Discussion of:

Sovereign Spreads and the Effects of Fiscal Austerity

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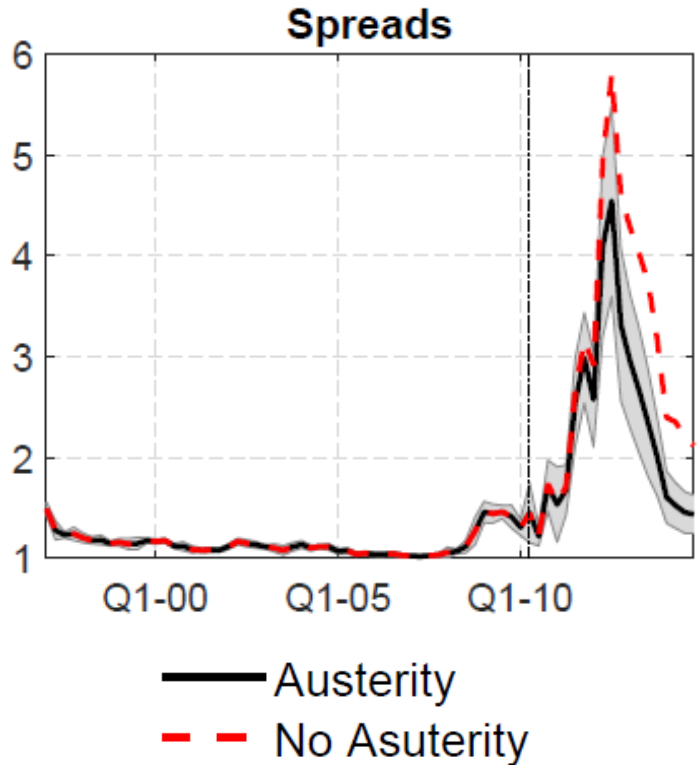
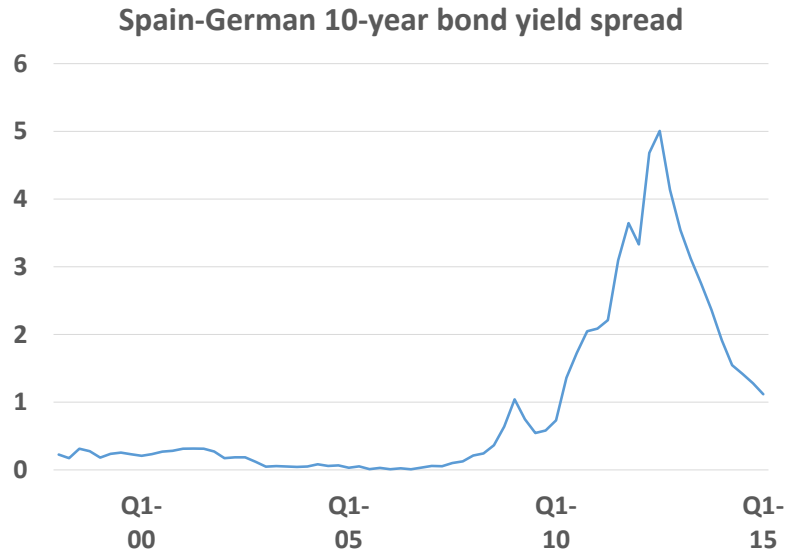
SUMMARY

- Question: What would have been the path of the bond yield spread in Spain without fiscal austerity during 2010-2014?
- Approach:
  - Eaton-Gersovitz sovereign default model $\Rightarrow$ endogenous yield spread.
  - Flexible yet exogenous fiscal policy behavior (with shocks) $\Rightarrow$ closely traces realized fiscal policy and helps in the identification of magnitude of austerity policy.
  - Wage rigidity and lump sum taxes $\Rightarrow$ fiscal multiplier is endogenous and positive.
- Trade-off: Spread may fall if fiscal austerity lowers the probability of a default vs. spread may increases when fiscal austerity lowers GDP.

SUMMARY: RESULT

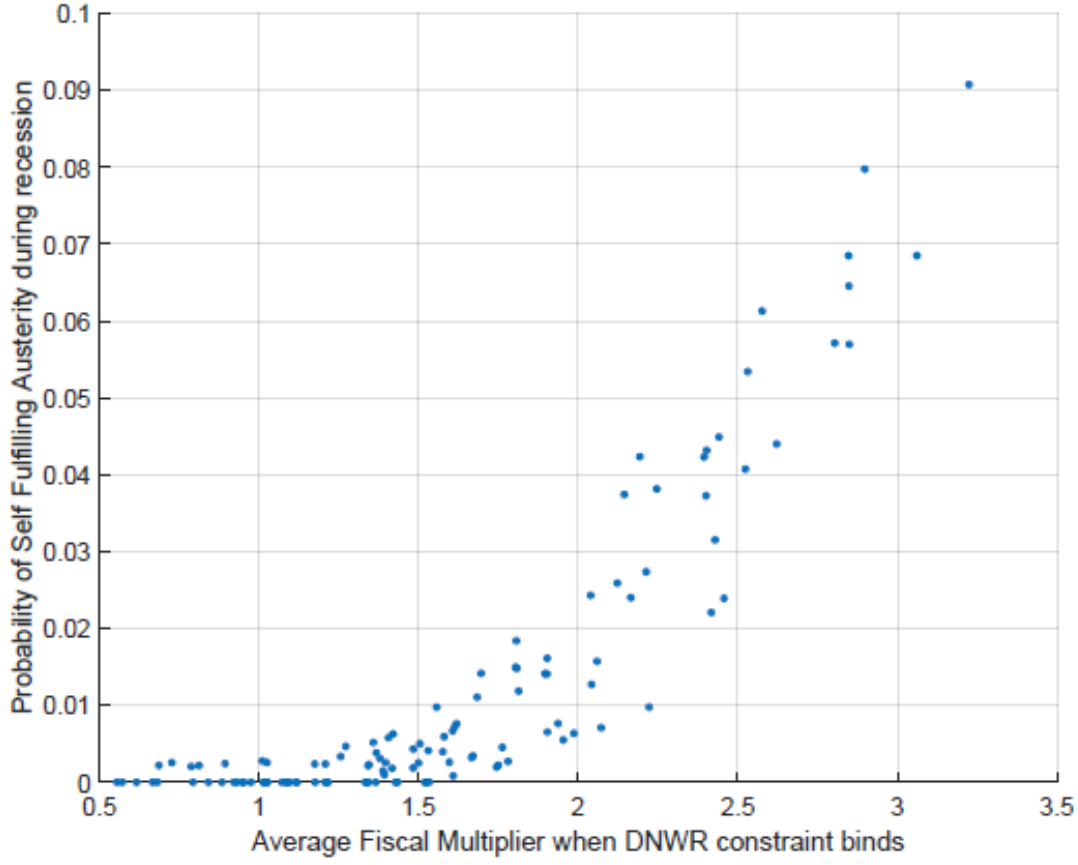
- Without austerity the spread would have been higher.
- This is despite the fact that austerity lowered GDP by 1.4%.





ROBUSTNESS

Vertical axis = ex-ante probability that austerity increases the spread



Model implies low frequency of periods with spread increases after austerity.

And only with "large" multipliers.

EVALUATION

- Clear question and execution.
- Allowing for multiplier effects of fiscal policy is a step in the right direction. Adds to a growing literature: Bianchi-Ottonello-Presno (2020), Liu (2020). In the line of Mendoza-Yue (2012) and Arellano-Bai-Bocola 2020) but with a different channel.
- Interesting analytics, as far as the model allows for.
- Main comments:
  - Assumed fiscal behavior.
  - Role of government expenditures.
  - Choice of case study.

ASSUMED FISCAL BEHAVIOR

- Assumption is that government expenditures G follow the process

$$log\left(\frac{G_t}{\bar{G}}\right) = \underbrace{\rho_G}_{=0.95} log\left(\frac{G_{t-1}}{\bar{G}}\right) + \underbrace{\rho_{GY}}_{=0} log\left(\frac{Y_{t-1}}{\bar{Y}}\right) + \underbrace{\rho_{GB}}_{=0} log\left(\frac{B_{t-1}}{\bar{B}}\right) + \varepsilon_t^G$$

  Austerity: accumulation of $\varepsilon_t^G < 0$.

- Debt level (B) follows the process

$$log\left(\frac{B_{t+1}}{\bar{B}}\right) = \gamma_B log\left(\frac{B_t}{\bar{B}}\right) + \gamma_G log\left(\frac{p_{G_t} G_t}{\bar{G}}\right) + \gamma_Y log\left(\frac{Y_t^{nom}}{\bar{Y}}\right)$$

  as long as the government repays.

- The lump sum tax adjusts according to the government's budget constraint.

ASSUMED FISCAL BEHAVIOR

$$log\left(\frac{G_t}{\bar{G}}\right) = \rho_G log\left(\frac{G_{t-1}}{\bar{G}}\right) + \varepsilon_t^G$$

- Useful in empirical literature to identify fiscal shocks and thus to measure multiplier.
- Fiscal austerity programs: lower G for a finite number of periods. Formulation assumes ε_t^G are uncorrelated over time $\Rightarrow$ unanticipated future measures (beyond intrinsic persistence).
- Other than $\varepsilon_t^G < 0$, government follows business as usual during austerity. Plausible representation of fiscal policy during fiscal crises?
- An alternative: endogenous G as in Bianchi-Ottonello-Presno (2020), perhaps with a lag. Measure effect of estimated ΔG_t. Maybe even evaluate ΔG_{t+n}

ROLE OF G IN THE MODEL

- G is wasteful spending.
- Does not matter for multiplier effect. Austerity makes the tradable good relatively more scarce and lowers relative price of non-tradable good (real exchange depreciation). If downward wage rigidity binds $\Rightarrow$ fall in non-tradable employment.
- Absent wage rigidity, austerity is good for welfare because it increases resources available for private consumption.
- Paper focuses on positive implications. But spread depends on difference in continuation values $V^{Repay} - V^{Default}$. Does it matter that G has no social value?
- Bianchi-Ottonello-Presno: G has social value. Better framework to think about design of austerity programs.

SPAIN AS A CASE STUDY

- Case of peripheral European economies has received attention.
- But relatively narrow window of "action" to learn about how fiscal policies and other fundamentals affect the spread.
- Even study approach could inform about $dSpread/dG$.
- Could use other countries. Examples abound in emerging economies.

OTHER COMMENTS

- Austerity is usually bundled with foreign official loans. De-facto seniority of those loans could have an effect on yield spread. Boz (2011) and Fink and Scholl (2016).
- Alesina and Ardagna (2010) "If agents believe that the stabilization is credible and avoids a default on government debt, they can ask for a lower premium on government bonds. Private demand components sensitive to the real interest rate can increase if the reduction in the interest rate paid on government bonds leads to a reduction in the real interest rate charged to consumers and firms."
    - Motivation for paying attention to the effect on spread.
    - Incorporating this channel could be useful for normative implications of austerity.