Discussion of “Sovereign Default Risk in Financially Integrated Economics,” by P. Bolton and O. Jeanne

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Questions and ingredients

- Paper raises some critical questions:

- How should we think of "Greek-style" crises?
- How does "contagion" work?
- How do "incentives" work?

Key ingredients

- Public domestic debt as collateral for interbank loans
- Public domestic debt is "tradable"
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The role of domestic debt: Deja vu all over again?

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- Governments become “borrowers of first resort”
Relationship between bank’s government debt and quality of institutions

Source: Kumhof and Tanner (2004)
Guess which Euro countries have highest share?

![Bar chart showing the share of bank-held government debt held by domestic banks in various Euro countries.](chart.png)

- **Austria**: 26.12%
- **Belgium**: 27.32%
- **Denmark**: 32.47%
- **Finland**: 39.19%
- **France**: 57.33%
- **Germany**: 92.27%
- **Greece**: 89.56%
- **Hungary**: 73.77%
- **Ireland**: 48.92%
- **Italy**: 35.73%
- **Luxembourg**: 68.47%
- **Netherlands**: 24.03%
- **Poland**: 100.00%
- **Portugal**: 84.49%
- **Spain**: 35.59%
- **Sweden**: 20.00%
- **UK**: 20.00%
Key differences between “Argentina” and “Greece”

- **Argentina**
  - Can devalue and reduce domestic debt in dollar terms
  - Then can devalue again
  - And restructure its domestic debt

- **Greece**
  - Can “export” its domestic debt crisis
  - Has a lender of last resort
  - Has reduced incentive for fiscal adjustment
  - Has higher risk of default (from the union’s perspective)

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Current arrangements in Euro area are not sustainable ...
Houston, we have a problem ...

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- .. and we have not even touched on moral hazard problems
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So, when is the German taxpayer going to revolt?
Fiscal integration: first best, but politically infeasible ...
Solutions?

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- Limit financial integration? Bad and probably useless idea
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- In the long-run, you either have a club of “peers” or else ...