ECB-RESTRICTED

Discussion of:

“Fiscal Rules and Discretion with Risk of Default”

by Chiara Felli, ***Facundo Piguillem***, Liyan Shi

“Moral Hazard with Risk-Sharing and Safe Debt”

Ramon Marimon, Adrien Wicht, ***Luca Zavalloni***

XXII Banca d’Italia Public Finance Workshop

5 September 2024

Jacopo Cimadomo (European Central Bank)

Piguillem et al.'s paper

- The paper studies the optimal fiscal and default rules when governments can default on their debt obligations.
- A continuous-time model that encompasses hyperbolic discounting (myopia) and political economy frictions → rationale for **debt overaccumulation**

www.ecb.europa.eu ©

Piguillem et al.'s paper

1. When the myopia is mild, eliminating all spending constraints is close to optimal

→ Low government myopia limits to over-spending and leads over-default.

2. When there is severe myopia fiscal rules should be as tight as possible

→ Excessive government myopia leads to over-spending and under-default.

→ To solve this problem, the planner imposes tighter debt limits, which takes the form of force default in certain areas (debt limit).

3. Optimal default rules are more important than spending rules: the welfare gains of regulating default are at least one order of magnitude larger than controlling spending.

www.ecb.europa.eu ©

Operationalizing the debt default rule

- Either the constitution or some special law that forbids default when the debt level is below a certain threshold $b < \bar{b}$, or forces it when $b > \bar{b}$.
- A rule that forces default is de-facto a **debt limit rule**.
- Empirical illustration: debt limit at 125% of GDP
- Authors: “*these kinds of rules are rare, if not completely absent, in the currently observed set of fiscal rules.*”
- Their unusual existence “*should not be a deterrent to future implementation*”

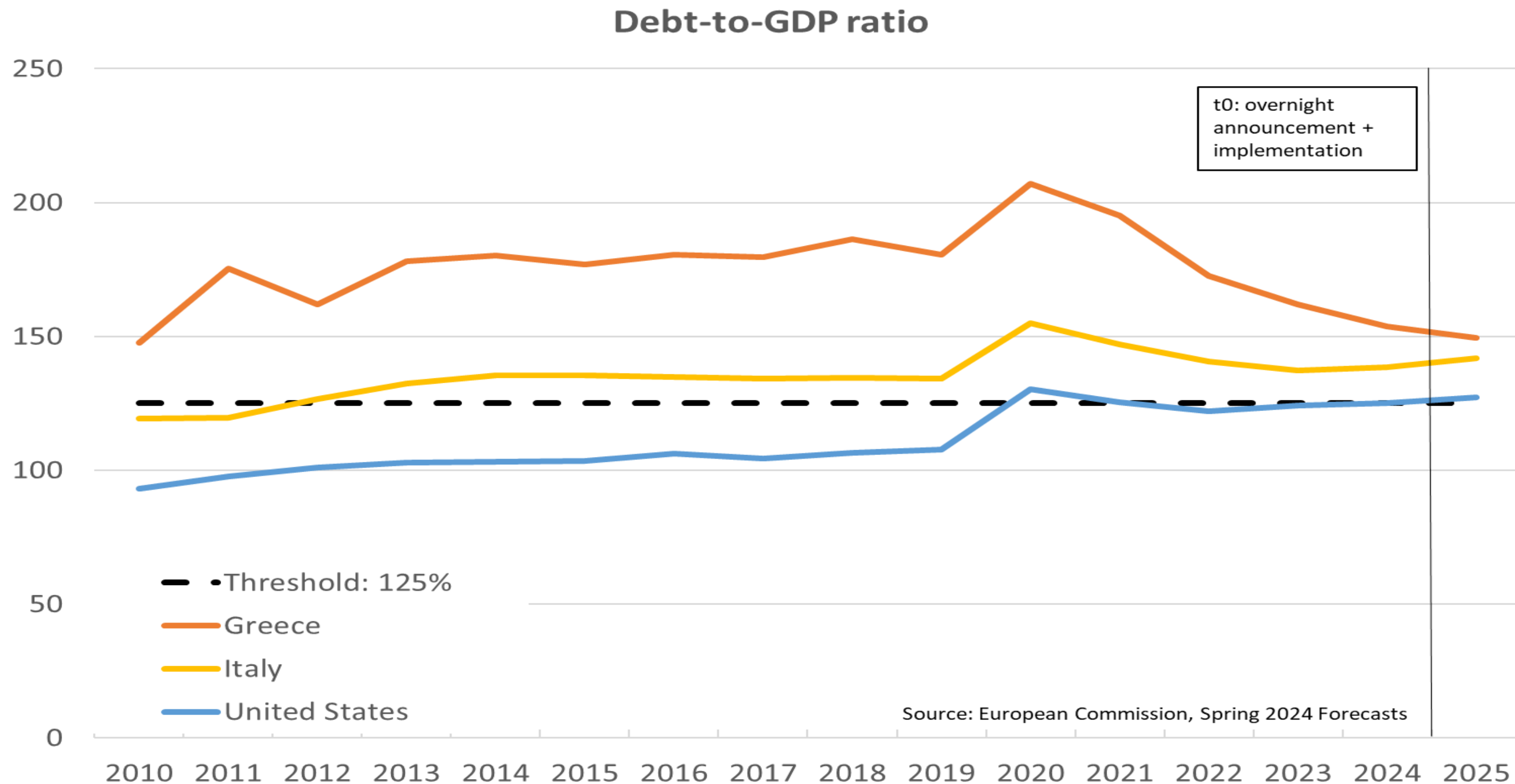
www.ecb.europa.eu ©

Piguillem et al.’s paper

- Very elegant and fascinating paper, I have really enjoyed reading it!
- Default is a viable option and can be welfare improving under some circumstances (Adam and Grill, 2017)
- Trade-off between commitment (rules) and flexibility (discretion)
- What about domestic lenders?
- My main comment is on the **“real life” implementation of debt default rules (e.g., debt limit)**, especially for the EU and other advanced economies (see debate on SDRM, e.g., Bénassy-Quéré et al., 2018)

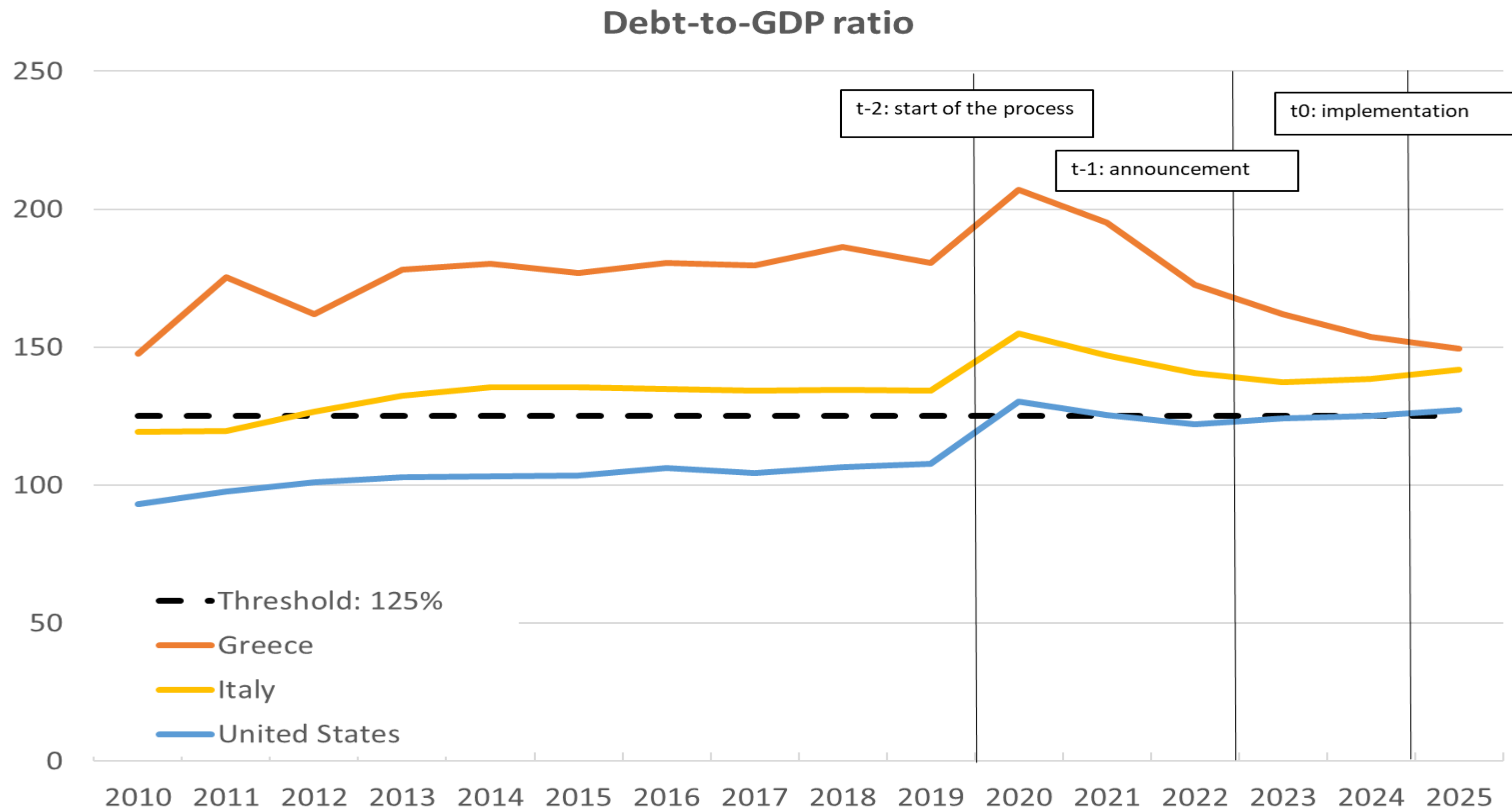
www.ecb.europa.eu ©

Implementation of a debt default rule



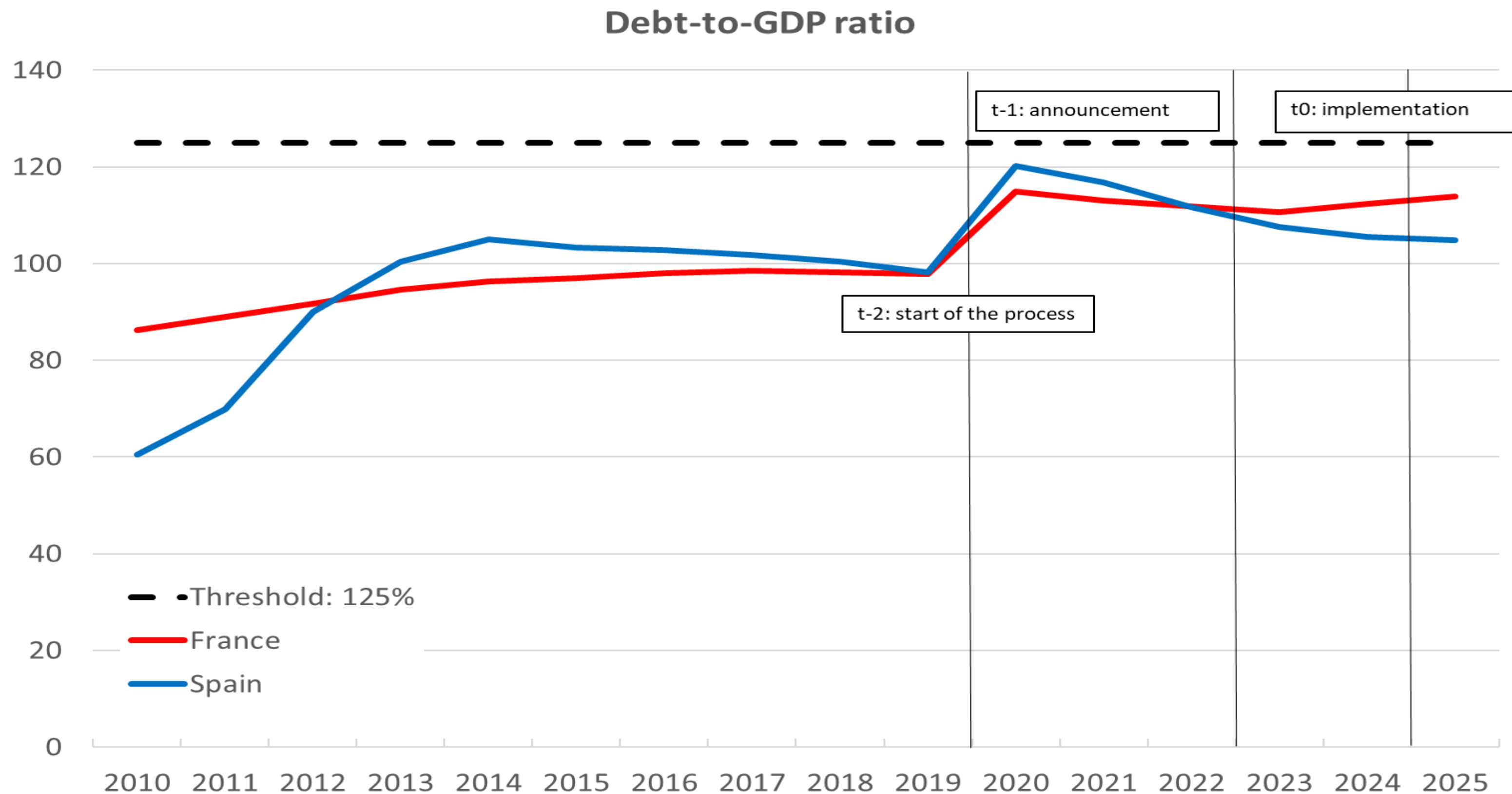
www.ecb.europa.eu ©

Implementation of a debt default rule



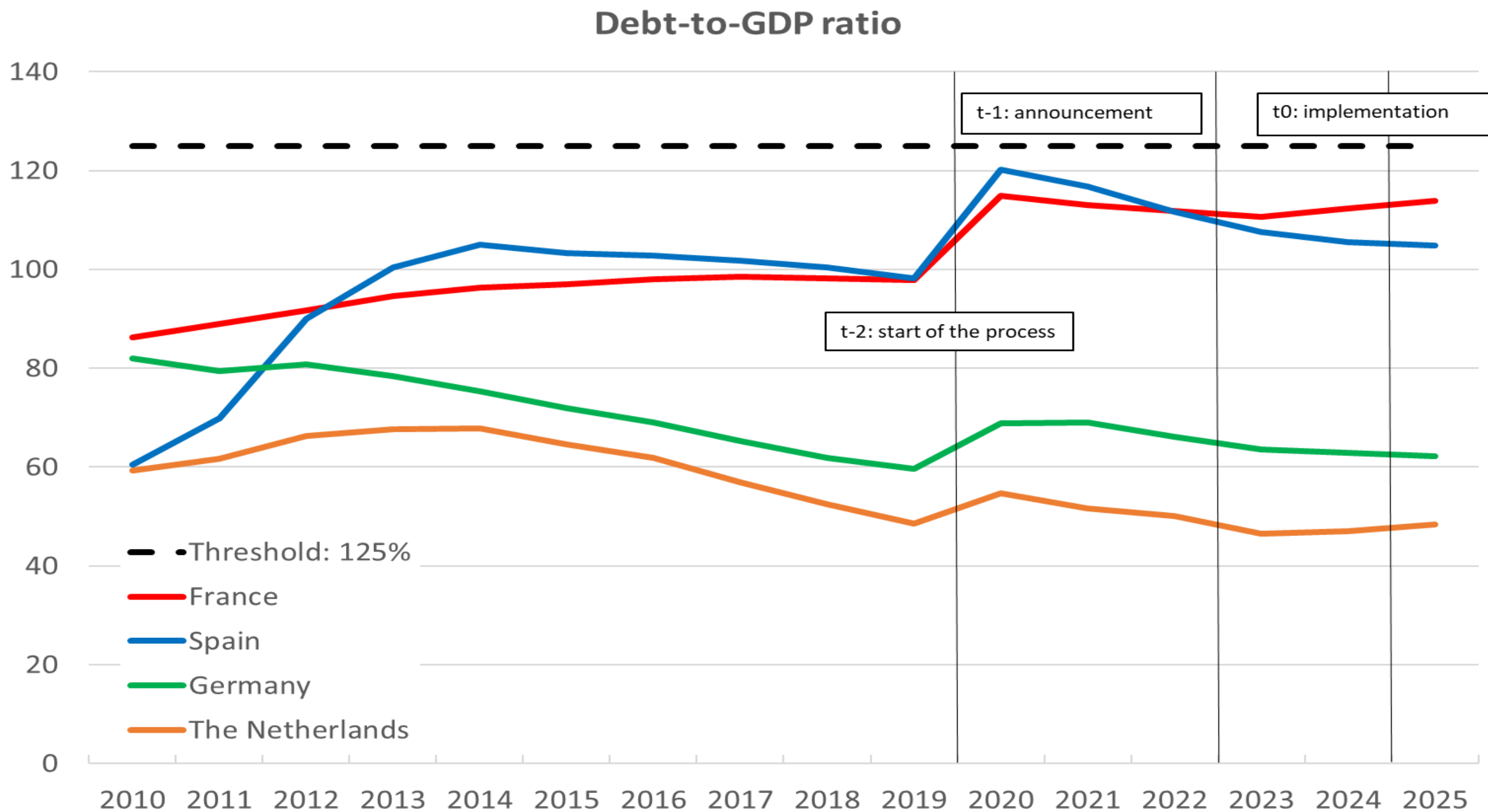
www.ecb.europa.eu ©

Implementation of a debt default rule



www.ecb.europa.eu ©

Implementation of a debt default rule



www.ecb.europa.eu ©

Implementation of a debt default rule

Successful introduction of a debt default rule (in advanced economies):

- Very high threshold (*useful?*)
- Overnight announcement and implementation (*de facto, discretion*)
- Suspension in a transition period for high-debt countries, until they have reduced their debt levels significant below the threshold (*problematic enforcement*)
- Outright reduction of national debt via the introduction of a common EU vehicle (Marimon, Wicht, Zavalloni, 2024; Amato et al. 2024) and/or stronger risk-sharing mechanisms, as e.g. in Bénassy-Quéré et al., 2018, (*politically difficult*)

www.ecb.europa.eu ©

Discussion of:

“Moral Hazard with Risk-Sharing and Safe Debt”

by Ramon Marimon, Adrien Wicht, ***Luca Zavalloni***

www.ecb.europa.eu ©

Zavalloni et al.'s paper

- Introduce a Financial Stability Fund provides long-term credit and insurance contracts to sovereign countries making their debt liabilities safe, without ever incurring in expected losses (see also Callegari et al., 2023)
- However, this can exacerbate moral hazard problems.
- Two contributions:

1. Mechanism design, with incentive compatibility (IC) constraints, can overcome these problems
2. Some form of conditionality can be a substitute for, or a better instrument than, IC constraints

www.ecb.europa.eu ©

Zavalloni et al.’s paper

- The Financial Stability Fund (Fund) is modelled as a long-term contract between a Fund (lender) and an individual partner (country or borrower) who is the government of the small open economy.
- The Fund contract chooses a state-contingent sequence of consumption, leisure and effort that maximises the life-time utility of the borrower given some initial level of the borrower’s debt.
- A **certain share of debt** is taken over by the Fund when the country joins the scheme
- The country may exercise effort ex-ante to be eligible for a better contract

www.ecb.europa.eu ©

Zavalloni et al.’s paper

- Great paper!
- It combines elements of the literature on optimal contracts with elements of the literature about sovereign debt and defaults

www.ecb.europa.eu ©

Comments and questions

1. Callegari et al. (2023): if the Fund does not have enough absorption capacity to be able to take all the new sustainable debt of a sovereign, the Central Bank (CB) might step in 'to purchase whatever else is needed', e.g. → perfect complementarity between the Fund and the CB. What are the implications of removing the CB (in Marimon et al., 2024)?
2. How one can operationalise such scheme, e.g., in the EMU?
3. Would the Fund still able to issue bonds at a risk-free rate when it takes over national (high-risk) debt?
4. Would countries contribute to the scheme in case of positive technology shocks (rainy day fund)?

www.ecb.europa.eu ©

Beetsma, van Spronsen, Cimadomo (EER, 2024)

- How can risk-sharing be improved with limited risk for moral hazard?
- A Central Fiscal Capacity targeting area-wide, national and regional shocks

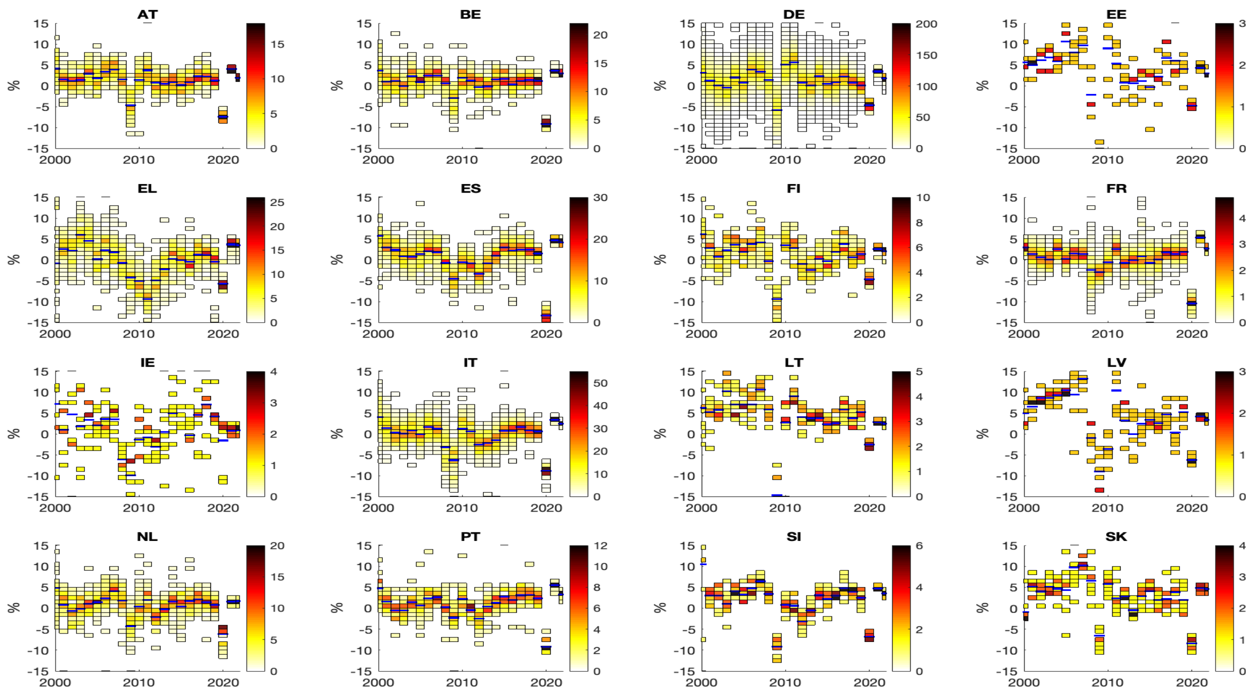


Figure: Growth rate of per capita GDP at the NUTS3 regional level in the EA

Beetsma, van Spronsen, Cimadomo (EER, 2024)

- Such CFC generates considerable stabilisation achieved with borrowing limit comparable to the EU's RRF: about 40% of regional shocks smoothed with 500 billion borrowing limit (per year)

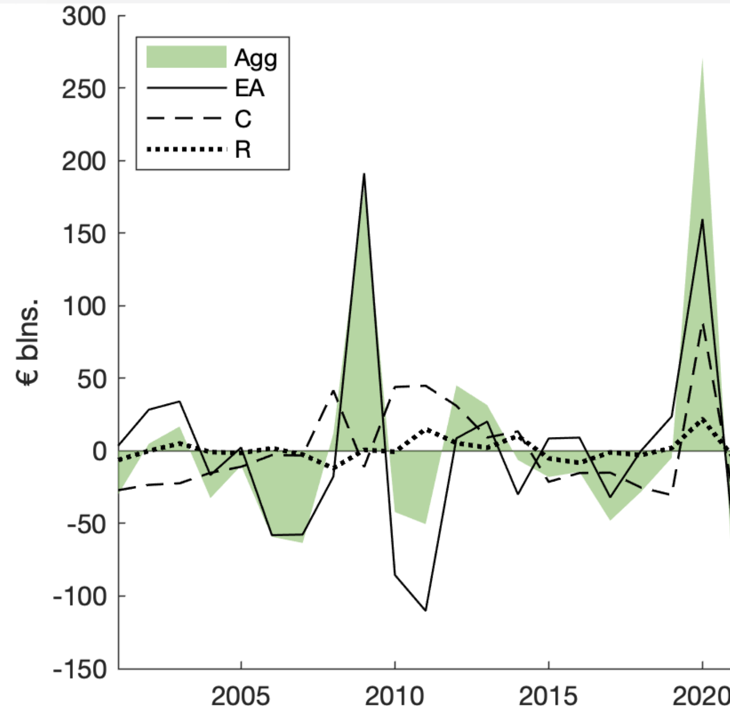


Figure: aggregate disbursement of the CFC in every year, in response to the three shocks

www.ecb.europa.eu ©

Thank you!

www.ecb.europa.eu ©

Other comments and questions

- Implication of adding *domestic* lenders (sovereign-bank nexus)
- Dynamic model and forward-looking financial sector
- What are the implication of imposing a debt default rule (on national debt) in a monetary union?

www.ecb.europa.eu ©

Sovereign Debt Restructuring Mechanisms (SDRMs)

Earlier proposals in the EU:

- Bénassy-Quéré et al., CEPR Reports (2018, 2019): mitigating the economic and financial disruptions of debt restructuring (EU safe asset, stronger risk-sharing, reducing home bias)
- Sapir and Schoenmaker (2017), Scheubel and Stracca (2016), Weder di Mauro and Zettelmeyer (2017)

www.ecb.europa.eu ©