Anzoategui (2021): Sovereign Spreads and the Effects of Fiscal Austerity

Discussion

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Conference CDC - IDB - JIE

May 14, 2021

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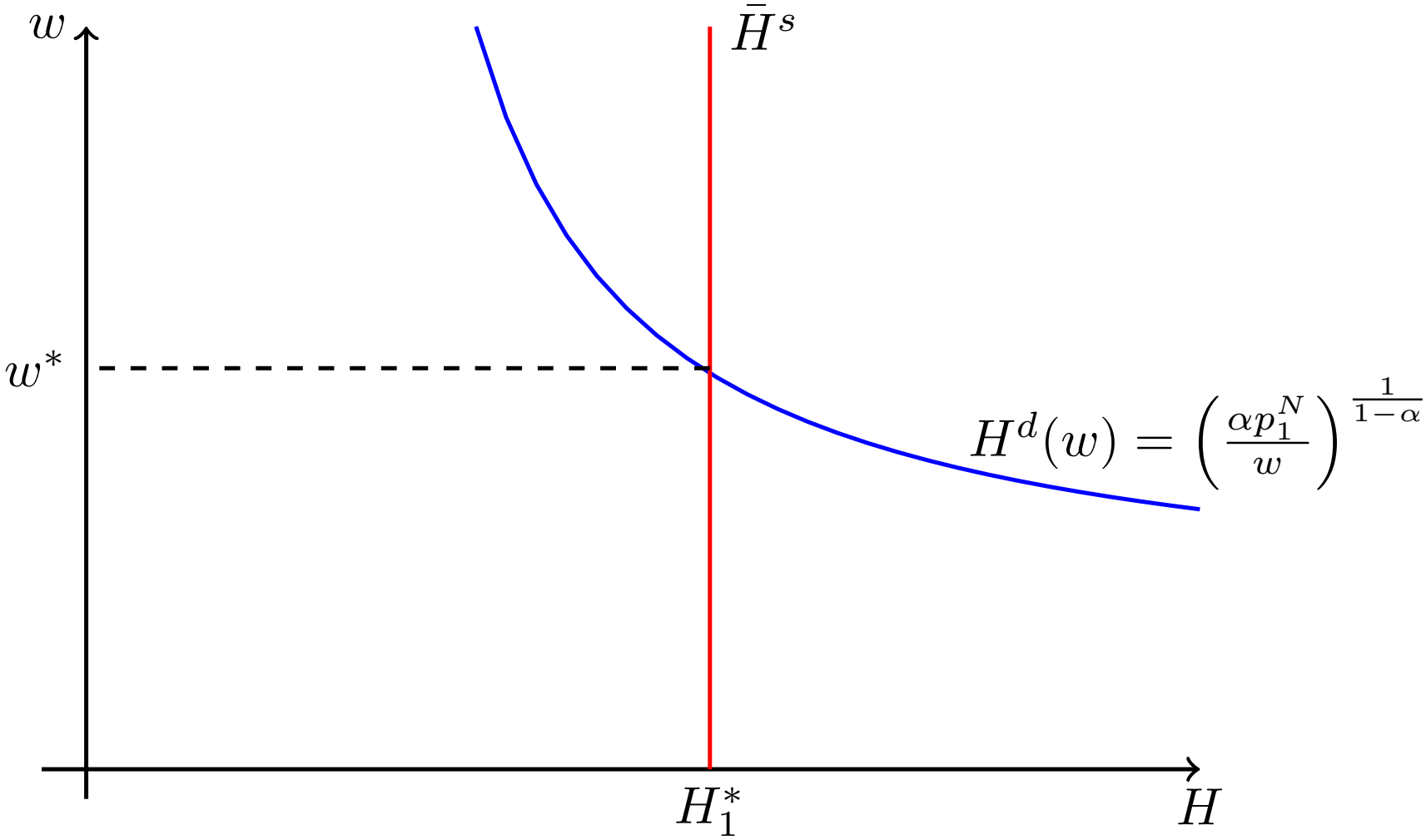
- This paper identifies conditions under which fiscal austerity may not be effective in reducing bond spreads ("self-defeating austerity")
- Lays out fully-fledged quantitative SOE model of default with:
  - two production sectors: T-NT
  - downward wage rigidity
  - government fiscal rules for spending and debt
- Analyze through lenses of model effects of austerity packages in Spain during recent debt crisis

Mechanism: Labor market with $w \geq \bar{w}$



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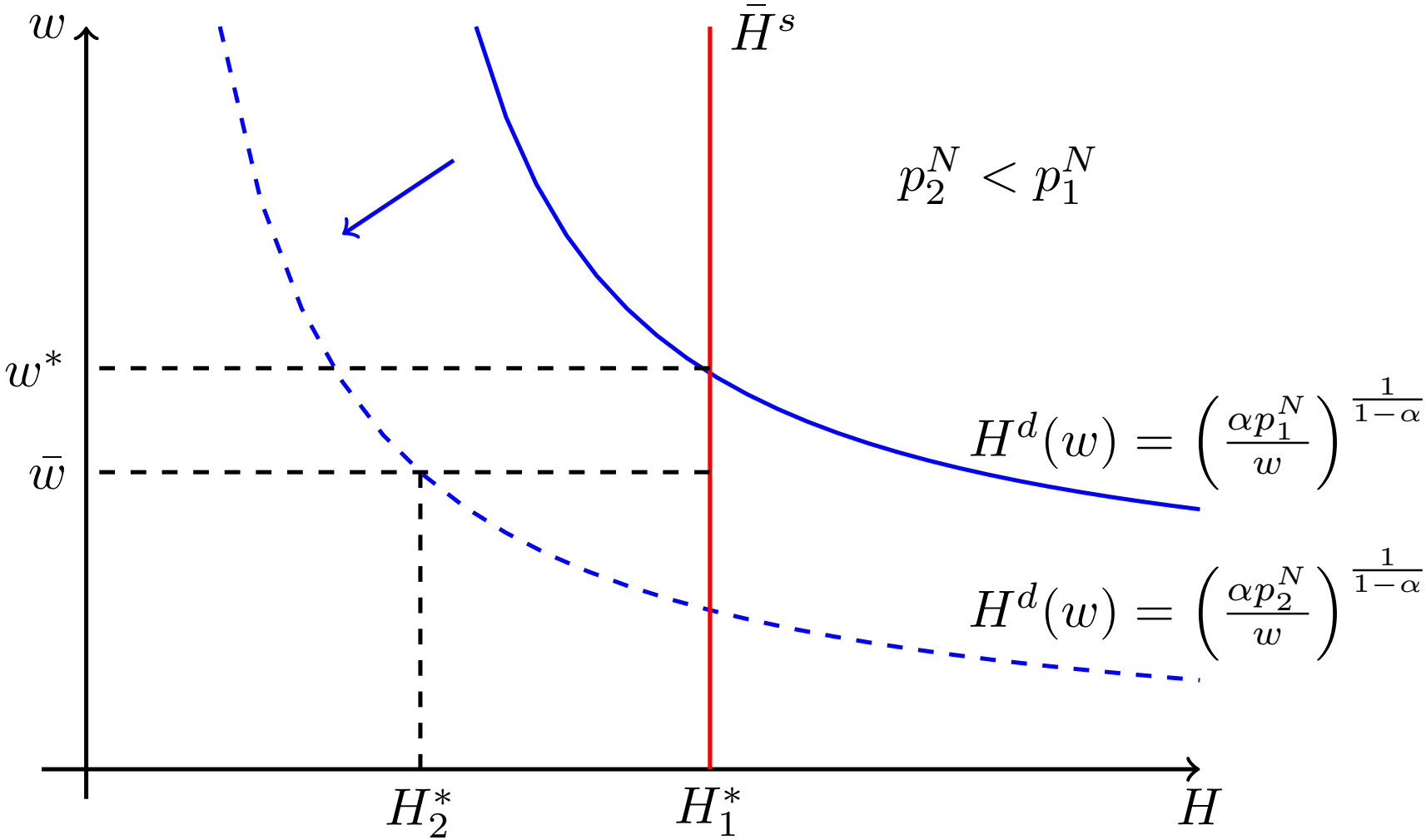

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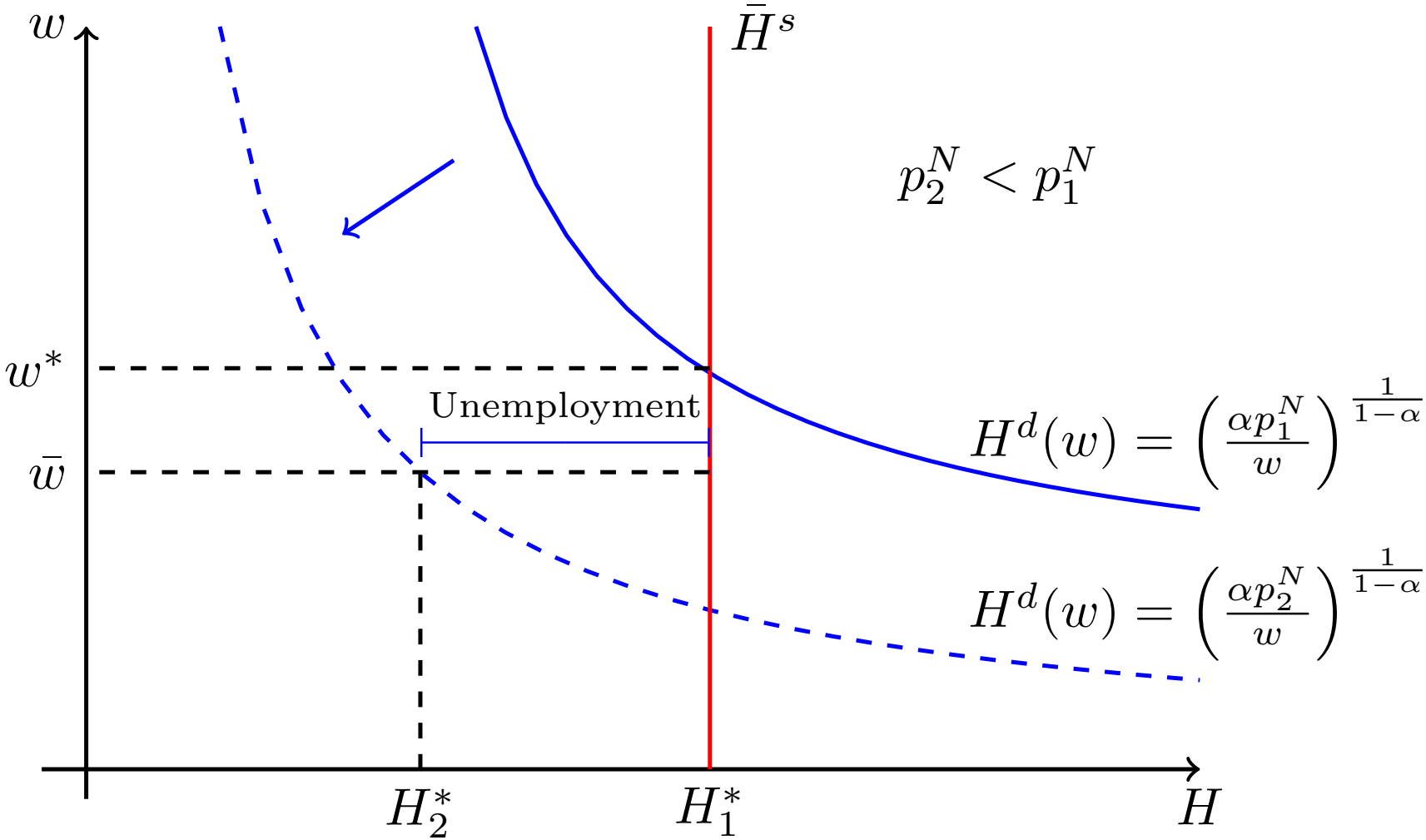

Mechanism: Relative price p^N

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$$\text{where } \iota \equiv B' - (1-\delta)B$$

Three channels through which a drop in G affects p_N

- reduction in G_N
- reduction in G_T
- reduction in ι

Which one dominates?

Same weight on NT in CES aggregators for C and G by assumption

$\Rightarrow$ reduction in $\iota \Rightarrow p_N$ falls (relationship in line with data?)

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- **Tax cut vs. debt reduction** following drop in G (role of γ_G)
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  - Complete markets
    - ★ Assume $\frac{1}{\mu} = \sigma$
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  - Non-state-contingent bond

$$p_N = \frac{\omega}{1-\omega}\left(\frac{Y_t - G_T + NBP^G + NBP^{HH}}{Y_N - G_N}\right)^{1/\mu}$$

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Main Comments (2): Fiscal Forward Guidance

- Importance of promised cut in the future (role of ρ)
- Focus of paper: reduce spreads through lower default risk next period
  - what about improving next-period bond prices when debt is long-term?
- Desirability for state-contingent spending cuts?
- Normative analysis?
- Bianchi, Ottonello, Presno (2019) address these questions

Main Comments (2): Fiscal Forward Guidance

Bianchi, Ottonello, Presno (2019)

Three policy proposals for fiscal consolidation next period:

i. current spending cuts

ii. commit to blunt spending cuts next period

iii. commit to well-designed spending cuts next period

- i.e. cut spending only if total income $y \in [\underline{y}, \overline{y}]$.

From following period on, policy and value functions given by Markov equilibrium.

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Initial Response of Main Variables and Welfare Gain

Variable	Current spending cut	Promised non-state-contingent spending cut	Promised state-contingent spending cut
p^N (%)	−0.527	0.111	0.121
debt (%)	−6.014	0.796	0.787
c^T (%)	−1.433	0.304	0.333
unemp (%)	1.405	−0.298	−0.326
g^N (%)	−3.000	0.636	0.696
spreads (%)	−0.178	−0.103	−0.137
welfare gain (%)	−0.056	0.075	0.088

Note: Initial response of key variables and welfare gain for following austerity measures: a promised spending cut next period in all states (column 1), a current spending cut (column 2), both of 3%. Column 3 corresponds to a promised spending cut of 4% next period only if total income $y \equiv y^T + p^N y^N$ lies within the range $[\underline{y}, \overline{y}]$, where $\underline{y}$ and $\overline{y}$ are set to 22% below and 3% above the average total income, respectively. Welfare gains are expressed as (percentage) increases in current total consumption under the optimal policy regime to be indifferent with the corresponding policy regime. The current state features debt equal to 20% above its mean and tradable income y^T given by its unconditional mean.

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Current consolidation reduces spreads (debt effect) but doesn't improve welfare

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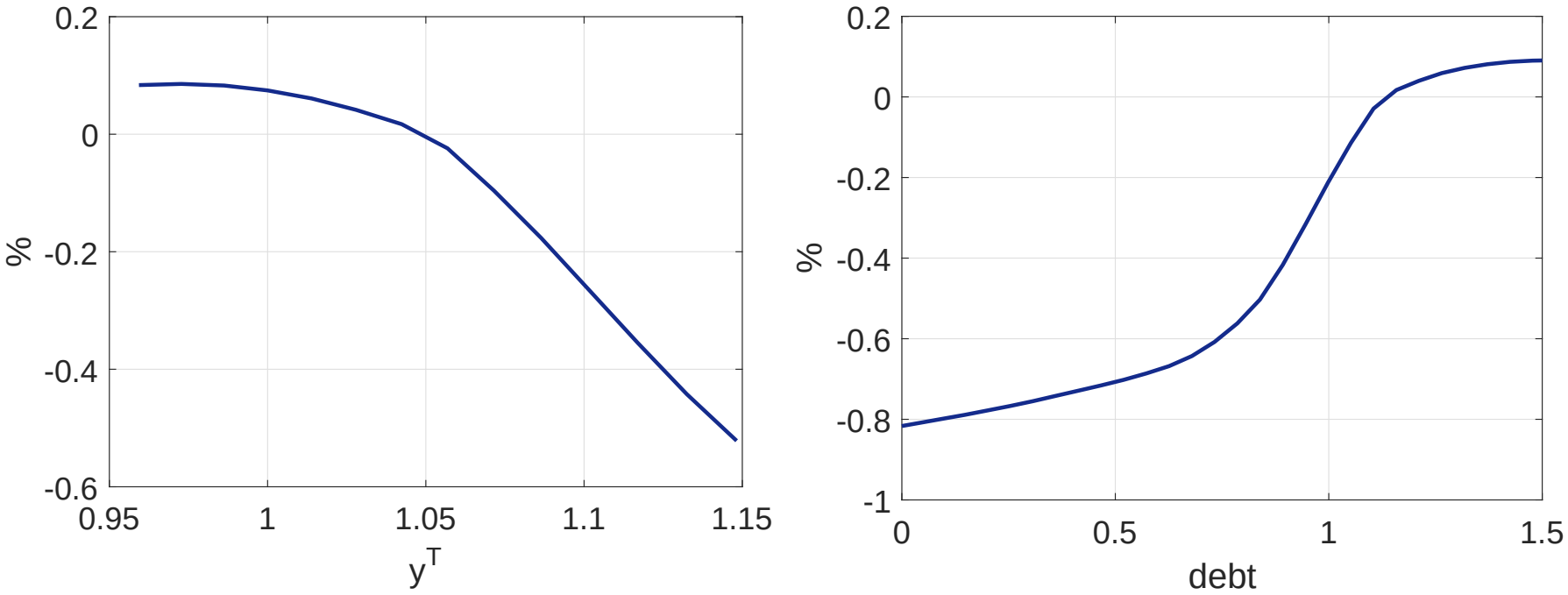
State contingency on spending cuts may help do better

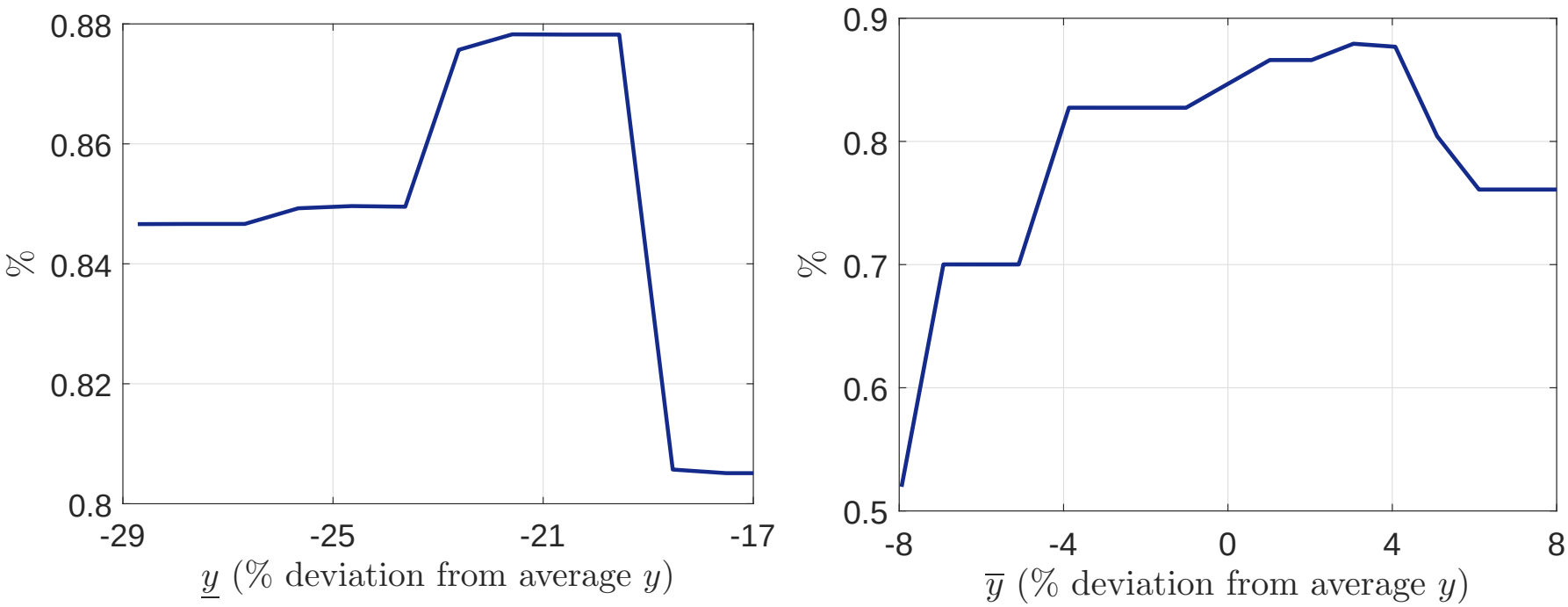
Designing Promised Spending Cuts



Welfare Gains from Promised Non-State-Contingent Spending Cuts

Note: Welfare gains from promising non-state-contingent spending cuts next period of 3%, as a function of tradable income y^T (left panel) and as function of debt (right panel). Debt is set to 20% above its average on the left panel and y^T is equal to its unconditional mean on the right panel. Welfare gains are expressed as (percentage) increases in current total consumption under the optimal policy regime to be indifferent with the promised spending cut.

Designing Promised Spending Cuts



Welfare Gains from Well-designed Promised Spending Cuts

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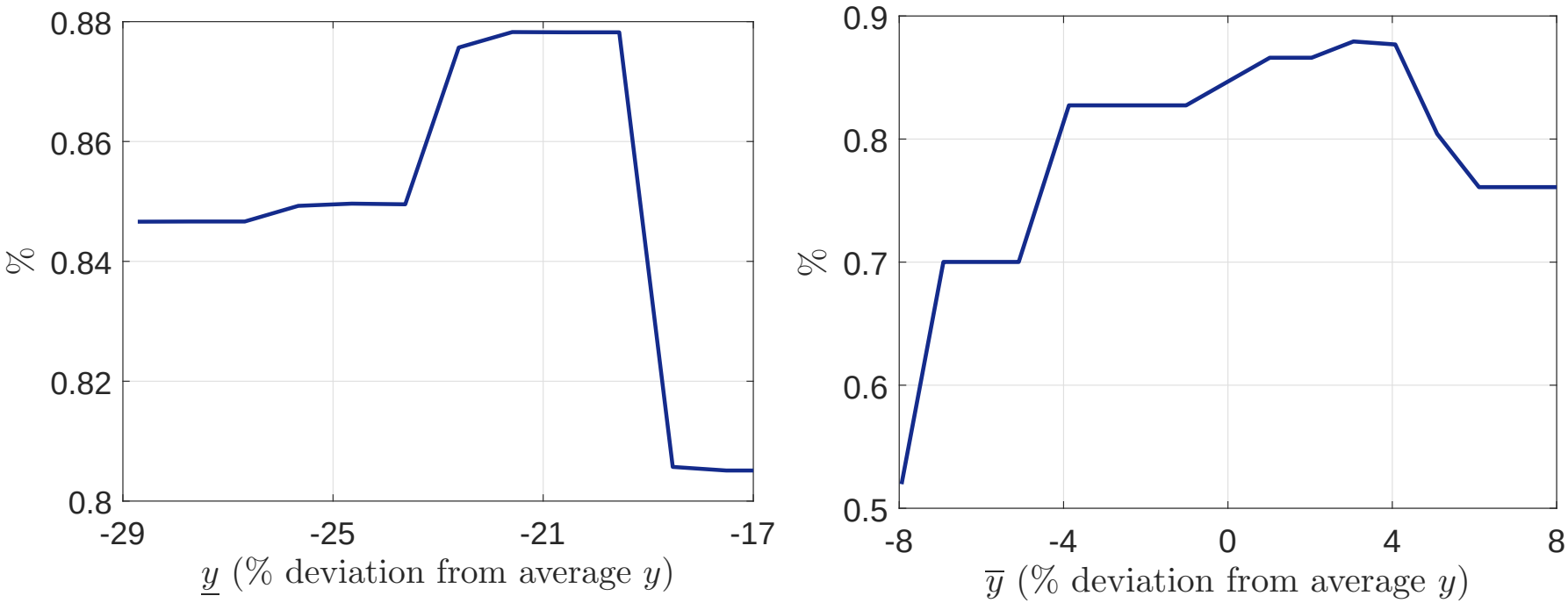

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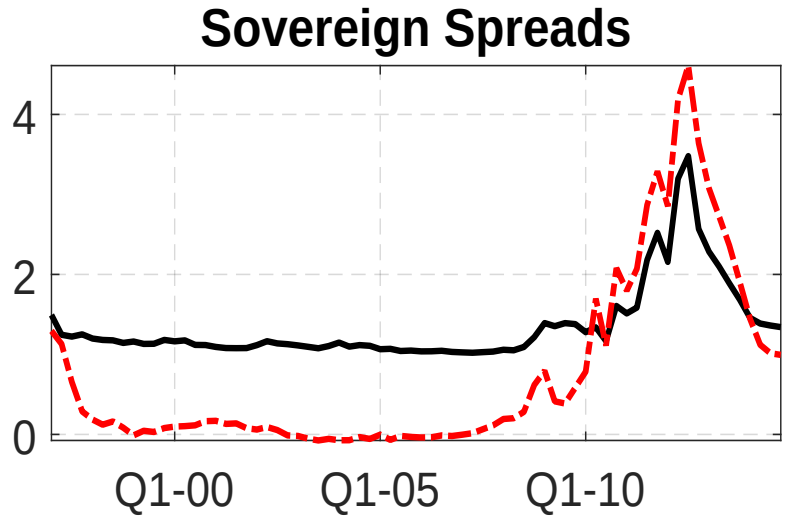
Not optimal to cut spending tomorrow in good states

Other Comments

- Shock decomposition for key variables?
- Potential concerns from model misspecification
  - does not allow for asymmetric response of G to debt and GDP.
  - optimal policy may prescribe fiscal stimulus/austerity depending on state of economy (Bianchi, Ottonello, Presno (2021))
- How economically meaningful is preference shock ϵ?



Concluding remarks

- Suitable quantitative framework to analyze optimal phasing of fiscal consolidation
- Interesting paper on very important topic
- Conditions for "self-defeating austerity" seem quite unlikely

Thank you!