Discussion of “Preemptive Austerity with Rollover Risk”

by JC Conesa and Tim Kehoe

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Plan for my 10 minutes

1. Summary of the paper

2. My comments

Summary of the paper

Big picture

- How do we design optimal fiscal policies for governments susceptible to sovereign debt crises?

- This paper:
  - Optimal policy when a country is *(i)* in a recession, and *(ii)* subject to self-fulfilling crises (CK 96, 2000)
  - **Key:** taxes are set ex-ante (1-period commitment)
- Findings:
  - **Preemptive austerity:** commit to high taxes to prevent a market run <u>even</u> if interest rate is low today
  - Increase taxes even in a recession
  - <u>Insight:</u> it's the austerity what allows the country to borrow cheap during a recession

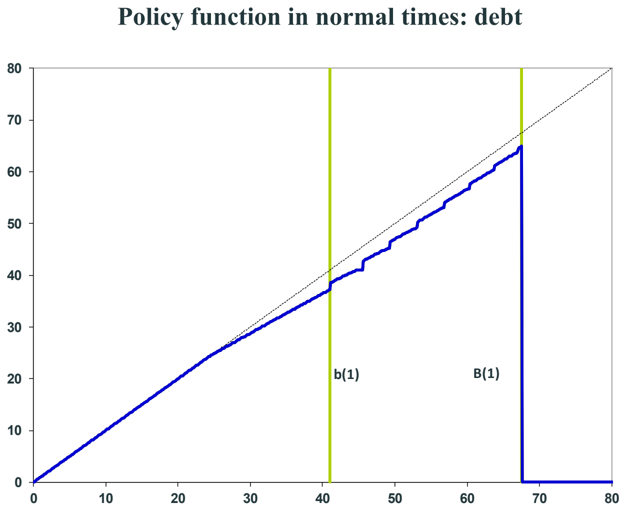
Main Elements of the Model

Follow's Conesa-Kehoe (2017) pretty closely:

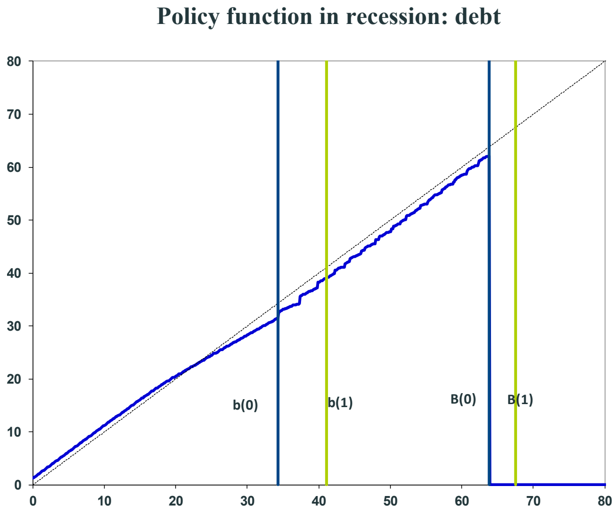
- Representative household, no investment
- Benevolent gov't. Cannot commit to repay
- Lenders: foreigners, risk-neutral, deep-pockets. Subject panics (sunspot)
- Focus on recession: productivity is low but may recover (permanently)

- **Key differences:**
  1. endog. distortionary taxes
  2. gov't can commit to taxes at the start of each period

Main Result: Preemptive Austerity (I)



Main Result: Preemptive Austerity (II)



My comments

1. Overall

- I like it. Very neat point.

- The paper reads as a *proof of concept*:

    1. there exists a parametrization of the Conesa-Kehoe model (with endogenous pre-committed τ) in which preemptive austerity is optimal

       and

    2. parametrization and timing are reasonable for a country like Germany

2. Decomposing the result

$\exists$ a range of values for fundamentals (debt, severity of recessions) for which the response to a recession is costly austerity even though country faces low spreads.

Logic goes the other way around: It is bc. of the painful austerity imposed during a recession that country can avoid the default and can keep borrowing cheaply.

- This is intuitive and neat.
- I don't necessarily see it in the equations nor the plots.
- One way to highlight this would be: study the recession case **but** keep (for 1 period or forever) the τ from normal times:

$$\text{Conjecture: } \underline{b}(z=0, \tau_{z=1}) < \underline{b}(z=0, \tau_{z=0}) < \underline{b}(z=1, \tau_{z=1})$$

2. Decomposing the result (doubling down!)

- Pretty sure you can prove this in a 2-period version of your model.
    - BTW: to make the conceptual point I think you don't need long-term debt, nor uncertainty about z.

- I hope Mark does this in his discussion 😎

3. Welfare

- **Q:** Is this tax commitment welfare improving?

- I suppose there is a non-trivial region in the parameter-space where the answer is **yes**.
- Easy to check if true for your parametrization.

- But could also explore "bounds": what needs to be true about default costs/size of recession/deep parameters/etc. such that the pre-commitment is actually welfare reducing.

Rest of my comments – Will send an email w/ this!

1. Making the τ contingent on the sunspot: does it over-turn the result?

2. Testable implications $\rightarrow$ go for them!
   - Austerity near the crisis zone, but not far
   - Diff. in institutional arrangements, fundamentals make austerity optimal or not. Can we document more systematically?

3. Can access to reserve accumulation change this?
   - Bianchi & Sosa-Padilla (2023?): use of reserves to escape crisis region (or prevent falling inside it)

4. Other minor things:
   - Relation w/ Philippon-Roldan (2018), analytic characterization of the taxes?

The End

AGAIN: Very nice paper, neat point.

Looking forward to the next (and final) iteration!