

Exit expectations in currency unions
by A. Kriwoluzky, G. Müller and M. Wolf
Discussion

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Message of the paper by Kriwoluzky, Müller and Wolf

This is a very good paper:

- relevant
- innovative
- carefully done

Work in progress: some results are still missing

Message of the paper by Kriwoluzky, Müller and Wolf

Countries belonging to a monetary union, when suffering from weak fiscal fundamentals, face two distinct risks

→ **redenomination risk (resulting from exit, ie return to a depreciated new domestic currency)**

→ **credit risk (resulting from sovereign default within MU)**

Main idea: assume country faces unsustainable gov't debt dynamics

- exit can restore stability when combined with monetary adjustment (via switch to passive MP)
 - FTPL logic
- default can restore stability within MU when combined with credible fiscal adjustment (via passive FP)
 - Conventional logic

Application: use calibrated model version to shed light on developments in Greece (2009-2012)

- a priori, either type of regime change (exit vs default) possible
- implications for outcomes prior to regime change are different
- structural model makes it possible to explore quantitative relevance of perceptions of exit risk vs default risk as drivers of Greek developments prior to debt restructuring

Empirical upshot (*work in progress*):

exit expectations account for small fraction of sovereign spreads, but may have some relevance to explain stagflation

Model features

- Country is small relative to the rest of the MU (Gali/Monacelli)
- New Keynesian framework (with Calvo-prices)
- Fiscal policy in the spirit of Leeper: active or passive
- Monetary policy: active or passive after exit under float; otherwise (actively) set by MU
- Regime change: Markov-Switching linear RE model
- Probabilities of regime change are exogenous

Regimes

Initial state (imperfectly credible, surviving with prob μ):

- country with

PF in Union

Two absorbing states:

- after one-time default, with prob $(1 - \mu)\lambda$:

PF in Union

- after exit, with prob $(1 - \mu)(1 - \lambda)$:

AF with Float and PM

Message of the paper by Kriwoluzky, Müller and Wolf

Exit vs Default premia: different impact

Exit: expected depreciation pushes up yields on **all** domestic-law bonds

$$r_t = r^* + E_t \Delta e_{t+1}$$

Sovereign default (δ_{t+1}): pushes up yields on gov't bonds

$$i_t = r_t + E_t \delta_{t+1}$$

Spillovers (Sovereign risk channel): effective private yields rise with δ_{t+1}

$$\tilde{r}_t = r_t + \chi E_t \delta_{t+1}$$

→ Consumption Euler equation of private HH depends on \tilde{r}_t

I) Default, but no exit:

$$i_t > \tilde{r}_t \geq r^*$$

II) Exit, but no default:

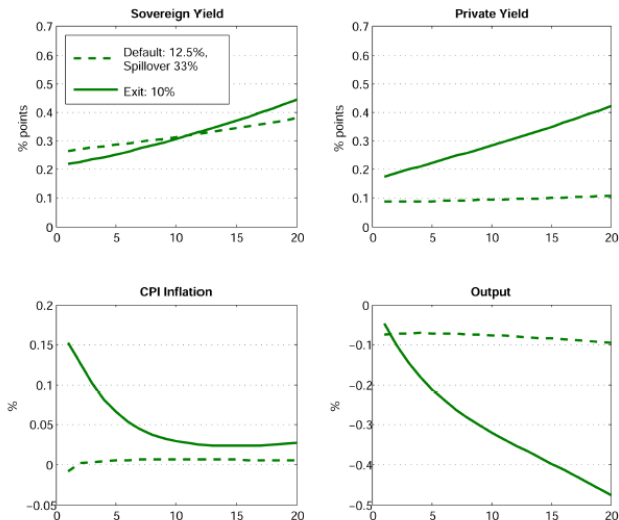
$$i_t = r_t = \tilde{r}_t > r^*$$

→ **Exit conducive to stagflation**

Message of the paper by Kriwoluzky, Müller and Wolf

Exit vs Default premia

IR's conditional on staying in the initial regime for 20 periods:



Comments and Questions

Q1) Special case: $\chi = 0$ (no spillovers):

→ sharp implications for different effects of exit vs. default risk prior to regime change

Exit: stagflation prior to regime change

why?

- **A1)** Some firms do not adjust prices upon exit (**Calvo-pricing**)
 - Expected nominal devaluation comes with real devaluation
 - Real interest rate goes up prior to regime change

Default: no implication on real economy

why?

- **A2) Lump-sum taxes**
 - Ricardian equivalence
 - Size of haircut indeterminate!

Comments and questions

Q1) Special case: $\chi = 0$ (no spillovers):

Plausibility of A1 and A2?

- **A1)** Nominal rigidity
 - Exit is a major event for the state of the economy
 - Why Calvo-pricing ?
 - Why not **A1')**: **flexible prices**?
 - Exit without real effects!
- **A2)** Nature of tax system
 - Why not **A2')**: **distortionary taxes**?
 - Anticipation effects under default become non-trivial

→ **A1')** and **A2')**: Implications for outcomes under exit and default may flip around?

Q2) Initial state

- Country starts with

PF in Union

Differently from early draft, initial regime with no fundamental foundation for regime changes

- why shift to self-fulfilling story ?
- shift to exit regime

AF and PM under Float

now driven not only by monetary, but also by fiscal adjustment
→ motivation is not straightforward!

- Why not:

PF and AM under Float ?

Q3) Sovereign-Bank nexus is missing

Model features:

- $\chi > 0$: sovereign yields carry a premium relative to private yields
- $\chi = 0$: sovereign default clean and separate from private sector

Fear in 2009 and later:

- Sovereign default likely to be not clean
- Fear of a collapse of banking system with non-trivial spillovers

Positive reading of the findings of the paper:

→ easy restructuring of sovereign debt within MU should be made possible?

Q4) Policy implications

to be taken seriously:

→ assumptions of small open economy and exogenous probabilities

- no role for EA authorities
- no systemic relevance of default, no bail-out story
- poor fiscal policy in the initial state:
 - no free-riding motive
 - so: what motivates such policy?
- not clear: is membership in MU advantageous?

Compare with

Draghi on the minimum requirements for monetary union (27 Nov 2014)

"Members have to be better off inside than they would be outside"

Summary

- The paper is well done and insightful

- Assumption that critical country is small relative to the rest of the MU leads to clean results
 - but be aware of the special policy implications

- More work is needed to address some of the open issues
 - default / role of banking system
 - strategic aspects
 - welfare