Sovereign Default: with Public Debt as Liquidity

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This paper develops a theoretical model in which sovereign default is costly since it dries out domestic liquidity and leads to inefficient resource allocation. Since the government cannot discriminate between domestic and foreign bondholders, it would choose not to default when taking into account such domestic cost of default. As a result, a significant amount of external debt can be sustained in the equilibrium even without the conventional reputation loss. Particularly, this paper emphasizes the relation between idiosyncratic shock and default risk and shows that, as idiosyncratic shock becomes larger, a higher level of external debt can be sustained in equilibrium. More interestingly, a novel finding in this paper shows that when idiosyncratic shock becomes large enough, the default may become pro-cyclical. This has rarely been generated in existing theories, though empirical studies show that many countries in- deed defaulted in “good” times throughout history.

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