Fiscal Rules and Sovereign Default
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Discussion
Almuth Scholl
Contribution

- Welfare effects of fiscal rules in the presence of sovereign default risk.

- Standard model of sovereign debt and default with time-inconsistent government preferences:

\[
U_t = E_t[u(g_t) + \beta \sum_{\tau=1}^{\infty} \delta^\tau u(g_{t+\tau})]
\]

- Debt rule versus deficit rule.
Findings

- The model generates the Brazilian level of debt and frequency of default with $\delta$ calibrated to the local interest rate.

- A simple debt rule can reproduce the welfare gain of the optimal fiscal rule.

- If, however, the debt threshold is too high or too low, a debt rule generates substantial welfare losses.

- Deficit rules produce substantial welfare losses.
Discussion

Comments: Calibration

- In the model, the interest spread is determined by the default probability, making it difficult to match the empirical value.

- The value $\beta = 0.70$ is based on household data from laboratory experiments, Angeletos et al. (2001). In the model, $\beta$ refers to the government present bias.

- Debt and default risk are not only affected by $\beta$, but also by $\delta$, the default output cost $\phi$, and the exclusion parameter $\theta$. Parameters $\leftrightarrow$ empirical targets?
Comments: No Rule versus Optimal Rule

- The default threshold is lower for $\beta = 1$ than for $\beta = 0.7$.

- The lower default threshold value should be reflected in the bond price $q(d', z)$ (not shown in the paper).

- Are there two effects?
  - Lower borrowing because there is no present bias with $\beta = 1$.
  - Lower borrowing because of the endogenous debt limit.

- Optimal fiscal policy is pro-cyclical.
  - Reason: Households are more impatient than investors.
  - But only for high debt $\rightarrow$ How pronounced is the pro-cyclical in the simulations?
Discussion

Comments: Debt Rule

- Welfare gains/losses are substantial, depending on debt limit.

- Welfare is affected by
  - the frequency of default and the output cost during default.
  - the impact of the debt rule on the bond price.
  - the impact of the debt rule on consumption smoothing and frontloading.

- How to disentangle the effects? What are the welfare effects if default episodes are excluded?

- Policy recommendation? The authors suggest a simple debt rule, but how to find the right debt threshold in practice?
Comments: Deficit Rule

- A deficit rule generates a substantial welfare loss because it prevents the government from frontloading consumption.

- This finding seems to depend on the assumption that the simulations start with an initial debt level of zero.
Comments: Transitional Dynamics

- In the model, if the country is highly indebted, the adoption of a debt rule would generate an immediate default.

- Many emerging markets have adopted fiscal rules, e.g., Brazil in 2000.
  - Most countries probably did not default after the debt rule was implemented.
  - Comparison of the model outcomes with the empirical evidence?

- What about debt rules that allow for a slow adjustment to the debt threshold?
Other Comments and Suggestions

- It seems to be feasible to incorporate time-inconsistent preferences and fiscal rules in richer economic environments.

- Production economy in which the government faces the choice between taxation, debt, and default. Debt rules may force the government to raise taxes with adverse effects on production and possibly welfare.

- Distinction between external and domestic debt. How are domestic bond holders affected by fiscal rules?
Alternative fiscal rules:
- Accounting for the cycle.
- Fiscal rules on government spending.
- Fiscal rules on tax revenues.

Compliance with fiscal rules? Credibility of sanctions?

Conclusions

Very nice paper with interesting results!