The Puzzling Behavior of Spreads during Covid

Fourakis and Karabarbounis
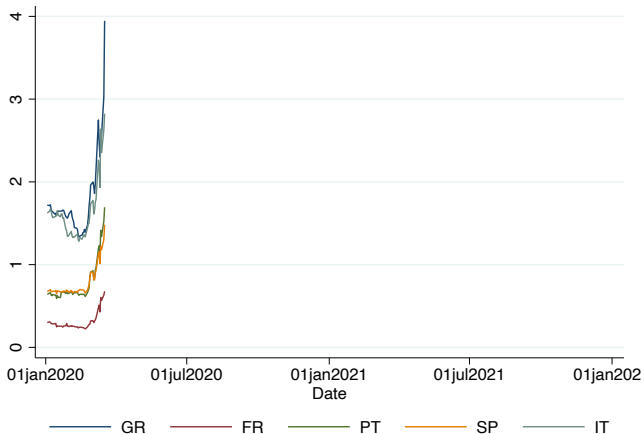
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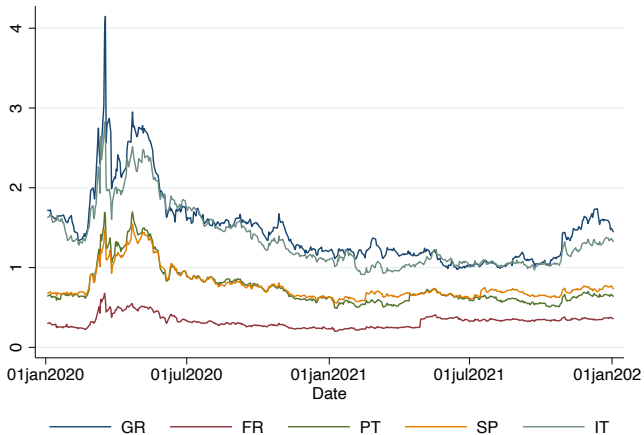
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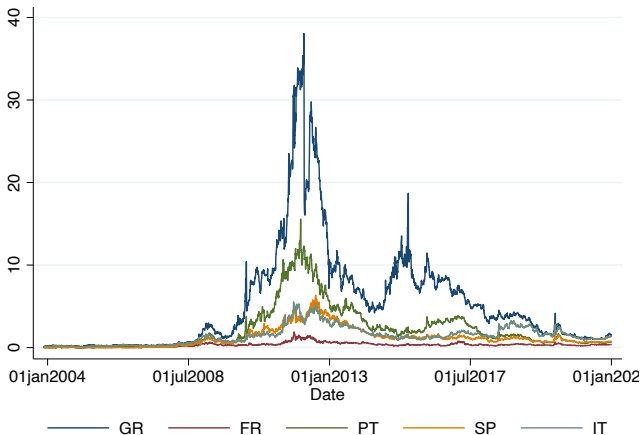
Motivation

Eurozone 10-year Bond Yield Spreads

MOTIVATION

This time is different! But, **WHY?**

The paper focuses on Greece and addresses the question in two steps:

1. Provide an estimate of the missing spread = actual - predicted.

   ▶ Based on historic linear relationship with debt-to-GDP ratio.

2. Build a small open economy model with long-term debt and default.

POTENTIAL EXPLANATIONS

Goal is to evaluate three broad sets of competing explanations:

1. <u>Nature of the shock</u>: persistence, unequal incidence.

NEW: savers vs hand-to-mouth consumers $+$ tradable vs non-tradables.

$\Rightarrow$ Covid as a constraint on labor supply by hand-to-mouth $+$ non-tradable consumption.

2. <u>Policy response</u>: Pandemic Emergency Purchase Programme.

NEW: stochastic arrival of official loans in the event of default

$\Rightarrow$ Official loans also available without restructuring during Covid.

3. <u>Initial conditions</u>: debt composition due to previous bailout.

NEW: Alternative parameterization strategy.

SUMMARY OF PAPER

The paper focuses on Greece and addresses the question in two steps:

1. Provide an estimate of the missing spread = actual - predicted.

   ▶ Based on historic linear relationship with debt-to-GDP ratio.

2. Build a small open economy model with long-term debt and default.

   ▶ Quantify model to match 2000-2019 boom-bust dynamics.
   ▶ Simulate model under Covid shock.
   ▶ Use model to run counterfactuals.

Findings: expected shock persistence and initial debt composition are the key spread stabilizers.

SOME REMARKS

Fantastic paper! Features relevant question, elegant framework & important policy implications.

Key contributions: government's motive for redistribution and novel calibration strategy.

Summary of my comments:

1. Towards fully isolating the role of the redistribution motive.

2. Differences between 2010 bailout vs 2020 PEPP.

3. What about external validity?

4. Other minor suggestions.

I. Isolating the Redistribution Motive

▶ Covid is a positive shock to the government's desire to borrow.

  * If desire is expected to be persistent ⇒ spreads rise.

▶ Key difference vs other recessions: distributional nature.

  * With no incentive to redistribute, persistence is irrelevant.
  * To see this: persistent productivity counterfactual.

▶ But two things are different under Covid shock:

  (i) (Affected) consumers are off their consumption-labor margin.
  (ii) Only a share of consumers are affected.

▶ Being able to disentagle (i) from (ii) seems important!

Consider an alternative shock that constraints both consumers.
Vary the degree to which consumers are differentially constraint.

II. 2010 BAILOUT VS 2020 PEPP

- ▶ Authors refer to bailout and access to official loans interchangeably.

- ▶ In the model, the former might follow if the government restructures while the latter is fully random.

- ▶ However, these are very different policy interventions in practice.

How does this simplification play out in the quantification and counterfactuals? Is this problematic?

- ▶ The 2010 bailout imposed tough fiscal austerity measures.

    - * Likely shows up in government consumption and tax rates.
    - * Affects expectations and distorts no bailout counterfactual.

- ▶ 2020 PEPP also includes private sector securities.

III. Beyond the Greek Experience?

▶ Focus on Greece as the "most extreme manifestation of the missing spread puzzle"...but puzzle holds for other advanced economies too!

▶ How much can we extrapolate from the Greek results?

▶ Counterfactual exercises offer mixed results:

  * Debt composition explains almost 60% of missing spread
  * Expected duration of lockdowns also generates a similar share

How big are missing spreads for IIPS?

Wishful thinking: fully recalibrate model for IIPS. Instead, adjust initial debt composition and size of Covid shock.

OTHER SUGGESTIONS AND CONCERNS

▶ In 2010, Greece was on the verge of abandoning the euro, whereas in 2020 the collapse of the euro was not really an issue.

How should I think about differences in redenomination risk?

▶ In calculating an alternative decomposition, it's unclear whether the averages used correspond to advanced economies only.

Moreover, it would be interesting to use the average of the IIPS sample used in section 2.

▶ Alternative debt composition and persistent lockdowns generate the highest spreads individually.

Isn't this the most interesting interaction to explore?

▶ This is a paper about $\frac{dq}{db}$. Can we analytically derive this object?

I tried but failed miserably...

Summing Up

► Missing spreads are explained by expected temporary lockdowns and predominance of official loans in debt composition.

► Requires incorporating agent heterogeneity and an alternative calibration strategy in sovereign debt models.

► Ideally, more on the role of government's redistribution motive, a more careful distinction between official policy interventions and potential application to other countries.

► Looking forward to reading the next version of the paper!