Distributional Incentives in an Equilibrium Model of Domestic Sovereign Default

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The questions

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- Is the current European situation not a crisis but rather a (constrained) optimal equilibrium outcome?

The research agenda in perspective

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- In many countries government debt held domestically
- If no selective default (Broner, Martin and Ventura, 2010) then default hits domestic agents as well, reshuffling domestic welfare distribution
- If government have preferences over redistribution, there are distributional incentives to default

The essentials of the model

- 2 agents: Rich and Poor, 2 periods, all debt domestic
- Rich income y_h, y_l
- Poor income y_l, y_l
- Poor excluded from debt markets
- Rich can only save in govt. bonds
- In period 2 govt. waste g: low or high (fiscal crisis)
- Govt. chooses default/repayment

First period

- Budget Constraints

$$T = \frac{qb}{2} \quad \text{(G)}$$

$$c_r = y_h + T - qb = y_h - \frac{qb}{2} \quad \text{(R)}$$

$$c_p = y_l + T = y_l + \frac{qb}{2} \quad \text{(P)}$$

- Government issues debt: it allows redistribution from rich to poor
- Rich buy debt: it allows them to save

Second period

- Repayment

$$\begin{aligned} \tau &= g + b && \text{(G)} \\ c_r &= y_l + b - \tau = y_l - g && \text{(R)} \\ c_p &= y_l - \tau = y_l - g - b && \text{(P)} \end{aligned}$$

  - Under repayment inequality high. More costly with high level of public spending

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- Default

$$\begin{aligned} \tau &= g && \text{(G)} \\ c_r &= \tilde{y}_l - \tau = \tilde{y}_l - g && \text{(R)} \\ c_p &= \tilde{y}_l - \tau = \tilde{y}_l - g && \text{(P)} \end{aligned}$$

  - Under default inequality low, but lower output

Results

- The government issues a positive but limited amount of debt
  - Government wants to issue some debt so it achieves some redistribution..
  - ..but if it issues too much rich anticipate 100% default, do not buy debt, no redistribution
- At equilibrium debt there is default risk and default happens at the time of a fiscal crisis.
  - Intuition: a fiscal crisis imposes a burden on the poor. Government hates additional burden imposed by repayment, default happens (if costs not too high)
  - Default part of social contract, price paid by the rich for financial market access!

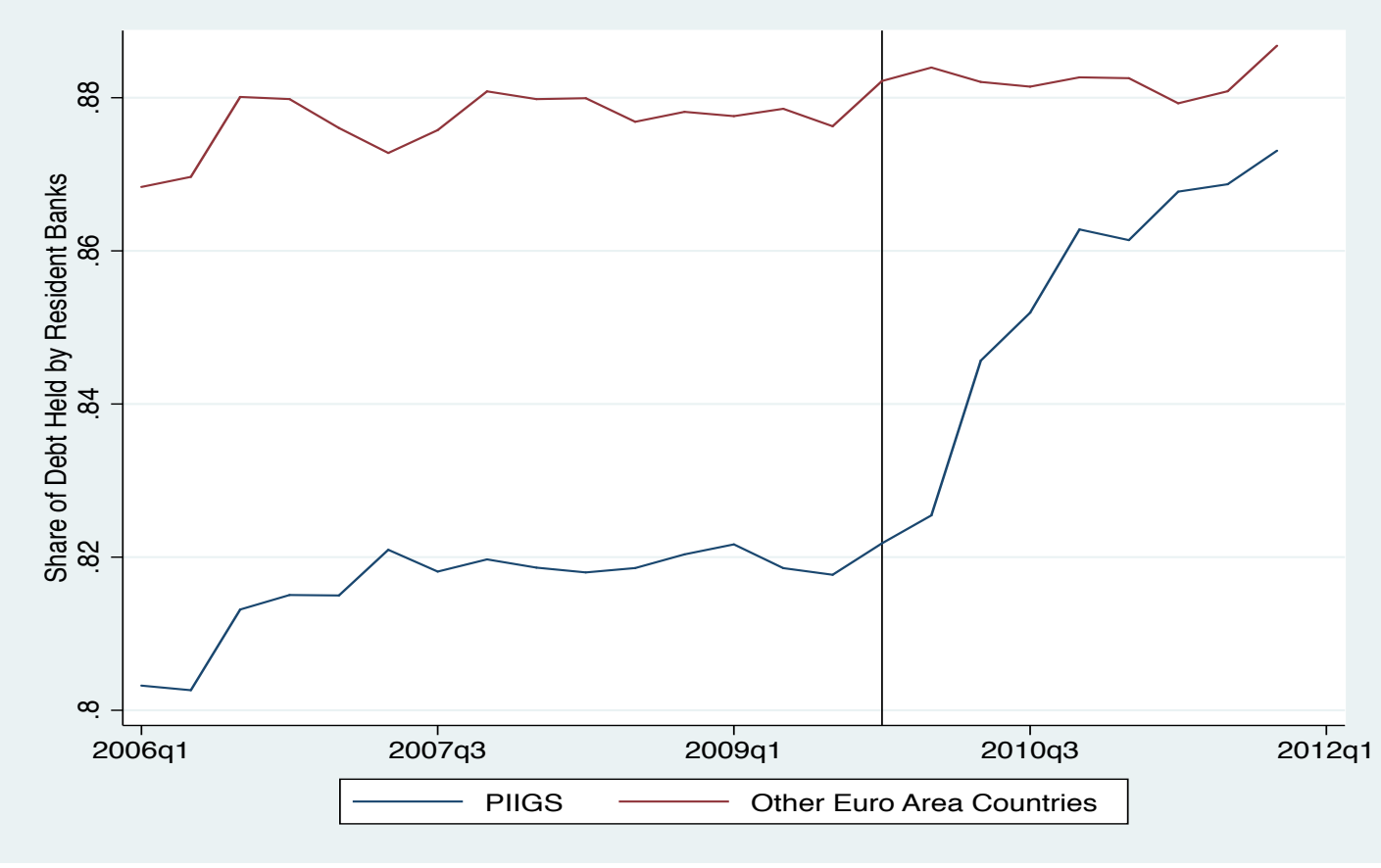
Are distributional incentives a first order issue for default decision?

- Theory
  - Second (or even third) best argument.
  - Results rely on very limited set of policy instruments for government (only lump sum taxes)
  - If government can achieve redistribution through progressive taxation -> domestic default not optimal!

Are distributional incentives a first order issue for default decision?

- Practice
  - Are distributional incentives first order in explaining existing Euro spreads?
  - In other words is the Italian Government paying high spreads because it want to redistribute from rich to poor (within Italy)?
  - or because it wants to redistribute from Germany to Italy?
  - Calibration not necessarily convincing as model too stylized

Some evidence in favor of the second hypothesis



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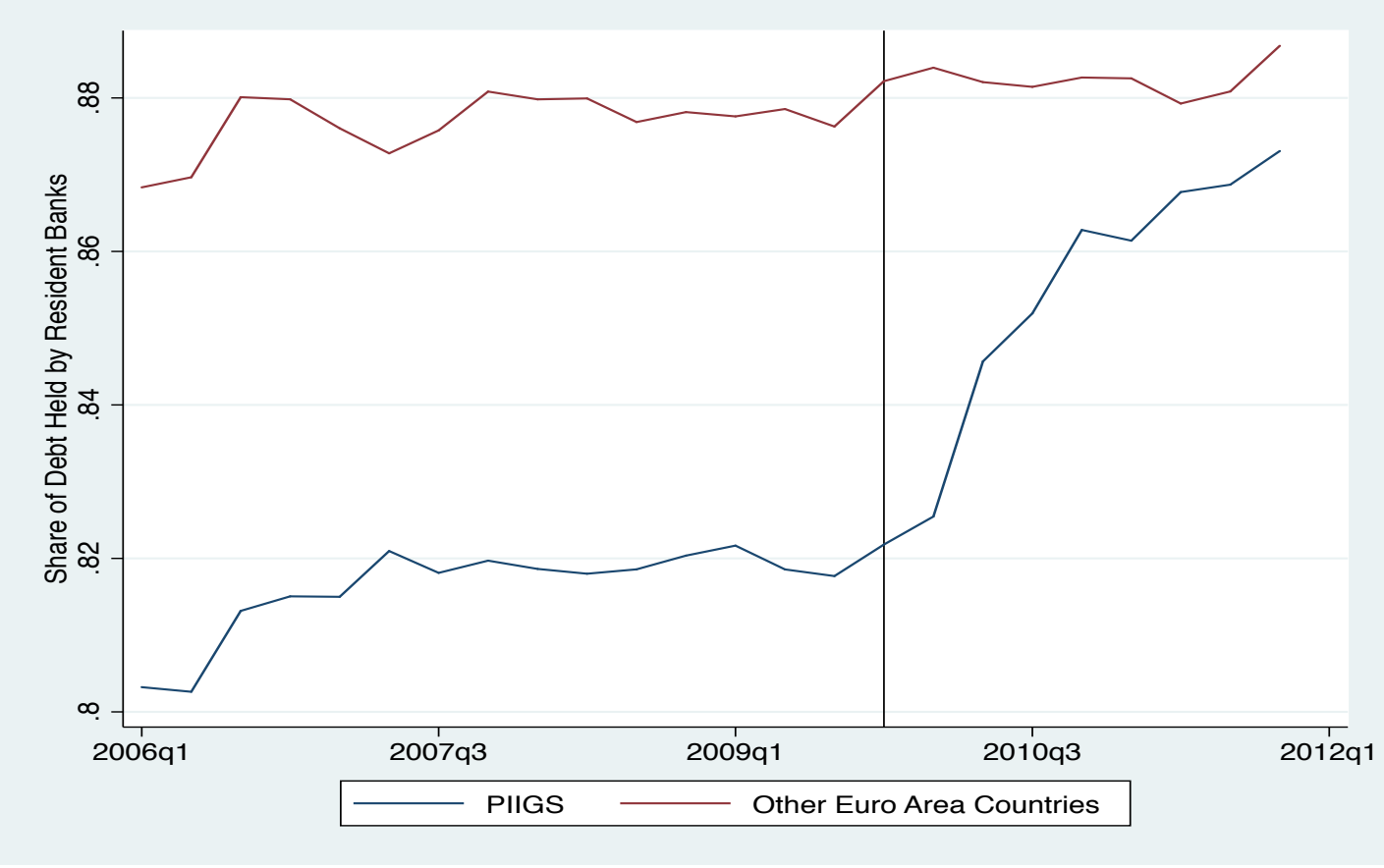

- Brutti and Saure, 2012
- Japan

Takeaway and directions

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  - To nail distributional incentives need to know actually holds government debt in the data? (Doepke and Schneider, 2006), possibly hard as lots of debt held by banks, but who owns the banks?

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- Takeaway
  - Domestic debt holders can have a role in determining default decisions
- Directions
  - To nail distributional incentives need to know actually holds government debt in the data? (Doepke and Schneider, 2006), possibly hard as lots of debt held by banks, but who owns the banks?
  - Default usually happens in bad states of the domestic economy, makes govt. debt risky for domestic holders, interesting pricing implications (Hur, Kondo and Perri, 2013)