Debt Sustainability and the Terms of Official Support by Corsetti, Erce, and Uy

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Motivation

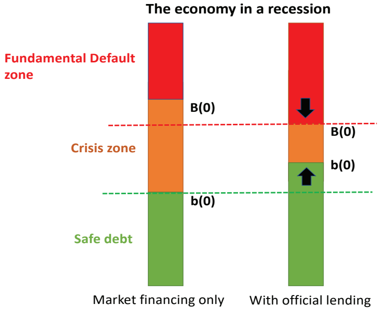
- During the European sovereign debt crisis, Cyprus, Greece, Ireland and Portugal received loans from the IMF and the European Stability Mechanism (ESM).
- ESM loans, comparing to IMF loans, featured:
  - longer maturities,
  - lower spreads,
  - bigger amounts.
- Natural experiment for investigating the role of official lending.

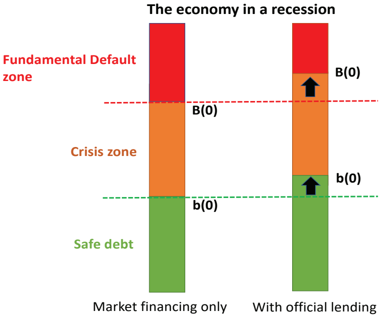
This Paper

- Extend Conesa and Kehoe (2017) with official lending.
  - borrowing and default with rollover risk and output risk
  - Market debt + two types of official lending.
- Trade-off with official loans
  - mitigates rollover risk and raise the default-free debt threshold —country better off with smooth consumption;
  - lowers long-run consumption and welfare due to higher debt —country worse off with higher incentive to default in response to fundamental shocks.
- Quantitative analysis for Portugal 2011–2015.
  - Long-maturity official loans decreased rollover risk—decreased spreads.
  - Replicates the negative comovement of debt and spreads.
  - Less need for austerity, but more likely to default in a recession.
- Counterfactual with different terms of official loans.
  - Differences in maturity of official loans matter more than differences in spreads.

Effect of Official Loans

- Debt sustainability with official loans

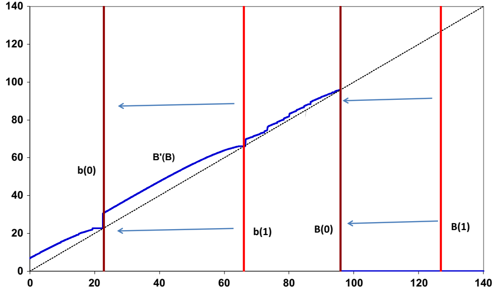




  - Depend on the trade off between consumption smoothing and long run consumption

Comment 1: Dynamics of Market Debt for Portugal

- Gambling for redemption in Conesa and Kehoe (2017)

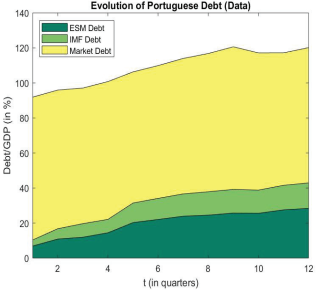


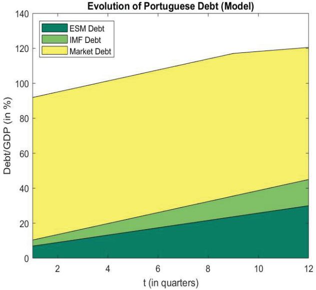
From Conesa and Kehoe (2017)

  - Incentive to smooth consumption and increase debt in recession due to the positive probability of recovery.
  - Depends on the size of recession, recovery prob., prob of self-fulfilling crisis.
  - Assume marginal benefit of government spending is higher in a recession than in normal times.
  - Impose the required government expenditure

Comment 1: Dynamics of Market Debt for Portugal

- Role of official loans in this paper
- Overpredict substitution from market for official debt and underpedict the increase in total debt.





- Illustrate the impact of official loans by examining policy function and price function

Comment 2: Official Lenders

- Country optimally chooses size of single official loan in simple model
- No tradeoff between choosing portfolio of ESM and IMF debt.
  - ESM debt-longer maturity, lower spread;
    IMF debt-shorter maturity and higher spread
- Aassumes the official lenders dictate the size, price, and maturity of official lending
  - Calibration uses the official loans information in the data.
  - Official loan portfolio is exogenously given.
  - Counterfactuals changes the official debt limit by 5% of GDP.

Comment 2: Official Lender

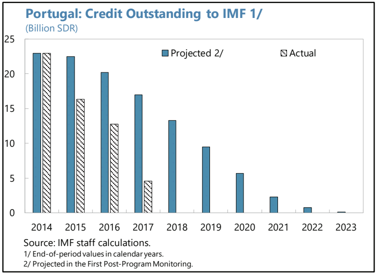
- Scopes for providing official loans with longer maturity lower rates?

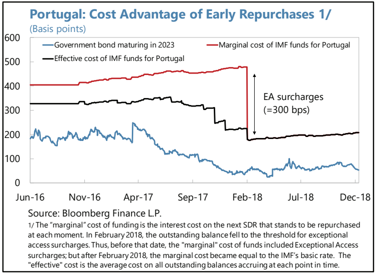
- Official lenders' optimization problem.
  - The official lender's objective functions
  - the constraints for providing official loans.

- Other consideration of official lender
  - Conditionality of official loans, e.g. deleveraging requirement.
  - Adverse effects of official bailouts.
  - Spillover

Comment 3: Early Repayment of Official Loans

- Early repayment of IMF loans saves on interest and hedges ex-rate risk





From IMF country report (2019)

- The paper's prediction on early repayment.
  Extend analysis beyond 2015.
- How does early repayment affect the debt sustainability?

Official Debt Sustainability

- IMF's Public Debt Sustainability Analysis

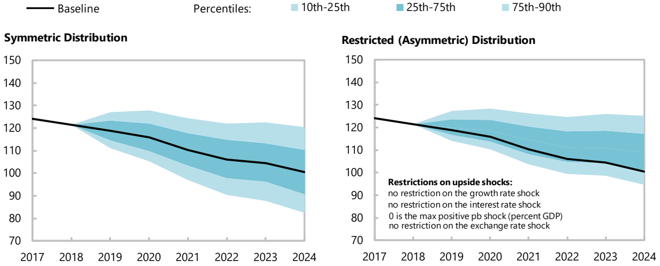
Figure 1. Portugal: Public DSA Risk Assessment, 2017–2024

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

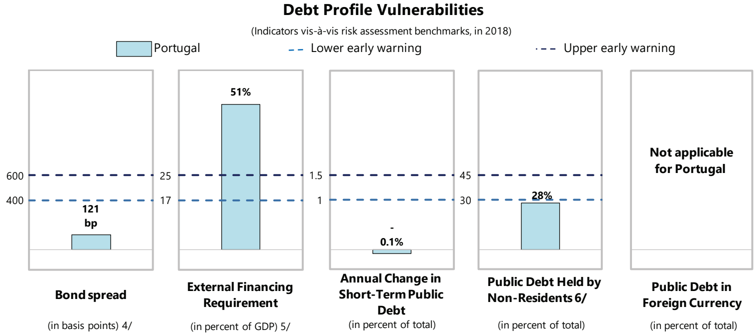
(Percent of GDP)



From IMF country report (2019)

Official Debt Sustainability

- Debt profile vulnerabilities from IMF



From IMF country report (2019)

  - This paper: the crisis zone is from 80–100% to 150–180% of GDP, depending on official loans.
  - Multi-dimensional indicator of debt sustainability

Conclusion

- Interesting and important work

- A lot to learn about the debt sustainability with official support.