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## *Discussion*

Andrew Atkeson began by responding to one of the points Ricardo Reis made in his discussion, regarding banking and sovereign debt in Europe. Atkeson noted that in the United States, interest on municipal debt is income-tax deductible at the federal level, and also at the state level for residents of that particular state. He argued that this creates an incentive for individuals, instead of institutions, to hold municipal debt and suggested that Europe could implement a similar policy. He stated that this would not resolve all of Europe's sovereign debt problems but suggested the policy as a starting point.

Francesco Giavazzi summarized the paper as focusing on two dimensions of policy—fiscal flexibility and the ability of the government to interfere in private contracts. He suggested that a third element—whether governments issue their debt in their own currency or in a foreign currency—was central to understanding the current situation in Europe. He characterized European governments, prior to August 2011, as issuing debt in a foreign currency because the European Central Bank (ECB) was not willing to purchase their debt. As a result, multiple equilibria (with low and high interest rates) were possible<sup>1</sup>, and the events of the summer of 2011 can be understood as shifts between these equilibria. After August 2011, the ECB declared its willingness to purchase government debt or finance the purchase of government debt by domestic banks. This eliminated the high-interest rate equilibrium, resolving the crisis. Applying these ideas to states in the United States, Giavazzi rhetorically asked whether Illinois and California could issue debt in their own currency. He argued that, formally, the answer is no—they cannot monetize their debt. However, during the crisis, the American Recovery and Reinvestment Act (ARRA) transferred a large amount of money to

the states. The federal government was able to do this because its debt was in its own currency, illustrating the importance of the currency issue. What is the impact of governing law? Around the Eurocrisis, Greek sovereign bonds with NYC governing law clauses had lower yields than those with Greece governing law clauses, perhaps because NYC courts offer more favorable terms for creditors in the case of default and/or because Greek courts are less trustworthy. (The two classes of bonds also varied along several other dimensions: time to maturity @ issuance, currency, etc.) Some municipalities must be more attractive than others if their courts help investors extract higher recovery rates in default.

Christopher Sims spoke next, recalling that at one point early in the twenty-first century, Alan Greenspan expressed concern about the possibility that the outstanding stock of treasuries would vanish entirely. At that time, most states were net creditors because of their pension funds. However, those funds are not easy for the states to access and might impact the state's fiscal flexibility. Sims suggested that the authors examine this issue. He also asked about the nature of the fiscal flexibility measure employed by the authors, and in particular whether it was quantitatively important. Sims noted that states differ substantially in their fiscal flexibility, and yet all have low levels of debt (in comparison with European countries). He asked whether the constraints on US states are strong enough for all states to explain this pattern.

Andrew Atkeson responded by acknowledging that the handling of pension systems differs in their data between US states and European countries. He also noted that Ricardo Reis, in his discussion, apportioned federal taxation revenues and debt to the states and also found that US states had low levels of debt relative to their tax revenues and economic activity. Atkeson summarized the existing literature, and in particular the Nobel lecture by Thomas Sargent, as arguing that the states and federal government are fiscally separate and noted that the ARRA seemed to violate this assumption. Nevertheless, transfers from the federal government to the states are based on funding formulas and not directed to specific states. The general result is that state debt levels are very low relative to state revenues. Even with pension liabilities added in, most states' explicit and implicit debts are less than one year's tax revenues, whereas in European countries debt levels are much higher.

Atkeson cited Thomas Sargent as noting that, historically, states have "been on their own" fiscally. As a result, the states have been very conservative about taking on large debt burdens. In the 1840s many states defaulted and subsequently voluntarily adopted constraints on their

budgets. These constraints vary from state to state, but it is difficult to determine the consequences of the variation in these policies. What really matters is what the state can do when confronted with financial stress. Recently in California, many of the issues arose from rules that required a two-thirds majority vote to raise tax rates. In contrast, New York was able to change tax rates in response to revenue shortfalls. However, Atkeson noted that it would be difficult to use these differences to explain the observed variation in municipal bond spreads across states.

More broadly, because of limits states have imposed on their debt issuance, Atkeson and coauthors believe the value to the states of being able to access credit markets is low. As a result, states are unable to sustain large debt burdens. The policy consequence of this reasoning for Europe is that, if they were able to implement the Maastricht Treaty and forbid large deficits, they would find their current levels of debt unsustainable. The temptation to default would be too strong, absent a federal system of transfers. Canadian provinces, such as Quebec and Ontario, demonstrate an alternative approach. They responded to the recent recession by issuing large amounts of debt, relative to their GDP, whereas US states followed a more procyclical fiscal policy.

Robert Hall pointed out that, in the past, California had seemingly violated Article 1 of the US Constitution and used a currency other than the dollar. Between the beginning of the Civil War and 1879, Californians continued to use the gold dollar instead of the greenback dollar. At its maximum, the gold dollar was worth \$2.50 greenback dollars. Moreover, the legal protections for private contracts permit some interference. In the United States, courts have interpreted the contract clause to rule out the elimination of private debts, but they have permitted legislation that substantially changes those debts' market value. Relatedly, coastal California residents whose property has lost value as a result of regulations have challenged these regulations under the Fifth Amendment's takings clause, but the courts have consistently ruled that, as long as the property retains some value, the takings clause has not been violated.

Martin Eichenbaum noted that issues about interference in private contracts and the takings clause were important during the administration of Franklin Roosevelt. Robert Hall concurred, and mentioned that California issued "IOUs" to many of its suppliers during 2009, effectively forcing them to involuntarily lend money to California. The secondary market in these IOUs suggested that they were worth less than their face value. Hall asked whether the issuance of these IOUs was legal and emphasized the relevance of this kind of legal "leakage" for the authors' work. Mark L. Wright recalled that California banks accepted

these IOUs at close to their face value. He suggested that California was legally allowed to issue these IOUs because they were not intended to circulate as a medium of exchange, the way a currency would.

Andrew Atkeson summarized the paper as stating that the US fiscal system was tested twice, once in the Civil War and once in the Great Depression. During the Great Depression, Minnesota interfered with private contracts by passing a moratorium on foreclosures, and the Supreme Court upheld this moratorium, despite Article 1 of the Constitution. As Harald Uhlig noted in his discussion, the Constitution is not a fixed system; the institutions in the United States were developed over time. During the banking panic in 1932, Michigan implemented a banking holiday, even though they did not have authority over nationally chartered banks, which were regulated by the OCC. During the three weeks between Michigan's banking holiday and Roosevelt's inauguration, all forty-eight states put banking holidays or similar restrictions in place. After Roosevelt's inauguration, a national banking holiday was enacted, and the legality of the state banking holidays was never litigated. Based on this precedent, it is hard to answer the question that Harald Uhlig raised in his discussion: What would happen if Illinois did something like that?

Atkeson also noted that in the United States the response to this experience was to create a banking union so that state governments would not be pressured to respond to regional banking crises. He argued that, in the case of Europe, this is an important policy option. However, even if Europe formed a banking union and shrank its banking sector, it would need to develop legal foundations for capital markets, such as a uniform bankruptcy code and securities laws. When the euro was first being considered, many policymakers expressed optimism that balance of payments issues would "sort themselves out," as long as the countries in Europe shared a common currency. This optimism proved unfounded, and Atkeson believes that the current view, that a banking union by itself would resolve many of these problems, will also prove excessively optimistic. Martin Eichenbaum recalled that when the euro was being discussed he asked IMF officials about what would happen if there was a balance of payments problem in Portugal. The officials responded by pointing out that no one would ask what would happen if Detroit has a balance of payments problem. Eichenbaum interpreted this response as exemplifying the excessive optimism Atkeson was referring to.

Mark L. Wright focused on one particular theme that arose in the discussions: to what extent would Europe have had problems even in the absence of any risk of government interference in private contracts because of the connection between European banks and sovereigns? He

acknowledged that this is a difficult question to answer but brought up some evidence from the bond market for nonfinancial corporates. For companies headquartered in Germany, France, Italy, and Spain, prior to 2010, average spreads to German sovereign debt moved together, despite differences in the economic performance of those countries. However, as the crisis developed and exit from the euro zone was discussed, Italian and Spanish corporate spreads widened relative to German and French corporates. Wright noted that firms that issue in the corporate bond market are less dependent on bank financing and argued that this evidence suggests the risk of interference in debt contracts was rising.

Harald Uhlig responded to this argument by noting that these firms may have local suppliers and recalled the paper of Acemoglu, Akgigit, and Kerr that was also presented at the 2015 NBER Annual Conference on Macroeconomics. If these large firms' suppliers were dependent on bank financing, network effects may have also harmed firms that issue in the corporate bond market, even though they are not themselves dependent on bank financing. Andrew Atkeson responded by describing the situation of a Greek yogurt company that was headquartered in Greece, but otherwise unconnected to the Greek economy. This firm was facing higher borrowing costs simply because it was headquartered in Greece. Atkeson also noted that credit-rating agencies provide a rating for "transfer and convertibility risk," which is an attempt to separate economic fundamentals from risks related to interference. The authors use this measure in their paper.

Ricardo Reis framed the paper as being concerned with the question, "to what extent are things so different in the United States than in Europe?" He argued that the authors only need a higher risk of interference in private contracts between a Greek and a German than between citizens of different US states and felt that this difference held de facto. The "delta" in the authors' paper represents this difference. Reis discussed the paper with an expert in US insolvency law, who agreed that courts do sometimes cut debt, as Robert Hall argued earlier. However, the courts would not treat cross-state payments differently than within-state payments, which is what is crucial for the authors' model.

Martin Eichenbaum pointed out that the Illinois Constitution explicitly forbids defaulting on pension obligations. Ricardo Reis responded that European constitutions also have this provision.

## Endnote

1. As an aside, Giavazzi noted that this story did not apply to Greece.