

Discussion of
Transmission of Quasi-Sovereign Default Risk:
Evidence from Puerto Rico
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This Paper

- Is a very interesting paper that uses a unique data set and provides a new empirical result on the effect of sovereign default risk
- Background
 - ▶ Detroit bankruptcy is a shock which causes a sudden increase in default premium on Puerto Rican government bonds
 - ▶ Puerto Rico's unique status provides an ideal environment to isolate the sovereign default risk from currency and banking crises

This Paper

- Analyzes the effect of increased risk of sovereign default on domestic industry
 - ▶ Theoretically, by a stylized two-period model
 - ▶ Empirically, using industry-level employment data
- Provides new evidence that increased default risk disproportionately hurts industries that are more dependent on government demand.
 - ▶ Emphasis on the “government demand channel”

Main Mechanism

- Increased sovereign default premium
 - Limits government's borrowing capacity and reduces its spending
 - Industries that are dependent on government demand hurt severely
- The model has a simple and clear linkage across
 - ▶ Default risk, government spending, and employment:
 $Pr(def)$ rises $\rightarrow qB$ declines $\rightarrow G_m$ falls $\rightarrow h_m$ declines

Main Mechanism

- Empirically,

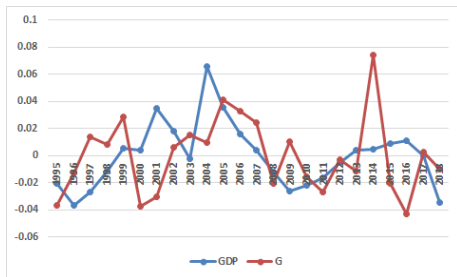
$$\log E_{it} = \alpha + \beta HighGOV_i \cdot PostDetroit_t + \rho \log E_{it-1} + \gamma_i + \gamma_t + \epsilon_{it}$$

- ▶ Significantly negative estimate of β : Strong evidence on the effect of increased default risk on reduced employment in *HighGOV_i* industries.
- ▶ It does not automatically guarantee that the channel is through “government demand”

Government Demand Channel

- Do we see evidence of decreased government spending?

Figure: Real GDP and Government Consumption



- ▶ Weak evidence from aggregate government consumption data (WDI)
- ▶ Make use of collected data on govt expenditure and primary balance
- ▶ Instrumenting government spending with the “PostDetroit” dummy?

Other Possible Channels?

- Credit supply channel?
 - ▶ Addressed by including external finance dependence (Rajan and Zingales, 1998)
 - ▶ U.S. data used: What if Puerto Rican industries' dependence on external finance is different from the U.S.?
 - ▶ Utilize collected data on bank loans and bank exposure to government bonds

Other Possible Channels?

- Government ownership?
 - ▶ Puerto Rico has a large public sector (public sector employees account for 25% of total employees¹)
 - ▶ If firms in *HighGOV_i* industries are heavily government owned, reduced employment could reflect public sector layoffs rather than demand effect.
- Size of typical firms in each industry?
 - ▶ If firms in *HighGOV_i* are disproportionately small, reduced employment could reflect size effect.
- Needs to document more characteristics of each industry

¹ “Puerto Rico Economy at a Glance”, by BLS, 2014