Discussion of "The Economics of Sovereign Debt, Bailouts and the Eurozone Crisis"

by Gourinchas, Martin and Messer

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Overview

- Simple, yet rich model of sovereign default with bailout policies applied to Eurozone:
    - Spillovers of default to other countries
    - International bailouts:
        - Transfers vs. inflation
        - Ex ante vs. ex post

Summary of the Model

- Greece starts with some debt. May want to borrow but cannot commit to repay.
- If Greece defaults, Germany's real economy contracts

  $\Rightarrow$ Incentives to bailout Greece ex post and avoid default

- Everyone knows ex-ante that bailout will take place

  $\Rightarrow$ Creditors willing to lend at lower rate. Higher borrowing and higher default probability

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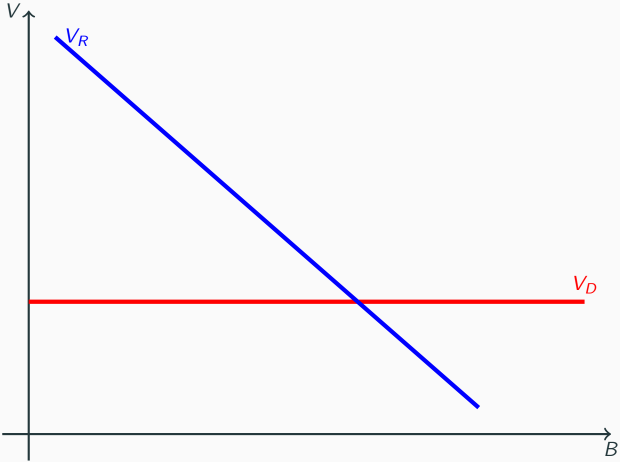
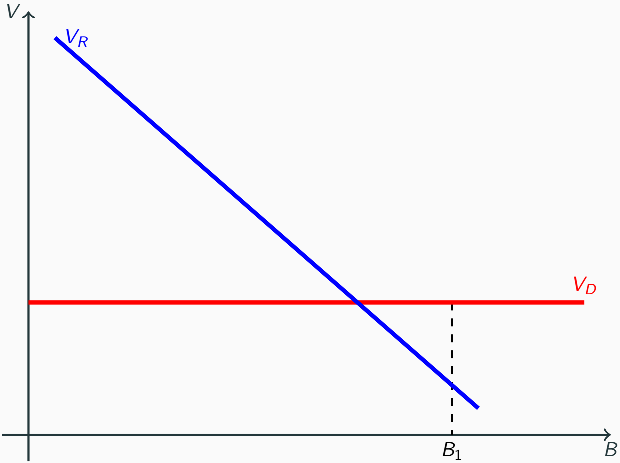
A key result: Even if Germany could commit, bailouts are not necessarily eliminated

Final Period: Values of Repayment & Default



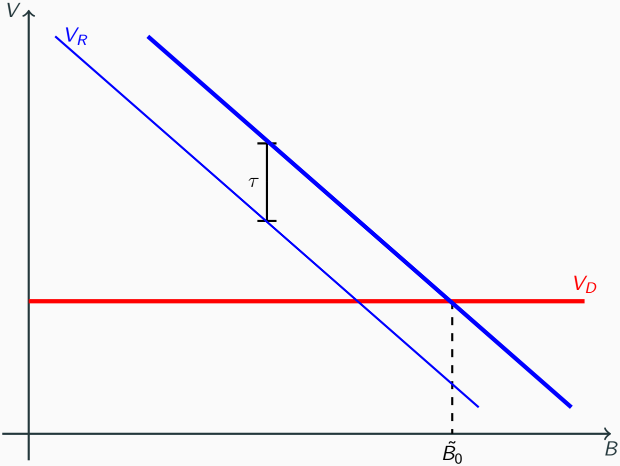
Final Period: Values of Repayment & Default

Government defaults if debt $= B_1$



Bailout makes govt. indiff. between R and D.

Consider a transfer *contingent* on repayment



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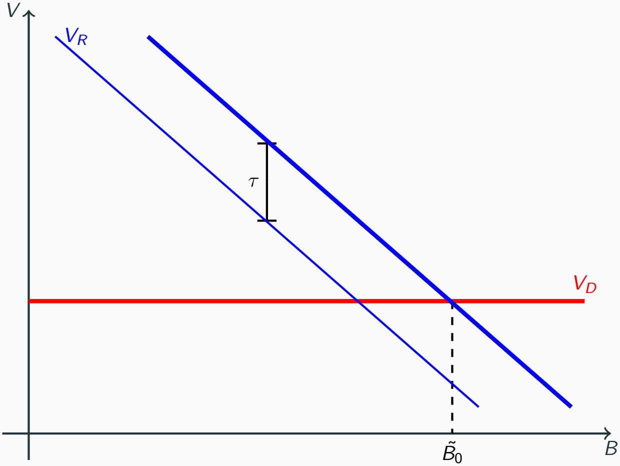
Greece not better-off $\Rightarrow$ Southern view



Initial Period: Government Can Borrow at Lower Rate

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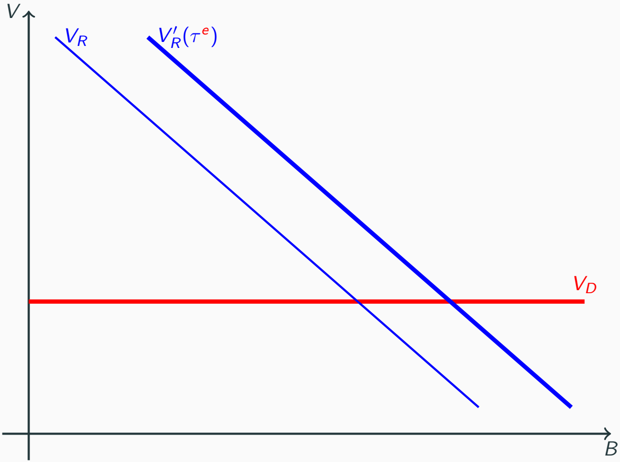
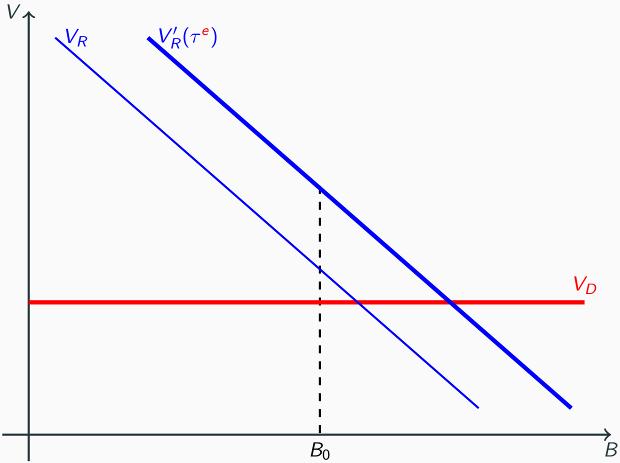


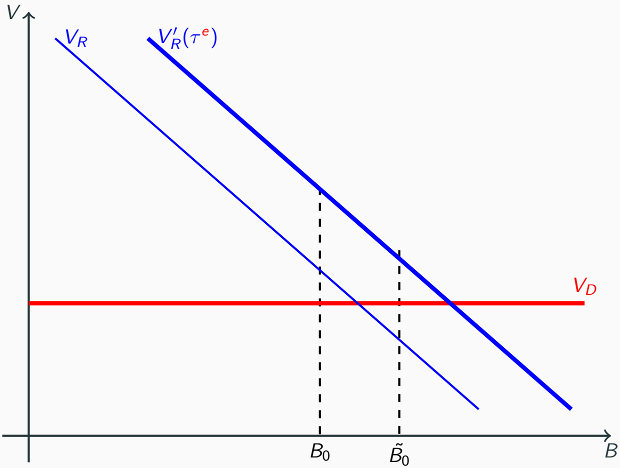
If initial debt is low...

Greece $\succ$, creditors $\backsim$ & Germans worse-off.$\Rightarrow$ North view



If initial debt is high...

Expected transfer avoids default ⇒ All gain



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Comment

- Exact source could matter for policy implications.
- If spillover is due to German banks holding Greek bonds

  ...more desirable for Germany to bailout own banks.
- If spillover is that Spanish spreads go up because investors update beliefs about future EU bailouts

  ...not necessarily a true cost

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- Stimulative monetary policy can help avoid rollover crisis (Bianchi & Mondragon, 2018)

Ex ante welfare effects of bailouts

- A key mechanism of the paper: a future bailout can avoid default today and improve welfare "ex ante".
- Question: If initial debt is very low, can a future bailout *still* improve welfare?
  - In particular, room for Pareto improvements if government is charged an initial fee?

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  - In particular, room for Pareto improvements if government is charged an initial fee?
- Transfer can be made <u>conditional</u> on repayment & income shocks
  - Departures from Aguiar, Amador, Hopenhayn and Werning

Measuring the bailout

- Key issue is what is the “right” interest rate adjusted by risk
- A common approach is to consider the market rate but default risk might be lower than market bonds
- Paper benchmarks with IMF loans (Zettelmeyer-Joshi 2005)
- Bailout proportional to difference between IMF and EU loans
  - Argument that this is a lower bound

Comments:

- What about “transfers” to/from junior creditors? Do bailouts lower or raise spreads of market bonds?
  - Effects possibly heterogeneous depending on maturity and risk of a rollover crisis

Final Remarks

- Very nice theoretical framework with a key policy takeaway: removing "no-bailout clause" can exacerbate crisis