Discussion of Perez, "Sovereign Debt, Domestic Banks and the Provision of Public Liquidity"

Alessandro Dovis

Penn State

New Faces in International Economics Conference

Introduction

- How government support debt without commitment?

  After a default:
  - Reputation cost: Cannot access market
  - Reduced form "output cost"
- Newer literature: Deeper model of output cost
  - Important for disciplining the model
  - Examples:
    - Disruption in trade
    - Disruption in domestic credit markets
- This paper: Output cost arises from
  - Reduction net-worth financial intermediaries
  - Loss of liquidity services associated w/ gov't debt

Outline

- Review mechanism in model
- Main comment:
  - Loss of liquidity services: Credible?
- Minor comments:
  - Government debt vs external debt
  - Scope and role of regulating banks asset holdings

Main Ingredients

- Benevolent government borrow from foreign lenders
  - Insurance and difference in discount factors
  - Cannot commit
- Net worth of financial sector (banks) state variable
  - Friction channeling funds from hhs to financial sector
- Public debt provides liquidity services
  - Only asset other than productive investment
  - Banks with bad investment opportunities invest in government debt
  - Do not raise wage: allow productive firms to invest more

Losses in Event of Default

- Reputation cost: Exclusion from int'l credit markets
- Reduction aggregate net-worth of financial intermediaries

$$N = \iota B^d + \int_{[z^*,\bar{z}]} R(z)l(z)$$

- Loss in liquidity services
  - Price exogenous and given by $\zeta(1 + r^*)$ with $\zeta \in [0, 1)$
  - Government issuance such it it meets demand

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- First two effects well-understood
- Focus on liquidity part: How to think about ζ?

Closed Economy: Woodford

Assume $z \in [\underline{z}, \bar{z}]$ so efficient allocation calls for $z^* = \bar{z}$

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  In steady state government "satiate" liquidity demand

  - No wedge between deposit rate and return on capital
  - Efficient production: $z^* = \bar{z}$
  - If $z < \bar{z}$ invest in government debt
  - If $z = \bar{z}$ efficient (aggregate) scale feasible

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- Ramsey outcome is credible
  - Sustained as MPE of policy game (limit of finite horizon)
  - Government has no incentive to renege and not repay debt
- Natural lower bound on government utility
- Caveat: non-distortionary taxation

Why Loss of Liquidity Services?

- Outcome after default:
  - Price exogenous and given by $\zeta(1 + r^*)$ with $\zeta \in [0, 1)$
  - Government issuance such it it meets demand
- Not SPE of policy game: punishment not credible
- Better than alternative (exogenous output cost)
  - Discipline via holdings of financial sector after default
- But closed economy MPE may be better theoretical benchmark

Role of Government Debt for Liquidity Provision

- Government debt only asset other than production technology available to firms
- What about foreign assets?
  - Data: After default large net export, i.e. accumulation of foreign assets

Government Debt vs External Debt

What is the empirical counterpart of gov't debt in the model?

If government debt then

- "Public" current account not strongly countercyclical as current account
- corr(Δ (external) Public Debt, GDP) typically negative
- This may be relevant for quantitative exercise

Role of Financial Repression

Financial repression: regulation of banks portfolio

- Forcing banks to hold more gov't debt may be optimal because it provides commitment device
  - Chari, Dovis and Kehoe (2014)
  - Internalizing an "externality"
- Very large role for financial repression here
  - Optimal minimal holdings gov't debt: 45% of net-worth
- Conjecture: Due to very low discount factor
  - Raise lots of external debt to front-load consumption
- Why β low? Match counter cyclicality of CA
- If public CA not countercyclical $\Rightarrow$ higher β ...

Multiple Equilibria and Role of Regulation

- Government chooses total debt B but price depends on composition: banks vs foreign lenders
- Is price unique given B?
  - If low share held by domestic bank then q^b is low
  - Self-fulfilling?
- So regulation of banks portfolio can be used to rule out inferior equilibria
  - Not only implement better outcomes by providing commitment device

Conclusion

- Great paper
- Role of government debt as liquidity provision and incentive to repay for government