

# Comment: “Fiscal Rules and Sovereign Default”

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## In a nutshell

- Quantitative analysis of fiscal rules with default
- Quasi-hyperbolic discounting
- Application to Brazil
- Study the fit of the model and evaluate different standard rules:  
debt limit, deficit limit

# Government's discount factor

- On the interpretation of the higher discount factor of the government
- Aggregation bias from heterogeneous individual preferences
- Why? Agents welfare can be improved by using a rule
- By-product of the assumption: low discount factors in the standard literature that are required to get reasonable debt levels
- There are a few other solutions to the low sustainable levels of debt: renegotiation and maturity mix for instance

## Government's discount factor

- Alternative: political economy frictions (Aguiar and Amador (2011))
- Set of political parties that take turns in power (Markov Process)
- All parties enjoy higher utility from consumption while in power compared to the times in which they are not in power
- Why? Incumbents have different intertemporal views than the opposition (disagree on the type of gov spending)

## Government's discount factor

- If  $\theta$  is the ratio of how parties view spending depending on being in power or not
- $\delta$  incumbency advantage: larger  $\delta$  greater the advantage to retain office
- The value of the incumbent can be written as

$$W_t = \sum_{s=t}^{\infty} \beta^{s-t} (\theta \delta^{s-t} + 1 - \delta^{s-t}) u(c_s)$$

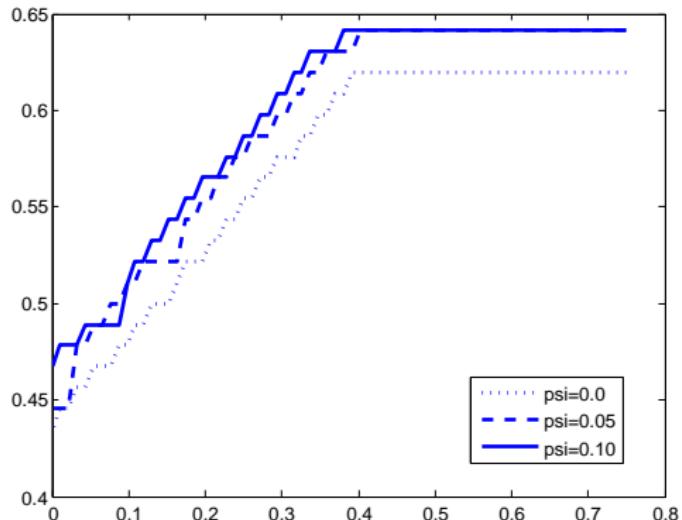
- Discount:  $\beta(\theta\delta + 1 - \delta) < \beta$
- Also, incumbent's discounting from 0 to 1 is different than from  $t$  and  $t+1$

## Fiscal Rules: alternatives

- Those fiscal rules are not the ones we usually have in mind (specially if you come from the DSGE literature)
- Feedback rules, easy to introduce  $\tau = \bar{\tau} + \psi (b' - b)$
- For DSGE you will usually require that  $\psi > 1/\beta - 1$  (if Taylor principle holds)

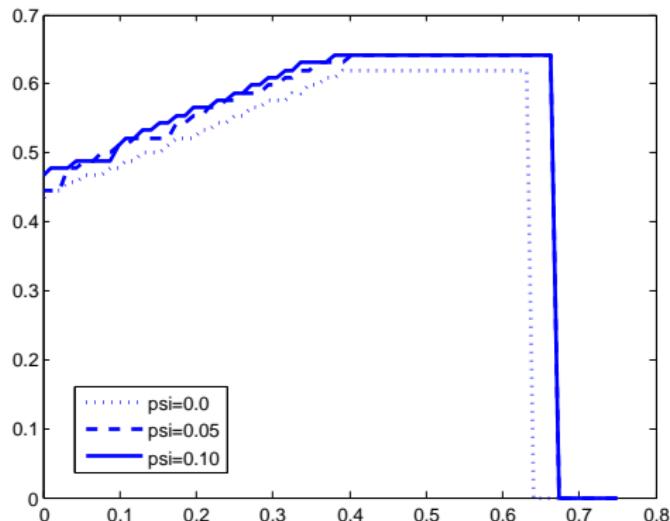
# Fiscal Rules: alternatives

Figure: Debt profiles



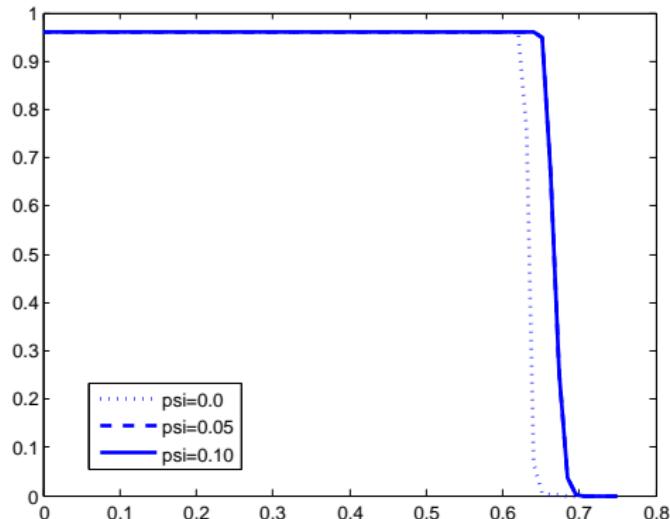
# Fiscal Rules: alternatives

Figure: Debt/default profiles



# Fiscal Rules: alternatives

Figure: Price schedule



## Fiscal Rules: commitment

- A key assumption of the paper is that the government can not commit to repay debt, but can commit to a fiscal rule
- It is easy to introduce a fiscal rule with full commitment: if the debt limit is set to  $\bar{b}$ , then  $u = -\infty$  if  $b' > \bar{b}$
- Imperfect credibility of fiscal rules might be key. The problem that arises here is how to deal with the penalty of deviating from the fiscal rule
- Need to define a penalty and compute the value of deviating from the fiscal rule
- Consolation prize: random deviation from the rule?

## Related approach

- Complementary approach: Pancrazi, Seoane and Vukotic (2016)
- Borrowing constraints are conditionality clause of supra-national authority
- Study bailouts subject to conditionality clause
- Our setup can be thought about one of endogenous entry/exit to a rule
- Welfare trade off, bailouts help during bad times but the conditionality clause limit alternatives for intertemporal trades and can drive the economy to default

## Related approach

- A country can ask for a bailout: loan at low rate from a multinational institution
- Conditionality clause  $b' \geq b$  as long as the country is in the “program”
- Exit the program voluntarily by repaying the loan
- The country can default while being in the program, but the third party loan is not-defaultable (multinational loans have priority)
- This can be a setup that allow us to think about partial commitment to a rule (there's an exit clause)