

“Monetary Conservatism and Sovereign Default” by Joost Röttger

Some comments by Galo Nuño

Banco de España

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Outline

- 1 The paper in the literature
- 2 The case without political distortions
- 3 The role of political frictions
- 4 Conclusion

The default literature...

- **Optimal default.** Eaton and Gersovitz (1981), Aguiar and Gopinath (2006), Arellano (2008)...
- **...with political frictions.** Cuadra and Sapriza (2008)
- **...with monetary policy**
 - ▶ In a closed economy: Sunder-Plassman (2014), Röttger (2015)
 - ▶ In an open-economy: Du and Schreger (2015) and Nuño and Thomas (2015)

...and the literature on the use of inflation to complete markets

- **Díaz-Giménez et al. (2008)**. Cash in advance model.
 - ▶ Non-state contingent nominal contracts (NSCNC) are welfare **improving** for low debt values
- **Niemann (2011)**. Cash in advance model.
 - ▶ Delegation to a conservative central banker is **not** welfare improving
- **Nuño and Thomas (2015)**. Default and sticky prices.
 - ▶ NSCNC are welfare **reducing** for any debt value
 - ▶ Delegation to a conservative central banker **is** welfare improving
 - ▶ These results revert for high output volatilities

This paper

- Three frictions
 - ① Incomplete financial markets (NSCNC)
 - ② Risk of default
 - ③ Political distortions
- Main results
 - ▶ Delegating monetary policy to a conservative central banker can be welfare **improving** or **reducing** depending on **political distortions**
 - ▶ Conservatism ($\alpha > 1$) implies lower π , higher b and more volatile c .

Outline

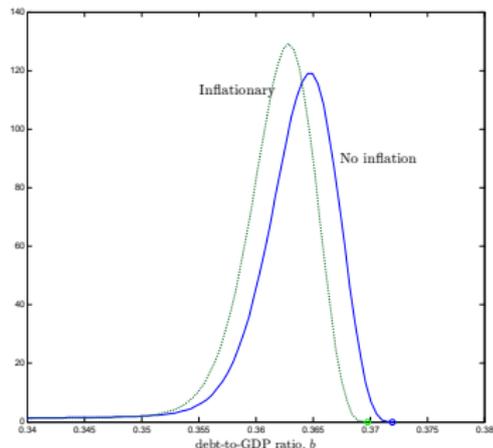
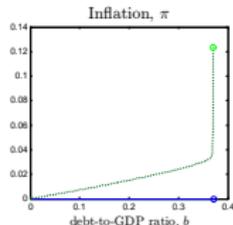
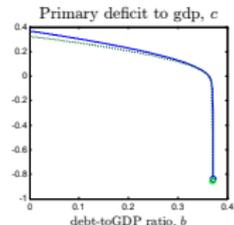
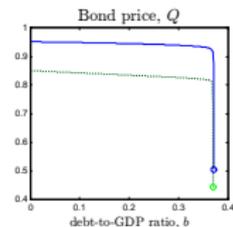
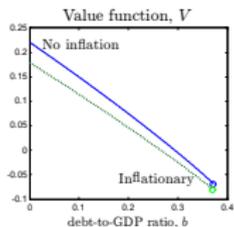
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The case without political distortions is very similar to Nuño and Thomas (2015)

- However the result is the opposite → monetary conservatism is welfare **reducing**!
- Why is it so?
 - ▶ Different calibration
 - ▶ Persistence of the shocks
 - ▶ Taxes versus GDP as a source of uncertainty
 - ▶ Timing of moves → Ayres, Navarro, Nicolini and Teles (2015)

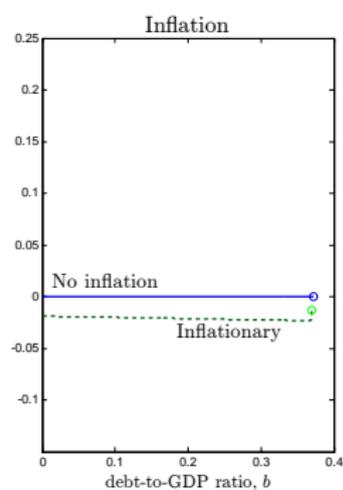
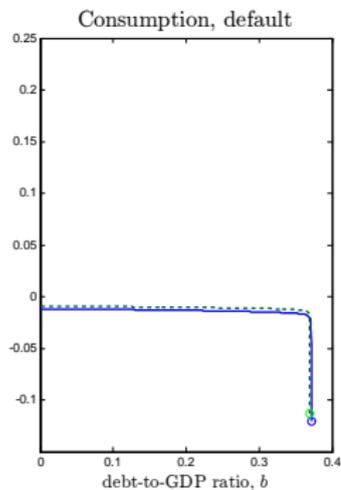
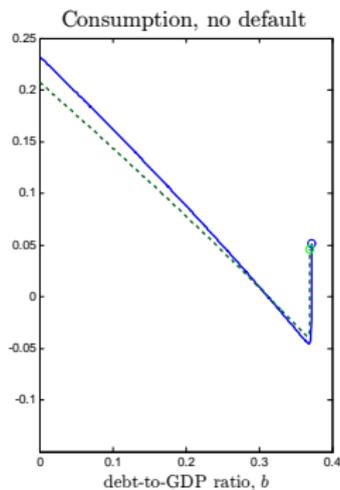
Is it welfare reducing for any initial debt level?

It would be interesting to compare the value functions and the distributions



Which are the mechanisms behind this result?

Welfare decomposition



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Key message: political frictions play a central role

- Introducing political frictions recovers the **optimality of monetary conservatism**.
- Two components
 - ▶ Political disagreement ($\theta > 1$) → enough to recover the result
 - ▶ Turnover risk ($\mu < 1$) → small welfare differences

Understanding the effect of political frictions

- Cuadra and Sapriza (2008) model political frictions as in Alesina and Tabellini (1989, 1990), Persson and Svensson(1989) or Ozler and Tabellini (1991).
- However in this paper the modelling is slightly different, there is only one household group but the Government has

$$\theta u(c) - \psi(\pi)$$

- ▶ The central bank has $u(c) - \alpha\psi(\pi)$
- Why does this mechanism change the results?
 - ▶ **Fiscal myopia** in Niemann (2011) produces the opposite effect
- Or is it the alternative **calibration**?

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A very nice paper...

...that still needs some analysis

- ① Which mechanisms are driving the differences with Nuño and Thomas (2015)?
 - ▶ Is it an average phenomenon or a state-by-state one?
- ② Why political disagreement recovers the optimality of monetary conservatism?
- ③ How robust are the results to alternative (plausible) calibrations?
 - ▶ In particular to discount factors