Sovereign Debt, Default Risk and Fiscal Consolidation in the EZ Periphery

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Abstract

We consider non zero sovereign and private default probabilities in a monetary, open economy, search and matching model. We empirically evaluate whether the emergence of a financial wedge in the form of a sovereign risk channel can reduce the size or even reverse the sign of the Keynesian fiscal multiplier, conditional to alternative fiscal consolidation measures. The model is estimated with Bayesian techniques using data of EZ peripheral countries (Greece, Ireland, Italy, Portugal and Spain). From posterior simulations we show that i) the unconditional relation between sovereign risk and macroeconomic fundamentals is weak; ii) fiscal contractions are self-defeating, such that the sovereign risk channel amplifies the Keynesian effects of the fiscal contraction. The consideration of a liquidity trap environment does not reverse, but reinforces, these results.

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