Sovereign Default: The Role of Expectations

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Discussion by Mark Aguiar

Sources of Multiplicity

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2. Price-taking Behavior

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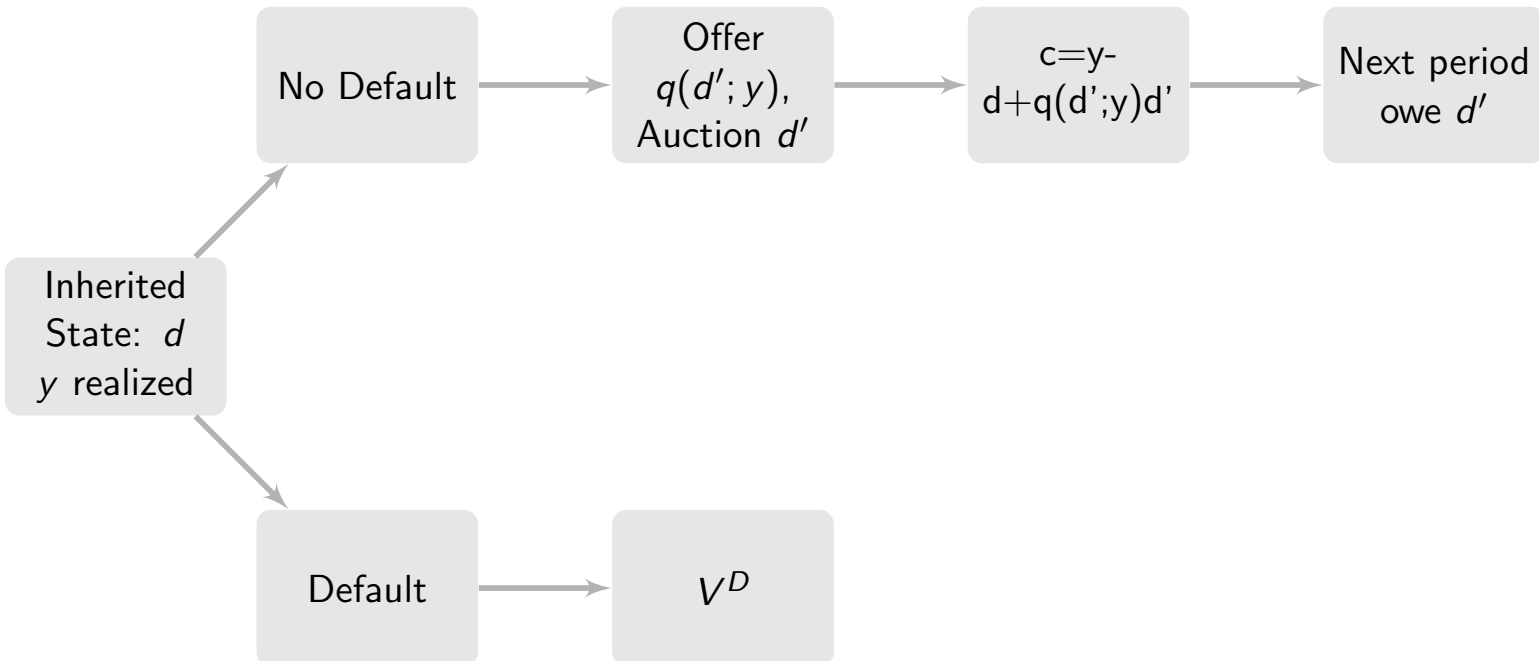
   - Typically coupon is fixed and price is endogenous
   - Some floating rate debt has been issued
2. Price-taking Behavior
   - More important departure

Eaton-Gersovitz Timing



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  - Acts as a monopolist in its own debt: Internalizes that by issuing more debt, q will fall.

Eaton-Gersovitz Equilibrium

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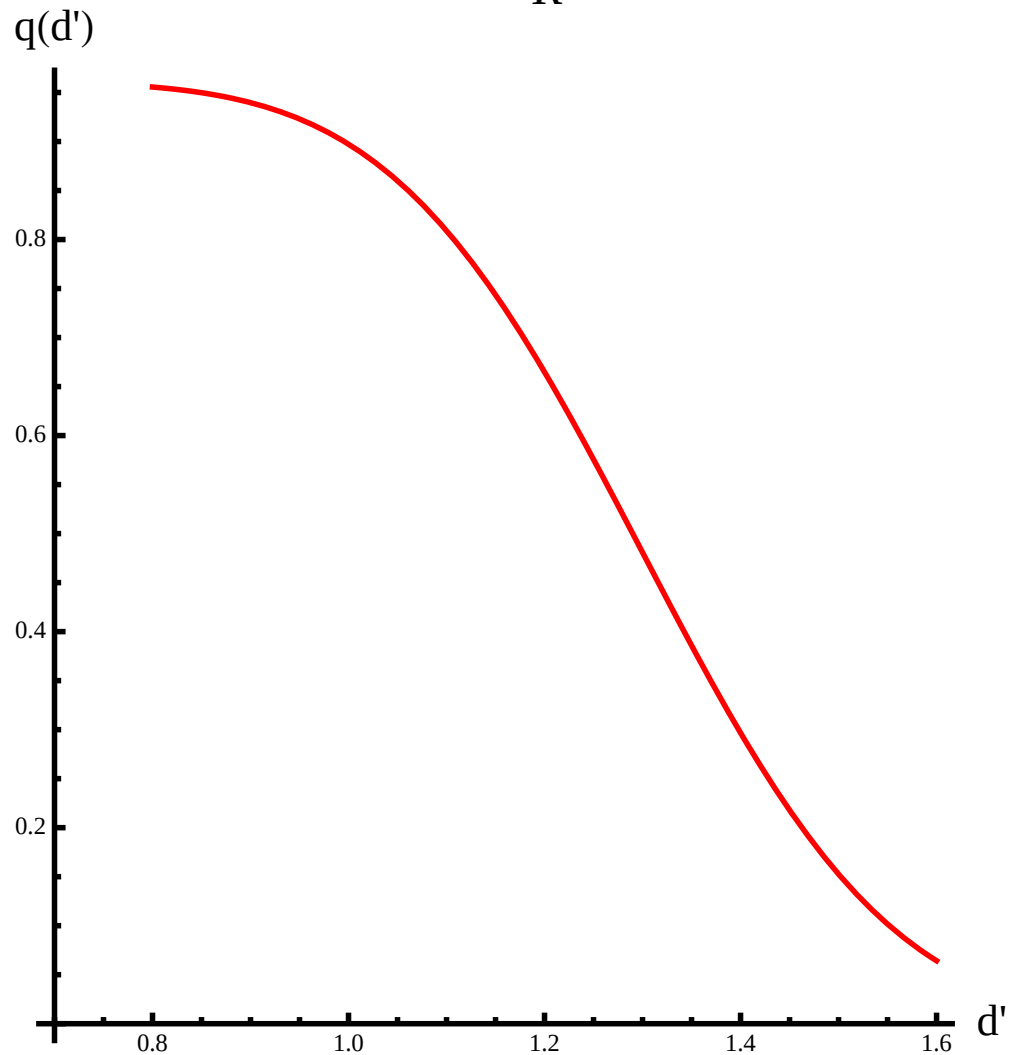

Eaton-Gersovitz Equilibrium

Government's Best Response: d^*

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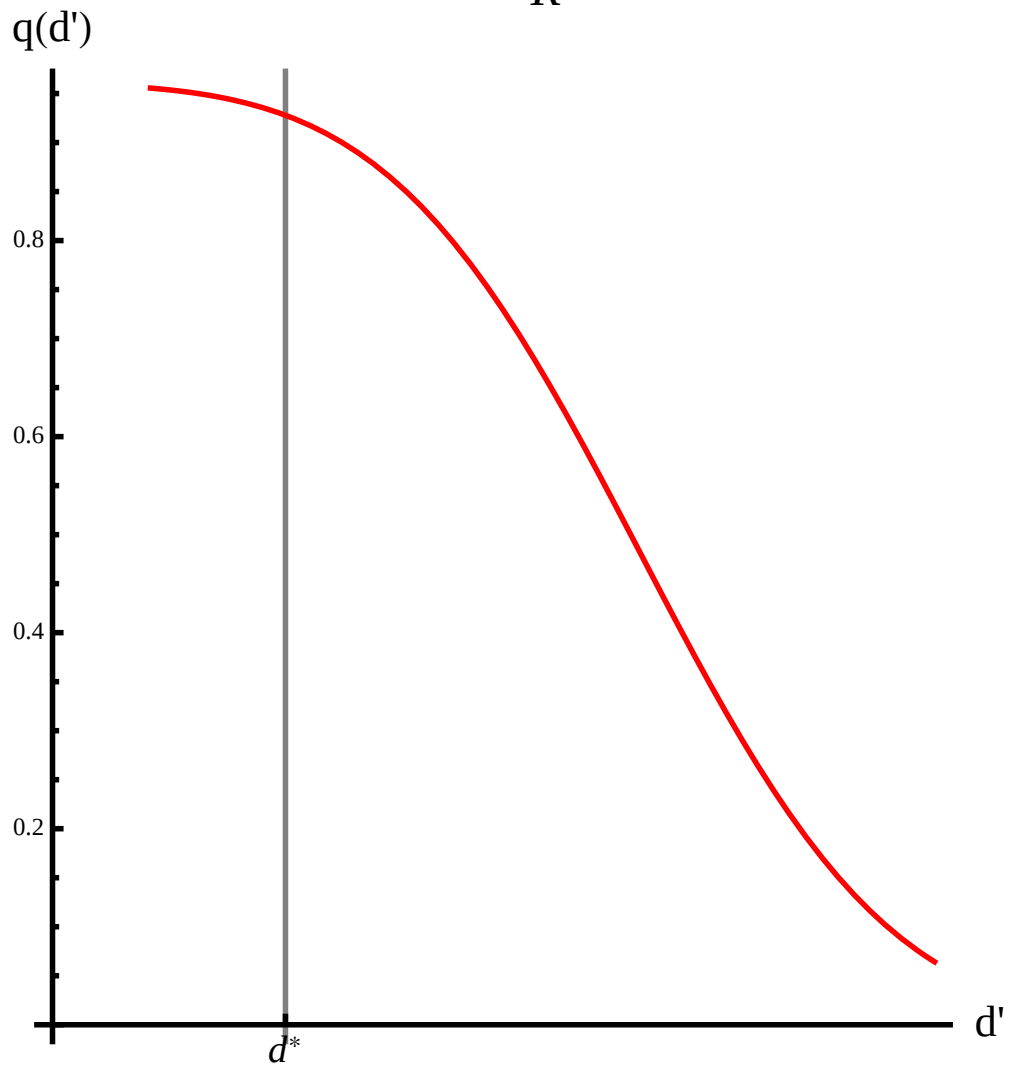

ANNT Alternative

- Government faces a price (scalar) for *any* amount of debt issued
- Faced with a price, government chooses the optimal amount to issue
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$$qBR(d) = \frac{1 - F(y_{Aut} + B(d))}{R^{\star}}$$

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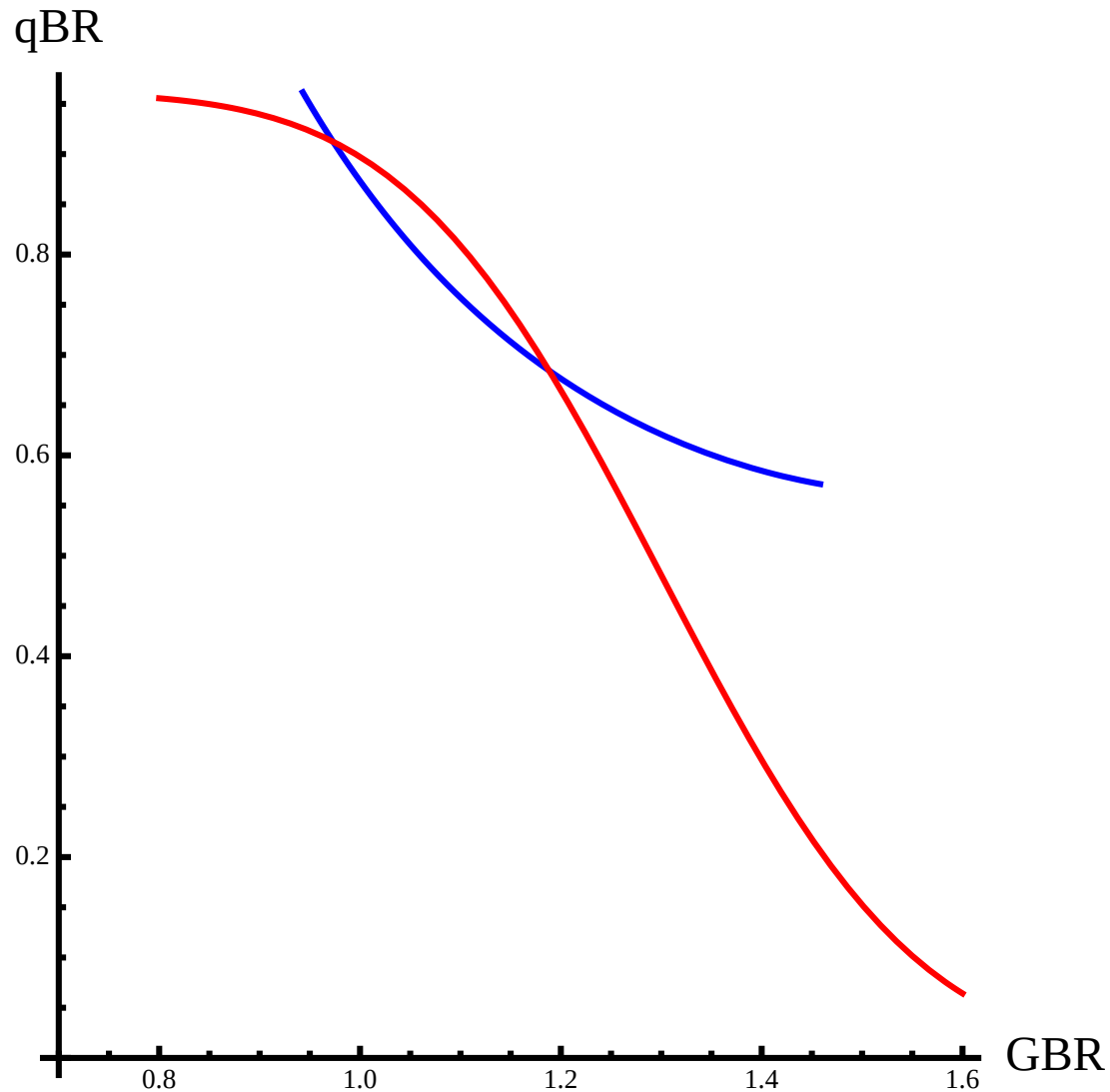
- There now may be multiple equilibria

ANNT Equilibrium



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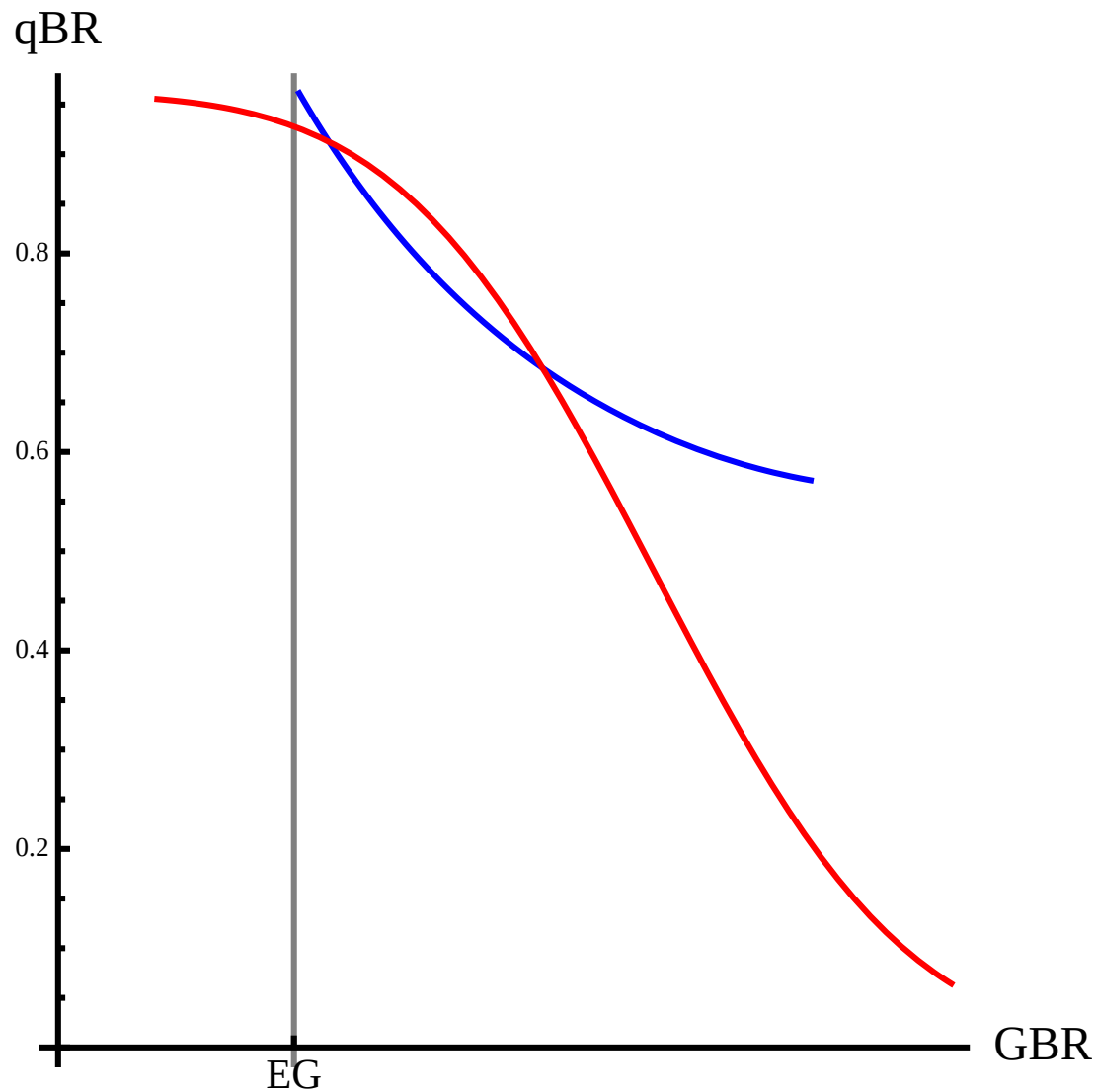

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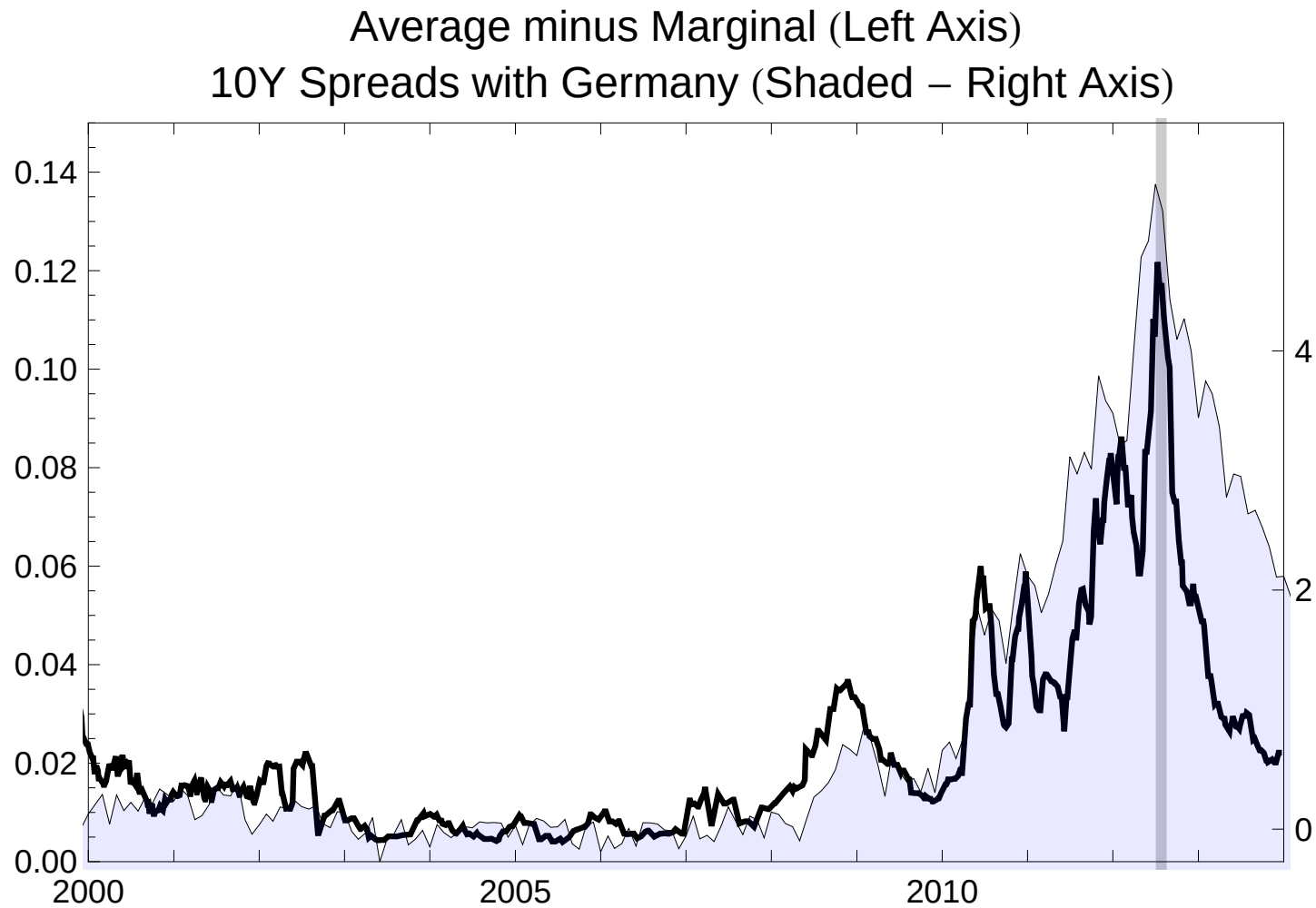
- Fiscal authorities recognize that prices depend on debt issuances
- Typical auction mechanics:
  1. Announce projected debt issuances at time of budgeting (may be updated)
  2. Announce debt auction calendar (may be updated)
  3. Before auction, announce target amount (in consultation with primary dealers)
  4. Collect bids (prices and quantities)
  5. Finalize auction amount and price (may differ from target)

Key Features

- Within an auction, bids induce a downward sloping "demand curve"
- Marginal price$<$Average price

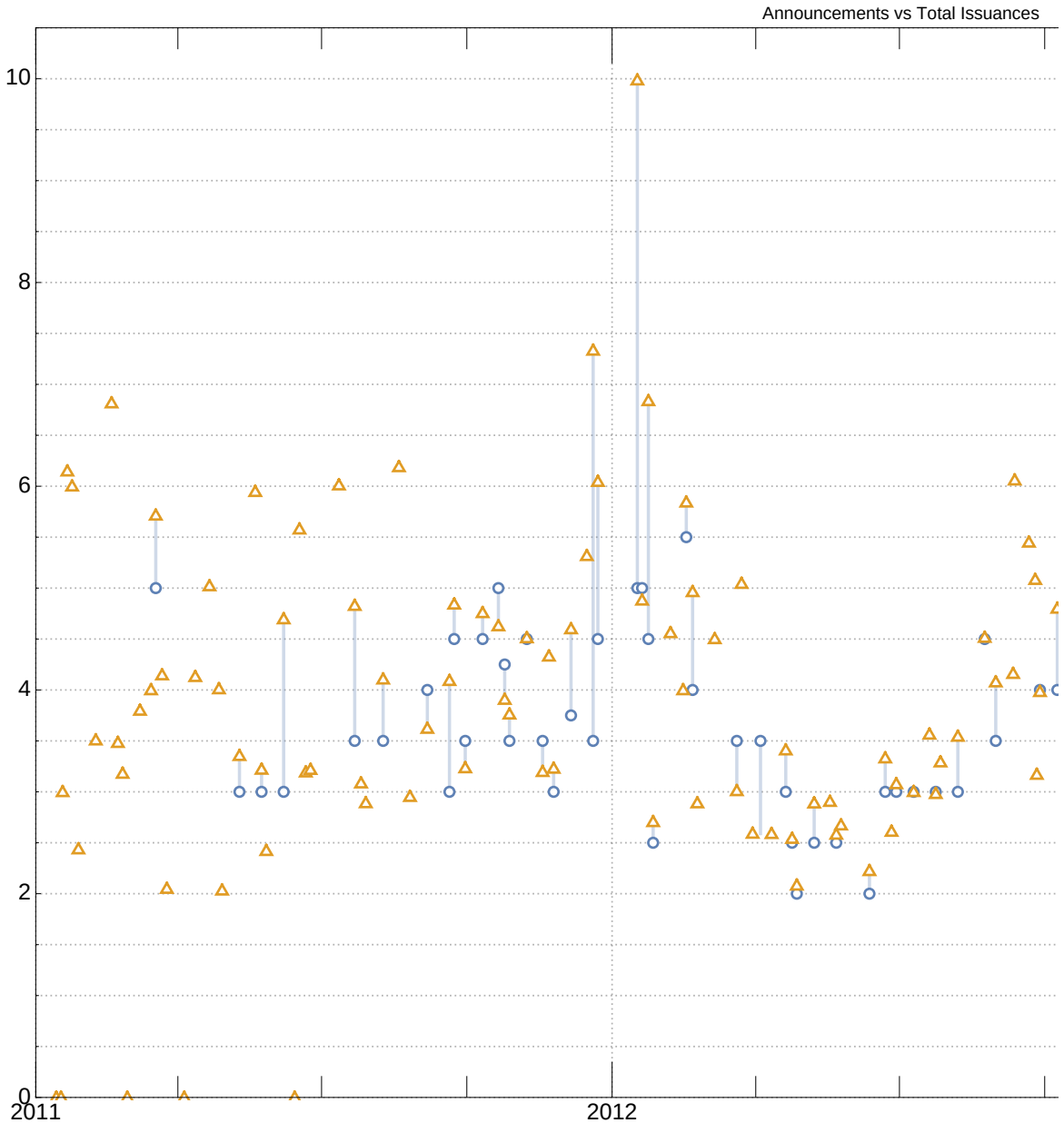
Marginal-Average Spread



Key Features

- Within an auction, bids induce a downward sloping "supply curve"
- Marginal price$<$Average price
- However...bids are entered based on forecasted debt issuance, not realized issuances

Announced versus Realized Issuance



Assessment

- Government's know that prices are tied to debt issuances
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  - May renege on debt targets
- But also not price takers
- Repeated game – perhaps MPE not the right concept