The dynamics of sovereign debt crises in a monetary unions

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Summary

- → Study of Sovereign debt and default, taking into account maturity and the role of government discount factor.
- → Based on Cole and Kehoe (2000) and Arellano (2008).
- → With two reasons for default : sunspot and « bad » conditions.

Main issues :

- → Endogenous choice of debt.
- → The role of bailouts,
- → … and in a multiple region setting, (tentatively a monetary union)

Main results
(at this stage)

Possibility of multiple equilibria and « scary » debt dynamics.

Bailouts (at punitive prices) lead to higher level of sovereign debt !

Issue 1

- → Nominal vs real magnitudes:
- → Here, real analysis (as if indexed bonds)
- → No role for inflation as a « pain reliever »

Issue 2 : about sovereign debts in a monetary union

→ First question to ask: what does it change (compared the case of sovereign currency and debt)?

Monetary sovereignty

		Exchange rate risk	Nominal risk	Real risk (ToT, capital, etc.)
Denomination	Local	No		
	Foreign	Yes		
Indexation	Yes		Small	Large
	No		Large	Small
Maturity	Short			Small
	Long			Large

Monetary union

		Exchange rate risk	Nominal risk	Real risk
Denomination	Foreign	Yes		
Indexation (in the single currency)	Yes		Yes	Large
	No		Large	Yes
Maturity	Short			Small
	Long			Large

Monetary union and cost of default

- → Increased because of loss of the exchange rate instrument
- → Decreased if intra-union transfers
- → Increased because of common agency problems and contagion

In sum

- → Sovereign debt issues not solved by monetary integration, just modified.
- → Likely to be more slippery, not less.
- → The puzzle : why risk premia have decreased between 1999 and 2007 ?
- → In retrospect : a major original sin of the EMU. Lessons of interwar period lost and forgotten !

Waiting for Harald !

(and others)