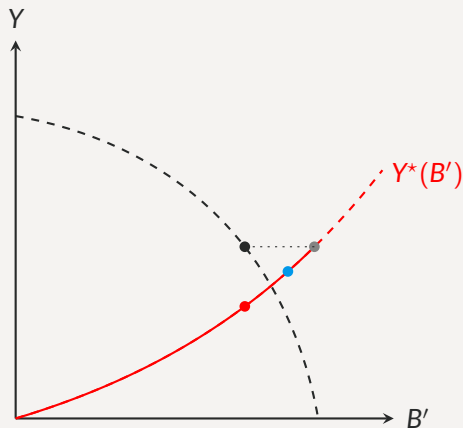


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Why does the constraint bind at B_0 ?

The debt-to-output tradeoff itself is the key to understanding this

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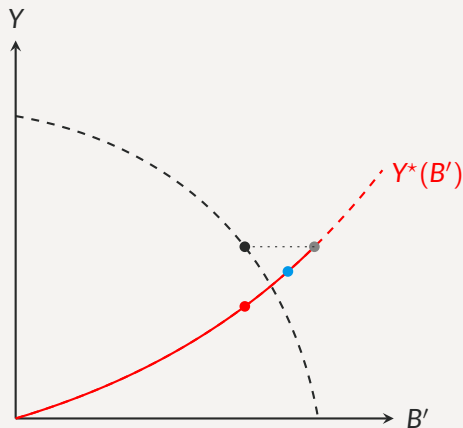
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Planner at t feels costs of inequality at t and $t+1$, costs of debt at $t+1$

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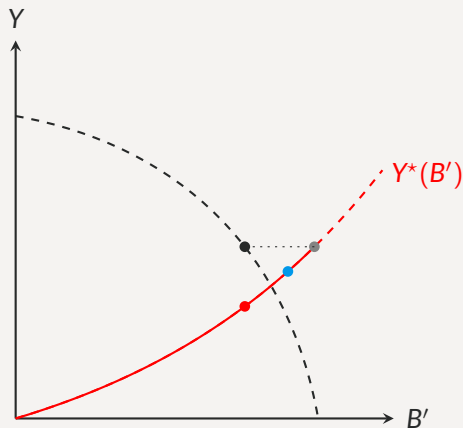
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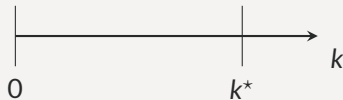
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Two Comparisons

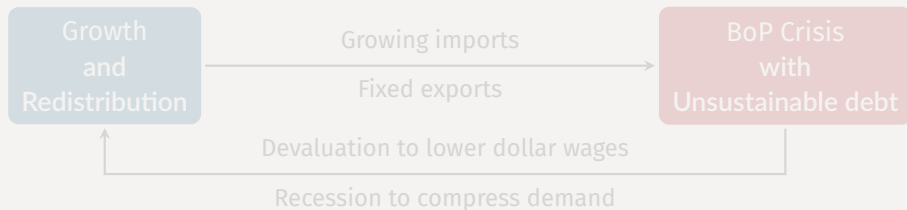
Phelan and Stacchetti (2001)

- 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



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

- 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?
 - ... Are all SPEs cyclical?

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