Discussion of O. Jeanne's "From Fiscal Deadlock to Financial Repression: Anatomy of a Fall"

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- **The Story**

– A government is embarked on a fiscally unsustainable path with increasing public debt.

– The only way to stabilize the debt is by extracing resources from the banks (fiscal repression).

– But fiscal repression is costly, so it pays to delay it until the government is at the brink of default.
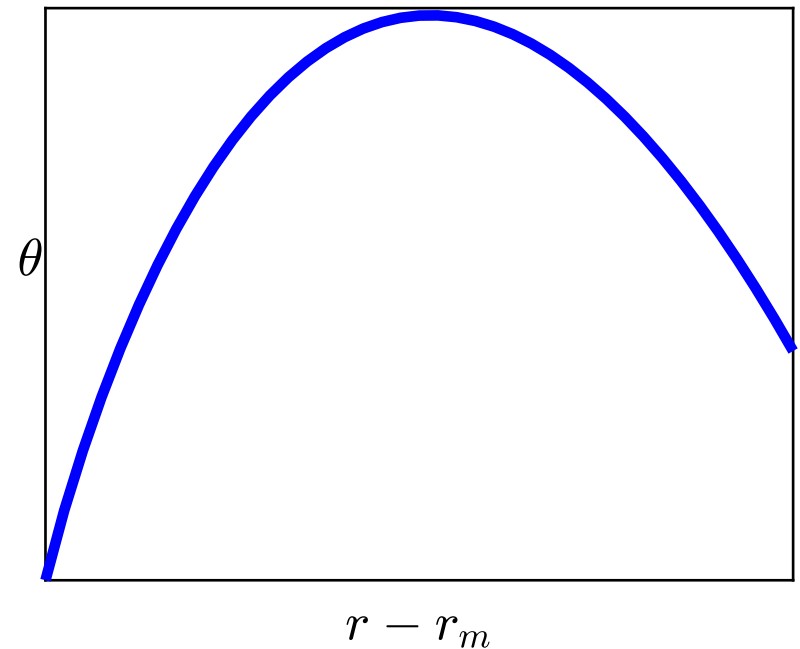
- **Overall Assessment**

– Clever theoretical treatment of financial repression.

– Simple model and intuitive result, though not obvious at all.

– Suggestive first pass at empirical evidence.

Financial Repression

Demand for Deposits

Laffer Curve

$r - r_m$

θ

m

$r - r_m$
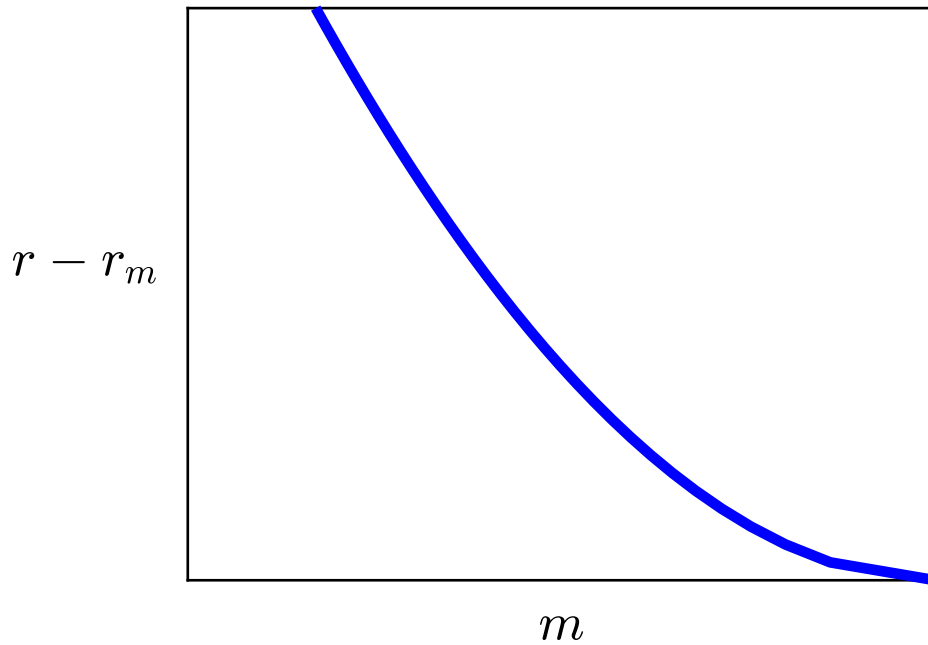
Notation

$m =$ deposits

$r =$ real interest rae (constant, exogenous)

$r_m =$ real interest rate on deposits

$\Rightarrow r - r_m =$ opportunity cost of holding deposits

$\theta = (r - r_m) \cdot m$ (financial repression: resources taken from banks by the gov't)

Indirect Utility Function

$$u(c_t, m_t) = -\gamma_\tau \tau_t - \gamma_\theta \theta_t$$

$$\gamma_\theta > \gamma_\tau$$

$\tau_t =$ tax revenue

$\theta =$ financial repression

$c_t =$ consumption

$m_t =$ deposits

γ_τ, γ_θ fixed parameters

Comment 1

The Fiscal Rule: Primary or Secondary Deficit?

Constant Secondary Deficit
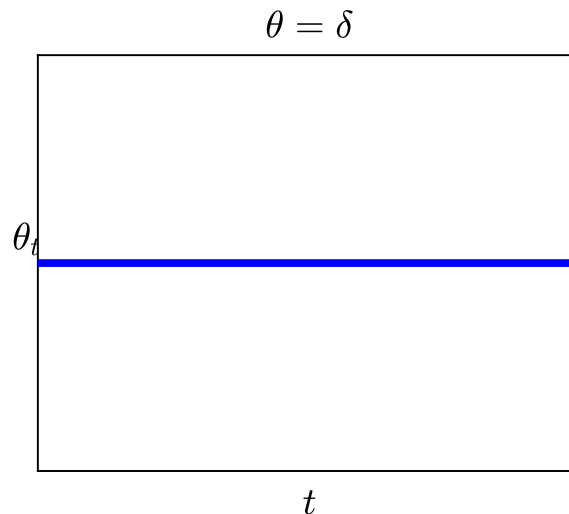
$$\dot{d}_t = g - \tau_t + rd_t$$

$$g - \tau_t + rd_t = \delta$$

$$\Rightarrow \dot{d}_t = \delta$$

Note d_t and τ_t increase over time.

Stabilization With Financial Repression

$$\dot{d}_t = \delta - \theta_t \text{ and gov't sets } \theta_t = \delta \Rightarrow \dot{d}_t = 0$$
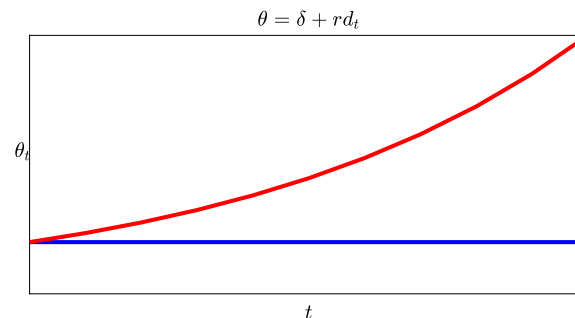
Constant Primary Deficit

$$\dot{d}_t = g - \tau_t + r d_t$$

$$g - \tau_t = \delta$$

$$\Rightarrow \dot{d}_t = \delta + r d_t$$

Note τ_t constant and d_t increases over time (faster than before).

Stabilization With Financial Repression

$$\dot{d}_t = \delta + r d_t - \theta_t \text{ and gov't sets } \theta_t = \delta + r d_t \Rightarrow \dot{d}_t = 0$$
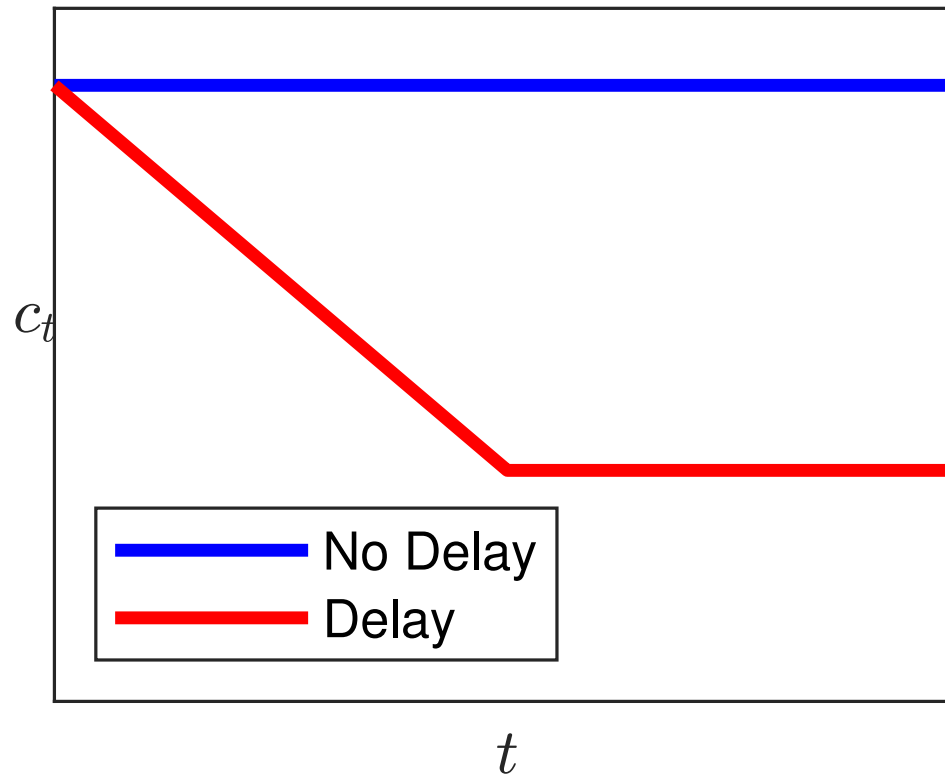

Question:

Does it still pay to delay financial repression? Worth exploring.

Comment 2

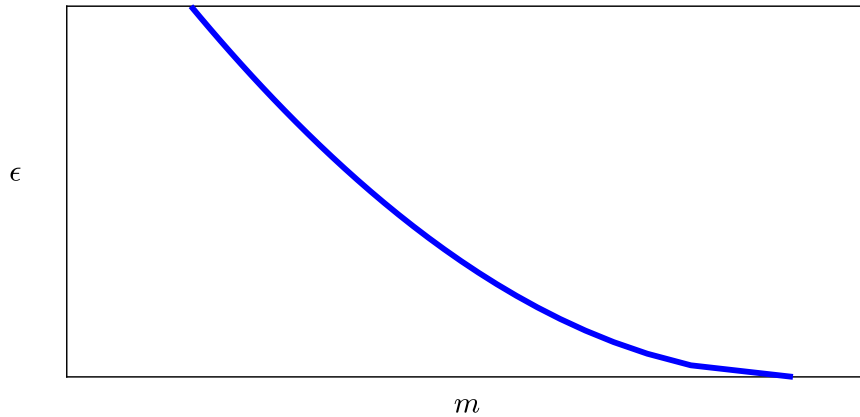# Linear Vs. Concave Preferences

Consumption Smoothing

consumption

$$c_t = y - \gamma_\tau \tau_t$$
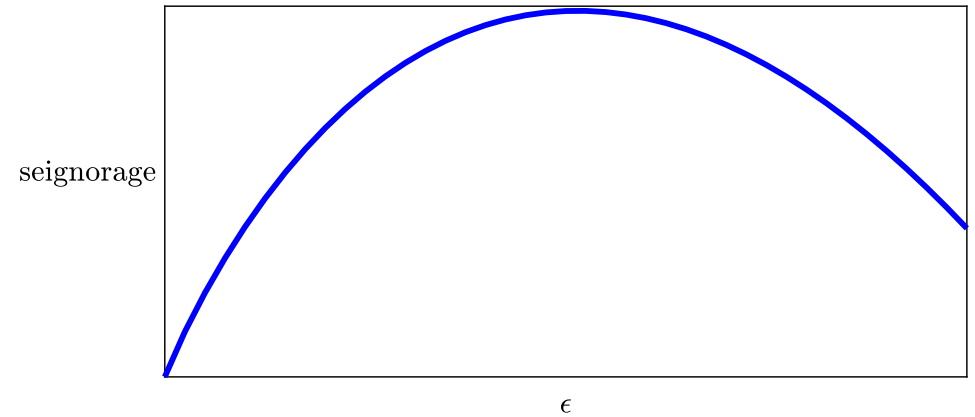
Comment 3

Normative Theory of First-Generation BOP Crisis

Inflation Tax

Demand for Money

Laffer Curve

ϵ

m

seignorage

ϵ

Notation

$m =$ money demand

$\epsilon =$ devauation rate

Conclusion

• Three comments:

(1) Constant-Primary-Deficit Rule (a section is in order)

(2) Concave utility (a comment is in order)

(3) Normative Theory of First-Gen BOP Crisis (a follow-up paper is in order).

• This is an elegant paper on a highly relevant topic, the optimal dynamics of financial repression.

I learned a lot reading it and recommend it to all.