Discussion of
“Efficient Sovereign Default”
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Incentive compatibility prevents full-insurance against domestic shocks.

Insurance implicit in pricing of non-contingent bonds.

Dynamics of (optimal) debt term-structure are realistic.
Defaulting countries issued debts in foreign currency
More Generally...

Many dimensions of sovereign “risk” are observable
Question

Can unobservability of one dimension of risk explain "missing" insurance with respect to observable dimensions?
Yes!

... but implied allocations are counterfactual.
Static Version of Dovis (2013) with Terms of Trade

- Terms of trade shock, $a_I$, observed

- Taste shock, $\theta_s$, observed/unobserved
Static Version of Dovis (2013) with Terms of Trade

- Lender welfare:
  \[ \sum_s \sum_l \pi_s \pi_l \left[ -m + y_{s,l}^* - r_{s,l} \right] \]

- Borrower production function:
  \[ c_{s,l} + \frac{y_{s,l}^*}{a_l} \leq f(m) \]

- Borrower welfare:
  \[ \sum_s \sum_l \pi_s \pi_l \left[ \theta_s U(c_{s,l}) + V(r_{s,l}) \right] \]
Incentive Constraints

\[ \theta_s U(c_s, l) + V(r_s, l) \geq \theta_s U(c_{s+1}, l) + V(r_{s+1}, l) \quad \forall l, s < N \quad \text{(IC)} \]

\[ \theta_s U(c_s, l) + V(r_s, l) \geq \theta_s U(f(m)) + V(r) \quad \forall l, s \quad \text{(SUS)} \]

... \quad \text{(PC)}
Lemma

*If taste shocks are observable, the optimal contract perfectly insures against ToT shocks.*

To prove, notice SUS constraint binds for all states:

\[ \theta_s U(c_s, l) + V(r_s, l) = \theta_s U(f(m)) + V(0) \quad \forall s, l \]

Note:

- Does not imply that allocations are the same across \( l \).
Lemma

*With unobservable taste shocks, the optimal contract perfectly insures against ToT shocks conditional on the high taste shock only.*

To prove:
- SUS constraint binds for high taste shock only.
Main Result

**Proposition**

*Consumption (and therefore domestic output) is lower when terms-of-trade are better.*

**Intuition:**

- High ToT $\rightarrow$ optimal to backload contract, now is a great day to get paid!

(Proven for log-utility with $2 \times 2$ states. But computer always agrees.)
Main Result

Corollary

Variance of borrower’s welfare is higher conditional on

1. Low taste shock (i.e. high productivity)
2. High terms-of-trade shock

To prove:

- Follows from main result I, (IC), (SUS)
Conclusion

- Important contribution, highlighting insurance built into debt valuation.

- Challenges assumption that default episodes are inefficient.

- Harder to explain missing insurance with respect to observable states.