Discussion: "Sovereign Debt, Default Risk, and the Liquidity of Government Bonds" By Gaston Chaumont

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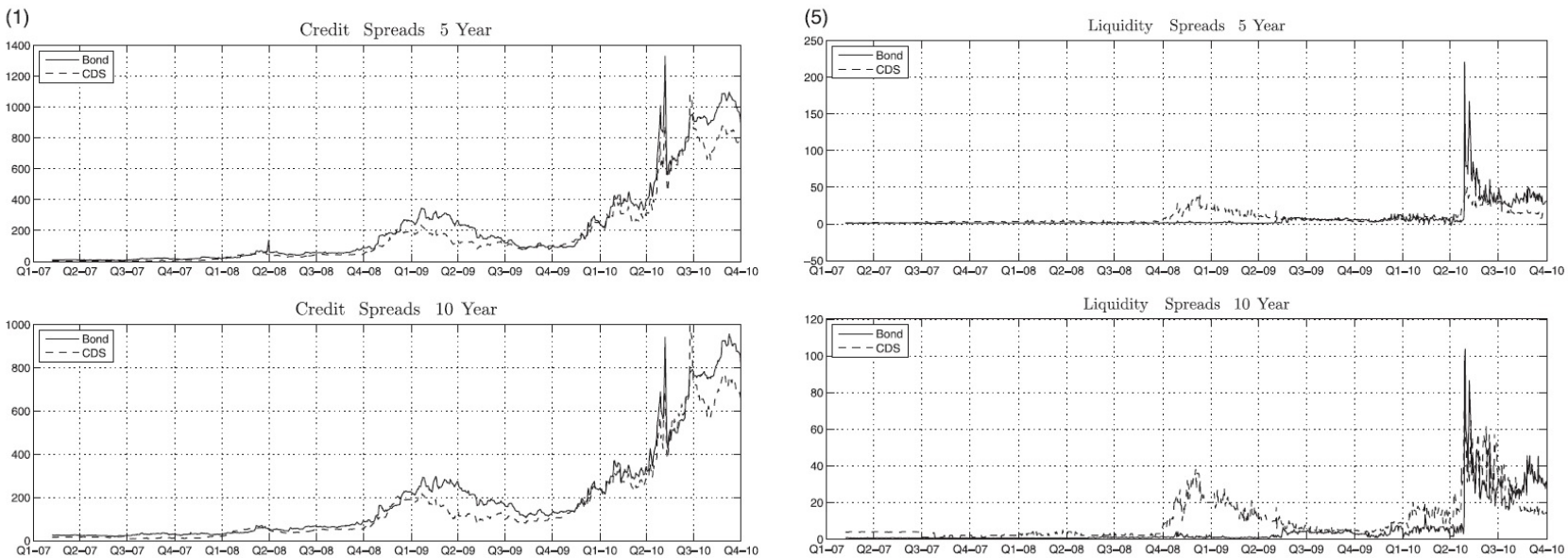
Motivation I: credit and liquidity spread interactions

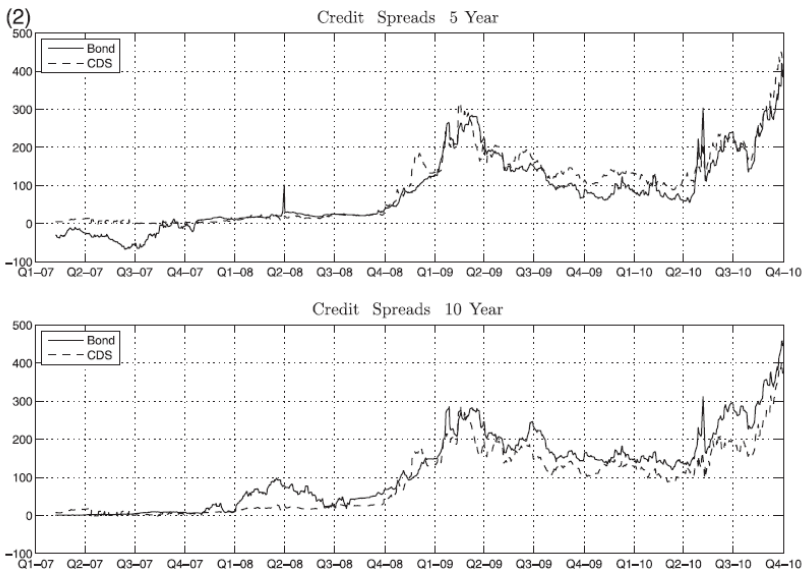
Greece

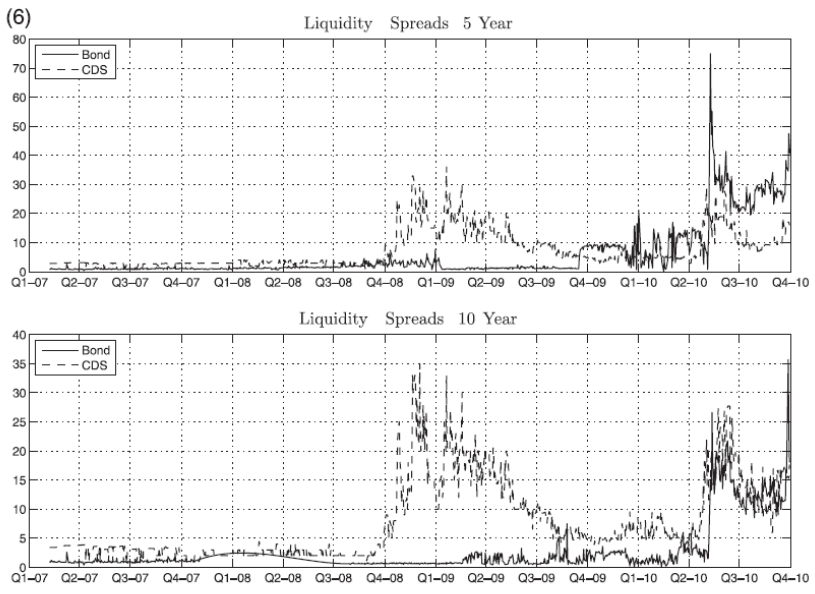
G. Calice et al. / Journal of Economic Behavior & Organization 85 (2013) 122–143



Motivation I: credit and liquidity spread interactions

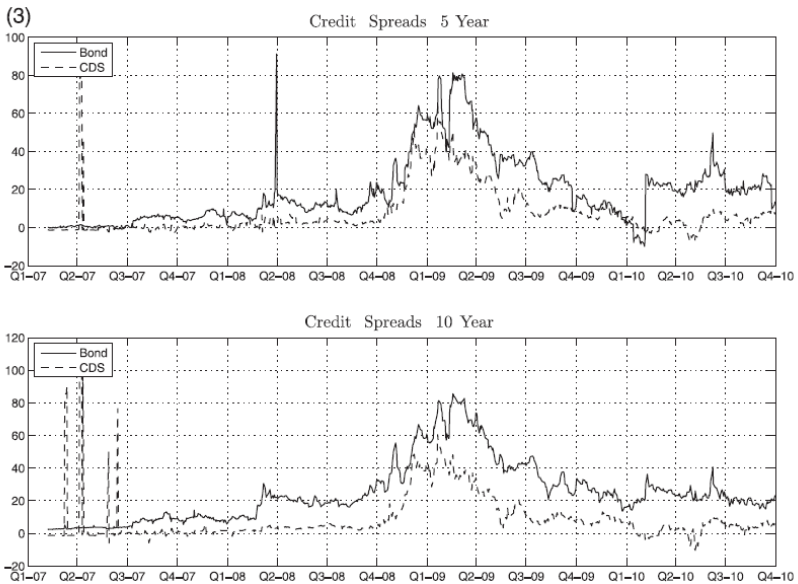
Ireland

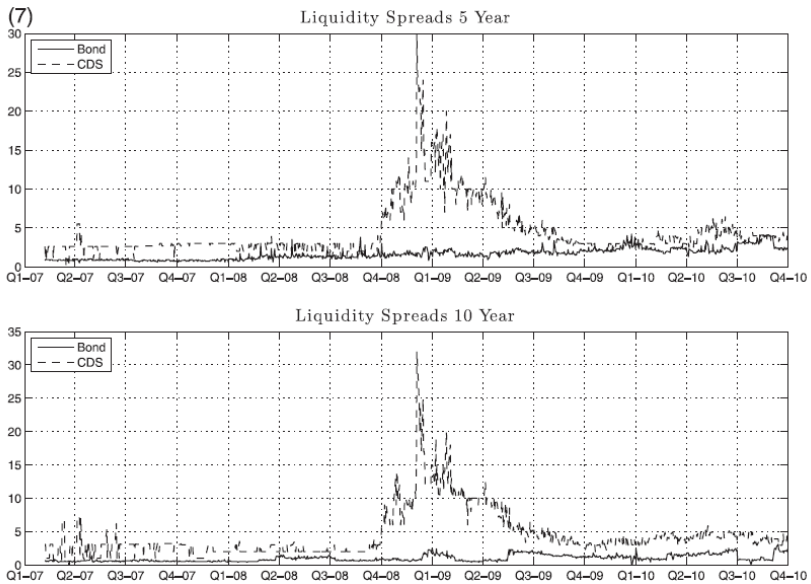




Motivation I: credit and liquidity spread interactions

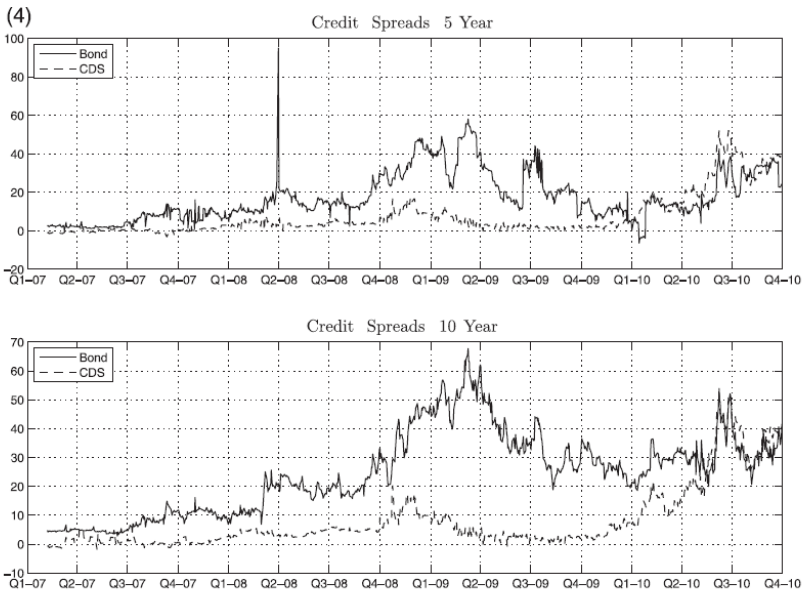
Netherlands

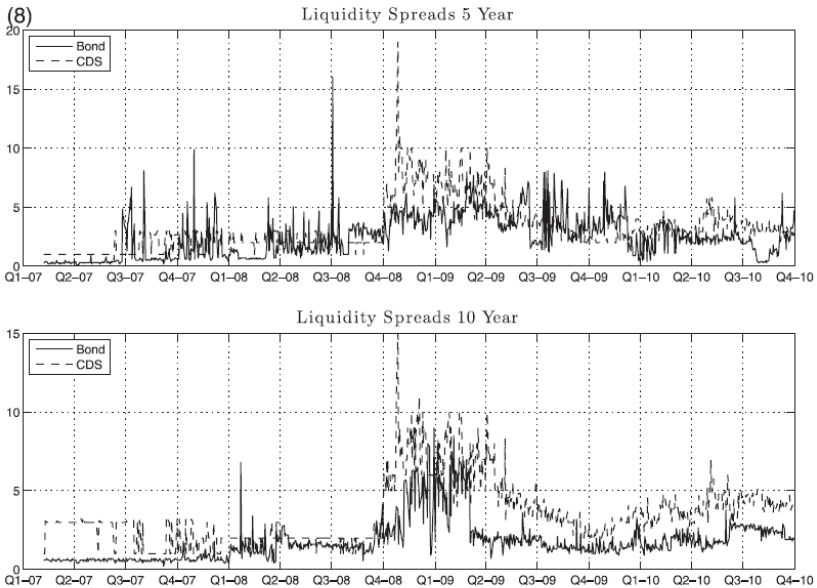




Motivation I: credit and liquidity spread interactions

France





Motivation II: "credit spread puzzle"

- In standard quantitative models of sovereign default (Aguiar and Gopinath, 2006; Arellano, 2008; Hatchondo and Martinez, 2009) a la Eaton and Gersovitz (1981) the spread reflects only default risk
- These models are unable to account for the observed dynamics of the bond spreads, while preserving the default rate at historical low levels.

The want operator

A theory that

- Accounts for the role of liquidity risk in sovereign debt markets
- Rationalizes the time-varying interaction between default and liquidity risk over the business cycle.

This Paper

Proposes a tractable model of sovereign borrowing in which credit and liquidity premia jointly determine borrowing and default decisions:

- Standard quantitative model of sovereign default with long-term debt
- Directed search model of secondary market

Use this model to quantitatively assess how search frictions in secondary markets affect

- the prices of both oustanding and newly issued bonds
- governments' borrowing and default policies
- policy interventions in secondary markets

Main findings:

- Trading frictions significantly tightens the financial constraint of the government
- Trading frictions significantly contributed to explain spreads
- ECB's SMP reduced spreads by 15 to 35 bps

Inspecting the mechanism

- Government sells bonds to risk-neutral dealers in primary (frictionless) market
- Dealers trade with a finite number of investors in a frictional secondary market
  - Directed search: investors need to pay higher fees to increase chances of trading with dealer
  - Two type of investors: high valuation (buyers) and low valuation (sellers)
- Main insight: Larger price discount to compensate for future expected transaction fees and holding costs

Comments I

- Contribution to the literature: Passadore and Xu (2022) already established the positive correlation between liquidity and default, and that liquidity premium accounts for a significant share of the spread.
- Novelty: Directed search generates endogenous liquidity conditions which allow for policy counterfactuals.
- Mapping model to data.
- Important to model recovery: well-established fact that defaulted debt becomes more illiquid.

Comments II

- Welfare analysis.
- Implications of mitigating lack of commitment (e.g., Hatchondo, Martinez and Roch, 2022).
- Risk premium and liquidity premium (Lizarazo, 2013; Kargar, Passadore and Silva, 2024).
- Financial links between sovereign debt markets.

Conclusions

- Nice paper to read! Interesting and policy relevant question.
- Contribution to the literature: Give more prominence to policy counterfactual analysis.
- Thanks!