Discussion of "The Employment Cost of Sovereign Default"

by

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ECB Conference
Public Debt, Fiscal Policy and EMU Deepening
20 November 2017

Outline

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  - Occurrence of default in (bad and) good times.
  - Clustered default episodes ("serial defaults").
- ... assesses policy experiments to reduce employment cost of default.
  - Labour market: wage and unemployment subsidies alleviate firms' pre-financing constraints.
  - Bank regulation: higher capital requirements/sovereign debt exposures for banks enhance loan provision.

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  - Formal/rigorous/analytical proof of (part of) the results would be recommended, in particular of link of productivity and default.

Implications and realism of key assumptions (1/3)

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- Consider the private sector equilibrium $\{s, R, v\}$:

$$s: \quad s = 1 - G\underbrace{(z - Rw)}_{+}$$

$$R: \quad \chi W = L^b = L^f = w(1-s)N + av$$

$$v: \quad \begin{cases} > 0 & \text{if } Ra \leq \lambda_f[1-(1-s)N, v]\frac{1}{1+r}\mathbb{E}_z\{\mathcal{J}(\Omega', \mathcal{D})\} \\ = 0 & \text{otherwise} \end{cases}$$

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- Given **wage setting** with fixed output sharing ($w = z - \omega$),

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Since $R > 1$, if $\uparrow z \Rightarrow \uparrow s \Rightarrow \uparrow u$.

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$\Rightarrow$ what if wage setting with constant share of output ($w = \omega z$)?

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  - Gertler and Karadi (2011) calibrate $\phi = 0.972$ to have expected bankers' lifetime of a decade. How realistic?

  $\Rightarrow$ what if $\phi > 0$?

Policy experiment (1/2): capital requirements

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- For instance, regulators could impose a limit on leverage:

$$\frac{L}{W} = \chi \leq \bar{\chi} \iff R \leq 1 + (1+r)\left(\lambda - \frac{1}{\bar{\chi}}\right)$$

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- Alternatively, regulators could impose a unit cost on loan provision, so that the participation constraint would yield:

$$P_{j,t} \geq (\lambda + \xi) L_{j,t} \Rightarrow L_{j,t} = \frac{\kappa + \gamma q_t B_{t+1}}{\lambda + \xi - \frac{R_t - 1}{1+r}}$$

  where $\xi \geq 0$ is the unit cost.

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- Likewise, standard models (e.g. Arellano, 2008) predict counter-cyclical spreads and have only foreign investors ($\gamma = 0$) VS this model predicts pro-cyclical spreads when has mostly foreign investors (low γ). This seems at odds with empirical evidence.

Default in good times

- if $\gamma = 0.1 \Rightarrow corr(Y, spr) = 25\%$?

Moment	Description	Data	Model $\gamma \in [0.1, 0.9]$
Mean			
$\mathbb{E}(B/Y)$	Debt ratio	69%	69 to 115%
$\mathbb{E}(d)$	Default probability	3%	1.5 to 3%
$\mathbb{E}(u)$	Unemployment rate	7%	7 to 11%
Correlation			
$corr(Y, spr)$	GDP and spread	-6%	-5 to 25%
$corr(Y, TB)$	GDP and trade balance	1%	-7 to 23%

Table 3: Model prediction and Portuguese data: Debt ratio 2000-2011 and GDP correlations 1995-2015.

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- Large theoretical literature models euro area crisis as determined by adverse demand shocks.
- This paper unveils a transmission mechanism of the real impact of default risk in high-debt/high-unemployment countries, but it does not show the determinants of the euro area crisis.

Other comments

- Where is the market clearing conditions for goods?

$$z(1-s)N = (w+\omega)(1-s)N = ...?$$

  If after-tax w goes to employed, where does ω go?
- No welfare implications are analysed in explaining the employment cost of default and in assessing the policy experiments. Maybe add this to tables?
- Table 3: different model statistics depend differently on $\gamma \Rightarrow$ make one column for each value of γ.

Thank you for your attention!