

# Aggregate Demand and Sovereign Debt Crises\*

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PRELIMINARY AND INCOMPLETE

## Abstract

Sovereign debt crises are associated with pronounced recessions. In the conventional view, poor economic conditions increase default incentives and hence bond spreads. I provide evidence suggesting that the reaction of consumption demand creates feedback from sovereign spreads to output. Because they ignore the savings behavior of private agents, existing models cannot capture this empirical feature of crises. I study the implications of this feedback mechanism in a model where the government of a small open economy borrows from foreign lenders but some of the debt is held by domestic savers who are heterogeneous in their wealth. This heterogeneity means that potential sovereign defaults carry redistributive effects in addition to aggregate income losses. Both of these effects introduce risk in private agents' expectations after bad news for repayment. Default risk then exacerbates the precautionary motive of households and depresses aggregate demand when spreads increase. The model is also consistent with facts about the timing of sovereign debt crises.

**JEL Classification:** E2, F3, G2

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## INTRODUCTION

Sovereign debt crises coincide with large output contractions. For the case of Spain during the Eurozone crisis, output fell by about 10% of its 2008 peak. Consumption dropped more than output, by up to 15% of the pre-crisis maximum. The resulting increase in aggregate savings was not a particular feature of the Spanish experience. In a more formal instrumental variables approach on country-level data from the Eurozone crisis, I show that increases in sovereign spreads caused drops in output and even larger drops in consumption.

The literature on sovereign debt largely assumes either households that are in financial autarky or one-sector small open economy models in which domestic demand is irrelevant. As a result, it can neither explain this pattern of household savings behavior nor account for its role in the unfolding of the crisis. The canonical model accounts for the correlation of output and spreads by arguing that recessions increase default incentives. Therefore, the presence of sovereign risk does not affect the economy unless a default actually happens. Finally, by construction, the assumption of a wealthless, hand-to-mouth household cannot capture the fact that a significant portion of government debt is held by residents. These debt holdings, which in the case of Spain account for more than half of the government's debt (see Figure 22), open the door for sovereign risk to have a direct impact on aggregate demand.

In this paper I propose a model of sovereign debt that rationalizes the large output and consumption drops in response to sovereign risk. Its main mechanism follows from explicitly considering the household consumption and savings decisions in the crisis. Debt crises are events in which the probability of default, along with sovereign spreads, shoots up. When sovereign risk increases, households attach a higher probability to the negative outcomes that would accompany a default. Their individually optimal reaction is to cut consumption in favor of higher savings. This increase in precautionary behavior leads, in turn, to low aggregate demand. The model predicts a vicious cycle of high spreads causing further output contractions. I calibrate the model to Spain's debt crisis and use it to assess the importance of the amplification channel in explaining the severity of the recession.

I consider a small open economy in which heterogeneous households can choose to be exposed to defaultable government debt. In the model, events during the crisis are intimately linked to expectations of outcomes should a default take place. Defaults both depress income and redistribute wealth in the domestic economy. Aggregate income losses are due to drops in TFP of the kind emphasized in the literature. Because governments ultimately service their debts by collecting taxes and because households are exposed to the debt, defaults also redistribute from bondholders to taxpayers. Whether a particular group stands to gain or lose depends on their share of debt holdings and also on the progressivity of the tax system. In the crisis, when shocks increase the probability of default, private agents anticipate these outcomes and view both their financial and nonfinancial wealth as lower and riskier. There is also a direct effect: increases in sovereign spreads shrink the government's budget

constraint by affecting its borrowing costs. In the crisis, conditional on no default, the present value of surpluses needs to increase. This means that high spreads transfer from taxpayers to bondholders in the event that a default does *not* happen.

In times of high sovereign spreads, the possibility of all these transfers adds risk to the economy as perceived by individual agents. As a result, crisis times are times of exacerbated precautionary motives. I show that these mechanisms amplify underlying shocks to generate demand shortages that are quantitatively large. In the end, this amplification makes sovereign risk costly.

Inspecting the households' relation with sovereign risk, I find three main channels through which the possibility of default affects them in the crisis. First, the fact that defaults carry aggregate TFP losses clearly depresses future expected income. Second, because debt is long-term, when spreads increase households make capital losses on their wealth portfolio. These capital losses shift the distribution according to the density of bond holdings, which is naturally concentrated on the richer, more risk-tolerant agents. Finally, a third effect arises from the covariance between bond returns and the stochastic discount factor of each household. In normal times, government debt is almost risk-free: any variation in returns is due to movements in the resale price which reflects long-term prospects of the economy. In the crisis, however, bond returns mostly depend on whether a default takes place. Because defaults happen in bad times, this asset correlates negatively with aggregate income. This means that the savings technology is overall worse in the crisis than it is in normal times.

Preliminary results suggest that the model is capable of substantial amplification. A robust feature of simulations is that output falls when spreads increase, driven by a combination of low TFP, high unemployment, and low demand from the domestic sector.

Non-Ricardian features are central to my analysis. In the model, Ricardian equivalence fails because of incomplete markets and borrowing constraints. A potential default would redistribute from agents who are exposed to sovereign risk to agents who are not. When the default probability increases, however, those who stand to gain do not increase their consumption. This happens because these agents are poorer and close to their borrowing limit, so future potential transfers do not enter their relevant measure of permanent income. Indeed, these agents have low marginal propensities to consume (MPCs) out of future income for the same reason that they have high MPCs out of current income.

The same non-Ricardian features allow for a clean separation of the debts of the government and the private sector. In canonical models of sovereign default, allowing households to borrow and save risk-free unravels the equilibrium. The reason is simple: if the government has access to lump-sum taxes and the representative household can commit to repay loans, then the government can use its tax policy to effectively have the household borrow on its behalf at the risk-free rate. This has led researchers to study models in which the private sector's ability to borrow and save is constrained. An alternative assumption is to constrain the tax instruments at the government's disposal. In my model, even though the government can collect lump-sum taxes, it cannot make those taxes agent-specific.

This provides a natural constraint on the government's ability to sidestep its lack of commitment.

A common argument during debt crises is that a lack of 'confidence' makes aggregate demand fall short of levels consistent with full employment. This paper addresses these arguments by making the lack of confidence a rational, although inefficient, response to the evolution of fundamentals in the economy. Furthermore, the amplification I emphasize helps explain why emerging economies exhibit high volatility of consumption relative to output 'as if' they were subject to trend shocks ([Aguiar and Gopinath, 2007](#)).

Debt crises spark intense debates about the effects of fiscal austerity. The tradeoff is usually summarized as follows. Fiscal consolidation can be beneficial because it increases creditworthiness and lowers spreads. But it can also depress the economy and worsen the recession. Austerity can even become self-defeating by compromising tax collections. The aggregate demand channel I emphasize makes the tradeoff more subtle. Fiscal consolidation, if it successfully reduces the government's debt burden, could potentially ease the fears of default and boost demand. Even though it is present in debates about the management of debt crises, this effect has not as yet received rigorous attention. Because of these forces, policies that enhance debt sustainability (austerity but also debt relief, default, or restructuring) can help close the gap between realized and potential output.

In the model, the elasticity of consumption to sovereign risk depends critically on four quantities. The first one relates to the size of government debt holdings in private wealth, the proportion of wealth subject to risk. I draw on related work by [Morelli and Roldán \(2018\)](#), who empirically document the exposure of Spanish households to sovereign risk. A second elasticity refers to the amount of risk correction that domestic agents would apply to the debt they hold. For this, agents in the model have risk-sensitive preferences ([Epstein and Zin, 1989](#)) that yield realistic asset pricing implications by separating risk aversion from intertemporal substitution. A third factor relates movements in wealth to consumption demand. This relation is governed by the distribution of MPCs out of changes in wealth and its correlation with the exposures to sovereign risk. I require the model to match the distribution of holdings of government debt to discipline this third elasticity. Finally, the effect of aggregate demand on output depends on nominal rigidities. In the model, nominal wages cannot always adjust to clear the labor market. The degree of wage stickiness is disciplined by its implications for unemployment.

The calibrated model allows to quantify the amplification of shocks. It does so by generating different notions of 'potential' output, which can be compared to actual output in the crisis. A natural comparison point is the same model solved without default risk: it measures how much output would have fallen only because of the benchmark model's underlying shocks. More subtle benchmarks can be considered that isolate the different forces at play. Section 7 describes the different comparison models in detail, each of which is designed to isolate one of the three channels outlined above. The comparison models all arise from modifying a feature of the economy when it is in default. I then solve for the equilibrium of the private economy in the modified version keeping the government's default policy from the benchmark model. The comparison models' output series are then counter-

factual series that would arise if the interaction of precautionary behavior with a particular feature of defaults was removed.

**Discussion of the Literature** This paper relates to several strands of literature. I build on canonical models of sovereign debt ([Eaton and Gersovitz, 1982](#); [Arellano, 2008](#)) by considering a benevolent government borrowing without commitment from international creditors. Recent papers have emphasized internal costs of sovereign default. [Mendoza and Yue \(2012\)](#) assume that domestic firms lose access to some imported inputs after a default, which reduces aggregate productivity. [Dovis \(2018\)](#) rationalizes these costs of defaults as a decentralization of the optimal contract between the country and its lenders subject to lack of commitment and information frictions. From these papers I take the shape and size of default costs, which are exogenous in my model.

Others such as [Gennaioli et al. \(2014\)](#), [Perez \(2016\)](#), and [Mallucci \(2015\)](#) argue that the presence of domestic debt creates default costs through the disruption of financial intermediation. These papers assume households who are able to save and provide deposits to the financial sector. However, because they use one-sector models in which the law of one price holds, they effectively abstract from the aggregate demand effects I emphasize.

I build on models in which nominal rigidities in wage setting combined with an exchange rate peg create an aggregate demand externality ([Schmitt-Grohé and Uribe, 2016](#), and a large literature). [Anzoategui \(2017\)](#) combines wage rigidities and default risk to estimate what would have happened to Spain had it not imposed austerity measures in the crisis. The tradeoff emphasized in that paper is that austerity depresses aggregate demand but endogenously decreases the probability of a debt crisis. [Bianchi, Ottonello, and Presno \(2016\)](#) also think about fiscal multipliers in the presence of sovereign risk and they characterize the optimal policy in the presence of wage rigidities, where the government can affect the real exchange via the relative demand for traded and nontraded goods. Both papers abstract from the precautionary effects that are at the core of my argument by assuming that private domestic agents are unable to save.

In a similar line, [Arellano et al. \(2018b\)](#) consider a New Keynesian small open economy model where the government chooses its fiscal and default policy. They focus on the optimal fiscal policy without commitment when the Central Bank follows a simple Taylor rule and find that monetary contractions not only reduce inflation but also future sovereign risk.

Three other studies explicitly think about anticipation effects from sovereign risk: [Bocola \(2016\)](#), [Arellano et al. \(2018a\)](#), and [Balke \(2017\)](#). In the first paper, when the probability of default is high, banks attach a higher value to safe assets. They lose appetite for risk and charge firms a higher interest rate. Investment drops which depresses growth in a complementary way to the one explored here. Because it works through the supply side of the economy, this mechanism cannot by itself account for the savings pattern of households in the crisis. Moreover, this mechanism requires that banks be unable to raise equity, which is correct in the short run but less likely as time passes. In contrast, I

take the opposite stand that banks and institutional investors act as a veil for the nonfinancial private sector. This also highlights inequality within the private sector as a driver of the output response to sovereign risk.

[Arellano et al. \(2018a\)](#) assume the correlation between private borrowing costs and sovereign spreads and think about the consequences for investment. In a centralized economy, they find that negative TFP shocks that endogenously increase sovereign risk also induce lower investment, and that the fall is concentrated in the nontradable sector. The reason is that, even if the planner wants to invest less because returns are low, it tries to tilt investment towards traded goods, production of which is needed to service the debt. The authors show that the allocation can be decentralized using a rich enough taxation scheme. In two-digit sectoral data for Spain in the 2011 crisis, they find that investment did fall by more in sectors that rank lower in a measure of tradability. In [Balke \(2017\)](#), the same public-private correlation in borrowing costs constrains firms' ability to obtain working capital loans, which depresses vacancy posting and hence job creation.

[Philippon and Roldán \(2018\)](#) describe in a related but more stylized setting the possibility of expansionary austerity. There, austerity can ease the fears of unconstrained 'savers' and boost aggregate demand. In a calibration to the Eurozone, the direct contractionary impact negates expansionary austerity. They then focus on the optimal design of the sovereign deleveraging plan. [Romei \(2015\)](#) considers the distributional impact of different speeds of fiscal consolidation in the absence of aggregate demand effects. In a flexible-price model, [Cuadra et al. \(2010\)](#) argue that governments constrained by their own lack of commitment to future actions find it optimal to follow procyclical fiscal policies.

Part of how sovereign risk affects demand is because of redistribution. In this sense, I build on models such as [Eggertsson and Krugman \(2012\)](#), [Auclert \(2017\)](#), or [Korinek and Simsek \(2016\)](#), where shocks contract demand because they redistribute from high-MPC to low-MPC agents. A very similar idea is present here, except that the timing of transfers reverses the identities of low- and high-MPC agents.

I also relate to studies in which sovereign debt policy responds to distributional concerns, as has been emphasized since [Woodford \(1990\)](#) and [Aiyagari and McGrattan \(1998\)](#). The distributional focus here is on the distribution of MPCs, but distributional concerns will also feature in the government's objective function. [D'Erasmus and Mendoza \(2016\)](#) build a heterogeneous-agents model of sovereign default and find that levels of debt like those of present day Spain suggest a government with a bias towards favoring its creditors. [Ferriere \(2016\)](#) and [Ferriere and Navarro \(2017\)](#) argue for a positive link between progressive taxation on the one hand and incentives to repay sovereign debt and fiscal multipliers on the other. [Guembel and Sussman \(2009\)](#) and [Andreasen et al. \(2011\)](#) study political economy considerations in sovereign debt policy, while [Dovis et al. \(2016\)](#) find that, in an overlapping-generations economy, the tension between the ex-ante desire to promote savings and the ex-post temptation to redistribute by taxing capital can lead to 'populist cycles' of austerity and external debt-financed expansions.

**Layout** The remainder of the paper is organized as follows. Section 2 presents some motivating evidence. Section 3 describes the model while Section 4 defines the equilibrium and provides some intuition on the inner workings of the model. Section 5 discusses the calibration and Section 6 summarizes results from the model solution. Section 7 focuses on crises in the simulated model. Finally, Section 8 concludes.

## 2. MOTIVATING EVIDENCE

Figure 1 plots total GDP and households' consumption for Spain in the 2000s. To show each series in as raw a form as possible, I plot them relative to the value at the start of 2008. Output and consumption strongly contract during the crisis years. Moreover, consumption contracts more than output as the crisis unfolds. Figures 20 and 21 in the Appendix reinforce this point by showing that the same pattern appears in HP-detrended data and that it corresponds to an increase in the trade balance. Peak to trough, the declines in output and consumption are of about 10% and 15%. These numbers can be misleading as they include the effect of the Global Financial Crisis and the Spanish housing bust. Comparing the trough of the crisis to early 2011 to isolate the effect of sovereign risk as much as possible, the output and consumption contractions are of the order of 5% and 10%.

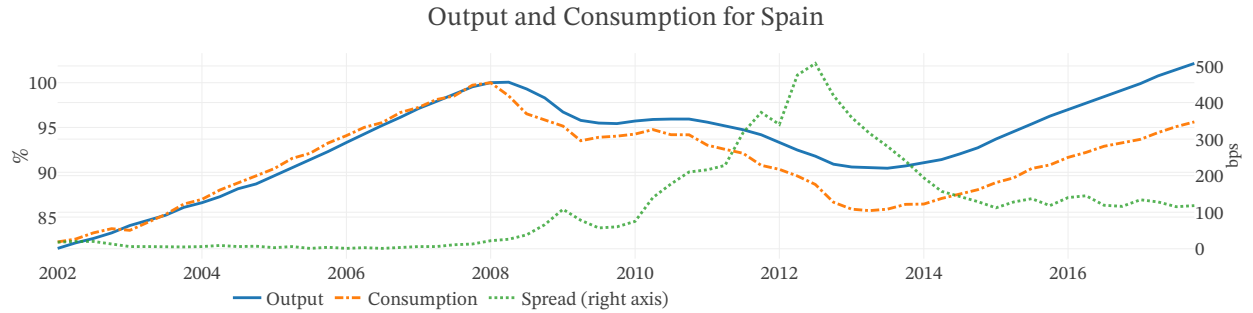


FIGURE 1: SPANISH OUTPUT AND CONSUMPTION IN THE 2000S

Table 6 in the Appendix replicates the volatility calculations from [Aguiar and Gopinath \(2007\)](#) using the Eurozone crisis data. For Spain and Portugal (and the Netherlands), the volatility of consumption is greater than the volatility of output, and the ratio of those volatilities is larger now than it was in [Aguiar and Gopinath's](#) data from the late 20th century. On the other hand, for countries that were mostly unscathed by the crisis (such as Austria, Belgium, Denmark, and Finland), the relative volatility of consumption remains low.

The case of Spain in the Eurozone crisis is of particular interest, as a default did not actually happen even though full repayment of government was uncertain during the period (see Figure 18 in the Appendix). Figure 16 shows that measures of slack in the Spanish economy increase significantly during the crisis in what looks like two phases, consistent with the private deleveraging followed by



sudden stop interpretation of [Martin and Philippon \(2017\)](#). The two phases are also noticeable as two separate instances of output contraction in Figure 1.

Finally, Figure 2 contains results from a Eurostat survey of Spanish firms who are asked about the reasons why they produce what they do and not more. For the proportion of firms reporting ‘demand’ as their main limiting factor, the same bimodal shape emerges, with slightly more firms reporting financial constraints in the sudden-stop phase. At the very least, the picture is suggestive that aggregate demand was low in the crisis when spreads were highest.

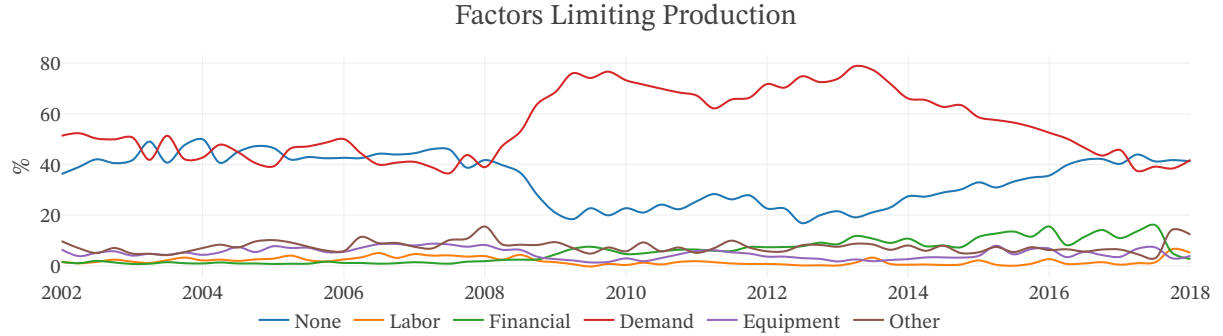


FIGURE 2: SPANISH FIRMS’ SELF-REPORTED LIMITS TO PRODUCTION

Source: Eurostat

## 2.1 Feedback

This section presents evidence of feedback between sovereign spreads and output. I use quarterly data for 11 European countries since 1996. Appendix C details the data sources. I am interested in estimating an equation like

$$Q_{jt} = \beta Spread_{jt} + \gamma X_{jt} + \mu_j + \delta_t + \epsilon_{jt} \quad (1)$$

for  $Q_{jt} = \log Y_{jt}, \log C_{jt}$ , where the  $X_{jt}$ ’s are controls and  $\mu_j$  and  $\delta_t$  are time and country fixed effects. Clearly, shocks that tend to make output or consumption drop also increase the spreads. This is, spreads are endogenous in equation (1), so some kind of exogenous variation is needed to estimate the causal effect.

I construct an instrument following [Martin and Philippon \(2017\)](#). I start by estimating the following auxiliary regression

$$Spread_{jt} = \underbrace{\bar{\sigma}_t \left[ \phi_0 + \phi_1 \frac{B_{j,t-12}}{Y_{j,t-12}} \right]}_{Z_{jt}} + \eta_{jt} \quad (2)$$

where the spread of country  $j$  in quarter  $t$  is predicted using the median spread in the Eurozone  $\bar{\sigma}_t$  and some exposure coefficients given by the debt-to-GDP ratios of country  $j$  three years before. The



fitted values  $\hat{Z}_{jt}$  are then used as instruments for the spreads in equation (1). This instrument captures the fact that some countries were likely to see their spreads increase by more in the crisis because of their past fiscal situation. Estimating a negative coefficient in this IV specification reflects that countries that saw their spreads increase more because of their earlier fiscal situation saw bigger output or consumption contractions in the crisis.

Table 1 summarizes the estimation of equation (1).

	<i>Dependent variable:</i>						
	$\log Y_{jt}$			$\log C_{jt}$			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Spread <sub>jt</sub>	−0.011*** (0.003)			−0.011*** (0.002)			
Spread <sub>jt</sub> (IV)		−0.048** (0.019)	−0.031 (0.024)		−0.088*** (0.022)	−0.035** (0.017)	−0.035** (0.016)
$R_{jt}^h$			0.049*** (0.011)			0.004 (0.007)	−0.009 (0.007)
$R_{jt}^s$			0.013 (0.046)				0.036 (0.031)
Model	OLS	IV	IV	OLS	IV	IV	IV
Country + Time FE	✓	✓	✓	✓	✓	✓	✓
Observations	968	968	540	968	968	540	540
Adj. $R^2$	0.995	0.994	0.997	0.997	0.993	0.999	0.999

Standard errors in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ . ECB borrowing rates available for AUT, BEL, DEU, ESP, FRA, IRL, ITA, NLD, PRT. 2003Q1 – 2017Q4

TABLE 1: FEEDBACK OF SPREADS AND MACRO OUTCOMES

Columns (2) and (5) report the benchmark IV estimates. An increase of 100bps in government spreads is associated with falls in output and consumption of almost 5 and 9 percentage points, respectively. These effects are not only large but also somewhat puzzling: the response of consumption is significantly larger, which seems at odds with consumption smoothing.

The remaining columns show the results of the same IV strategy but adding controls for some borrowing rates.  $R_{jt}^h$  and  $R_{jt}^s$  are indices of mortgage rates and rates for loans to small businesses, respectively, constructed by the ECB. I control for these rates to isolate the effect of the default probability on consumption, given a borrowing rate. Indeed, when government spreads increase, banks pass through these increases to their private borrowers as well (Bocola, 2016). When I include these controls, even though the coefficient on output becomes insignificant as fewer observations take out some of the power, and the coefficient on consumption becomes smaller (as expected), it is still the case that spreads affect consumption more than they do output.

To include these controls without reintroducing confounding, one needs to assume that the degree of pass-through is independent of economic conditions (the shocks that make output fall and spreads increase). Figure 19 in the Appendix shows these assumptions in a DAG. Finally, because the ECB rate indices are not available for all countries and years, Table 5 also reports the benchmark IV results for that subsample as well.

Finally, Anzoategui (2017) asks the question of what would have happened to the Spanish economy had the austerity plan of 2010 not been implemented. A model similar to the one here, but with a hand-to-mouth representative agent, is able to match key features of the crisis. In his interpretation, the sudden-stop phase of the Spanish crisis is explained by a combination of low government spending (the austerity plan), high risk premia from international investors (the sudden stop), and a large drop in productivity, concentrated in the nontradable sector.

One aim of this paper is to replicate the match to Spain's observed series for real activity, unemployment, and spreads. However, in my model two features could cause a recession: the precautionary effects and lack of aggregate demand I emphasize, or productivity. Comparing potential (or in other words, the part explained by productivity) to actual output measures the strength of the amplification channel.

### 3. MODEL

I consider a small open economy populated by a continuum of heterogeneous households, firms that produce tradable and nontradable goods, and a government. The key ingredients of the economy are an endogenous distribution of wealth that interacts with default risk and wage rigidities. There are incomplete markets and only two assets are traded: a one-period, risk-free private security and a long-term, non-contingent, defaultable government bond.

#### 3.1 Households

There is a continuum of heterogeneous households who differ in the realization of an insurable idiosyncratic shock to their 'effective' labor supply,  $\epsilon$ , as well as in their asset holdings. Let  $a$  and  $b$  denote holdings of the risk-free asset and of government debt, respectively. Households are limited in their ability to hold negative positions in these assets: it is impossible to short the government, and there is an ad-hoc lower bound  $\bar{a}$  on the risk-free asset. Respecting these restrictions, both assets trade at prices  $q^h$  and  $q^g$ .

Households value the consumption of traded and nontraded goods according to a CES aggregator

$$c = \left[ \varpi^{\frac{1}{\eta}} c_N^{\frac{\eta-1}{\eta}} + (1 - \varpi)^{\frac{1}{\eta}} c_T^{\frac{\eta-1}{\eta}} \right]^{\frac{\eta}{\eta-1}}$$

where  $\eta$  is the elasticity of substitution among the two goods. I assume an inelastic labor supply. Households have Epstein-Zin preferences over streams of consumption represented by the value function

$$v_t = \left( (1 - \beta) c_t^{\frac{\psi-1}{\psi}} + \beta \mathbb{E}_t [v_{t+1}^{1-\gamma}]^{\frac{\psi-1}{\psi(1-\gamma)}} \right)^{\frac{\psi}{\psi-1}}$$

where  $\beta$  is the discount factor,  $\gamma$  is the coefficient of risk-aversion and  $\psi$  is the inverse elasticity of intertemporal substitution.

In period  $t$ , households observe the aggregate state of the economy  $\mathbf{S}_t = (B_t, \lambda_t, \xi_t, \zeta_t, z_t)$ , comprised of total government debt outstanding  $B_t$ , the current distribution of households over their idiosyncratic states  $\lambda_t$ , the current value of a shock to sovereign spreads  $\xi_t$ , the current state of the country in international credit markets  $\zeta_t$ , and the current level of a productivity shock  $z_t$ . In equilibrium, this information is enough to recover the relative price of nontraded goods  $p_N(\mathbf{S}_t)$  and the current wage rate  $w(\mathbf{S}_t)$ , as well as the price of government debt  $q^g(\mathbf{S}_t)$ , lump-sum taxes  $T(\mathbf{S}_t)$ , firms' profits  $\Pi(\mathbf{S}_t)$ , and the price of consumption (CPI)

$$p_C = p_C(p_N) = \left[ \varpi p_N^{1-\eta} + (1 - \varpi) \right]^{\frac{1}{1-\eta}}$$

where the price of traded goods is normalized to  $p_T = 1$ .

The household's idiosyncratic states are the current level of its labor productivity  $\epsilon$  as well as the total value of its asset portfolio  $\omega_t = a'_{t-1} + R_{t-1,t}^b b'_{t-1}$ . I adopt the convention that the risk-free asset pays one unit of the traded good while the government bond yields a repayment  $R_{t-1,t}^b$  made of coupon payments and a resale value. Let  $\mathbf{s} = (\omega, \epsilon)$  denote the idiosyncratic state vector. Individual labor productivity follows an AR(1) process in logs so  $\log \epsilon_{t+1} = \rho_\epsilon \log \epsilon_t + \sigma_\epsilon \nu_{t+1}^\epsilon$ , where  $\nu_t^\epsilon \stackrel{\text{iid}}{\sim} \mathcal{N}(0, 1)$ .

Because of nominal rigidities (see below), there can be rationing in the labor market when labor demand falls short of supply. In that case, I assume that households are rationed proportionally so that everyone works the same amount of hours. These assumptions mean that a household with current shock  $\epsilon$  receives (pre-tax) labor income equal to  $y^L(\mathbf{s}, \mathbf{S}) = w(\mathbf{S})L(\mathbf{S})\epsilon$  at wage  $w$  and employment  $L$  in state  $\mathbf{S}$ , of which a fraction  $\tau$  is paid to the government as labor income taxes.

Households also receive income from ownership of the firms. I assume that this income is rebated lump-sum in proportion to the current value of the shock  $\epsilon$ . Because the integral of  $\epsilon$  is normalized to 1, households receive income  $y^\Pi(\mathbf{s}, \mathbf{S}) = \Pi(\mathbf{S})\epsilon$ .

The household's problem (3) summarizes the discussion above.

$$\begin{aligned}
v(\omega, \epsilon, \mathbf{S}) = \max_{a', b', c} & \left( (1 - \beta) c^{\frac{\psi-1}{\psi}} + \beta \mathbb{E} \left[ (v(a' + R_b(\mathbf{S}, \mathbf{S}')b', \epsilon', \mathbf{S}'))^{1-\gamma} \mid \omega, \epsilon, \mathbf{S} \right]^{\frac{\psi-1}{\psi(1-\gamma)}} \right)^{\frac{\psi}{\psi-1}} \quad (3) \\
\text{subject to } & p_C(p_N(\mathbf{S}))c + q^h(\mathbf{S})a' + q^g(\mathbf{S})b' = \omega + \ell(\mathbf{S})\epsilon - T(\mathbf{S}) \\
& \ell(\mathbf{S}) = w(\mathbf{S})L(\mathbf{S})(1 - \tau) + \Pi(\mathbf{S}) \\
& R_b(\mathbf{S}, \mathbf{S}') = 1_{(\zeta'=1)}\kappa + (1 - \rho) (1 - \hbar 1_{(\zeta=1) \cap (\zeta' \neq 1)}) q^g(\mathbf{S}') \\
& b' \geq 0 \\
& a' \geq \bar{a} \\
& \mathbf{S}' = \Psi(\mathbf{S}, \xi', \zeta', \zeta')
\end{aligned}$$

This problem is affected by the presence of sovereign risk in at least three distinct ways. An increase in default risk depresses expected future income, generates capital losses through movements in realized  $R_b$ , and worsens the savings technology by making expected  $R_b$  more negatively correlated with future income. Section 4.4 discusses these effects in detail.

The solution to the household's problem consists of policy function  $\phi_a, \phi_b, \phi_c : s \times \mathcal{S} \rightarrow \mathbb{R}$ . It is important to notice that the value function  $v(\mathbf{s}, \mathbf{S})$  describes a household *after* the government's default decision.

### 3.2 Firms

There are two types of firms that produce traded and nontraded goods. Their technologies are concave in labor and are given by

$$Y_{Nt} = f_N(z_t, \zeta_t) L_{Nt}^{\alpha_N} \quad (4)$$

$$Y_{Tt} = f_T(z_t, \zeta_t) L_{Tt}^{\alpha_T} \quad (5)$$

The functions  $f_i$  for  $i \in \{N, T\}$  describe productivity in both sectors. TFP depends on the productivity shock  $z_t$  and is reduced when the economy is in default. As a benchmark, I consider the case where the shock  $z_t$  only affects the production of traded goods

$$\begin{aligned}
f_N(z, \zeta) &= 1 - \Delta 1_{(\zeta \neq 1)} \\
f_T(z, \zeta) &= z (1 - \Delta 1_{(\zeta \neq 1)})
\end{aligned}$$

where  $\Delta$  is the output cost of default and  $\zeta = 1$  denotes good standing in international markets.

In equilibrium, firms in both sectors must pay the same wage. However, because of nominal rigidities, the wage  $w_t$  cannot fall below  $\bar{w}$ , as in [Bianchi et al. \(2016\)](#). When the constraint does not bind, the economy operates at full employment; otherwise, workers are rationed. This is a less than standard way of introducing nominal rigidities and is discussed in more detail in Section 4.5.

### 3.3 Fiscal policy

The government's policy determines three actions: whether to repay its current debt obligations in full, how much new debt to issue, and the level of lump-sum transfers it gives to households.

Government debt is long-term and pays an exponentially decaying coupon as in [Leland \(1998\)](#): a unit of face value purchased at  $t$  pays  $\kappa(1 - \rho)^{s-1}$  in period  $t + s$ . Therefore,  $(1 - \rho)$  units of debt purchased in period  $t$  are equivalent to 1 unit purchased in  $t - 1$ , which is useful to not have to keep track of the whole distribution of bonds of different maturities. Coupon payments are denominated in units of the traded good.

The government's policy consists of repayment and issuance strategies  $h'(\mathbf{S}, \xi', z'), B'(\mathbf{S})$ . The issuance strategy simply states how much new debt the government is issuing. On the other hand, the repayment strategy maps an aggregate state in  $t$  and a realization of shocks in  $t + 1$  into a probability of repayment.

When the government is in default (denoted by  $\zeta = 2$ ), coupon payments are interrupted. Holders of the debt can still trade it in the secondary market. Defaulted debt is valued as the government recovers access to markets with constant probability  $\theta$  each period. While in default, new debt cannot be issued (even if it would command a positive price), which restricts  $B'(\mathbf{S}_t) = (1 - \rho)B(\mathbf{S}_t)$  in default states.

The government's budget constraint (6) equates resources from (net) debt issuance and labor income taxes to expenditures given by coupon payments, government spending, and lump-sum transfers

$$\underbrace{q^g(\mathbf{S}_t)}_{\text{debt price}} \underbrace{(B'(\mathbf{S}_t) - (1 - \rho)B(\mathbf{S}_t))}_{\text{new debt issued}} + \underbrace{\tau w(\mathbf{S}_t)L(\mathbf{S}_t)}_{\text{income tax}} = \underbrace{\kappa 1_{(\zeta=1)}B(\mathbf{S}_t)}_{\text{coupon}} + \underbrace{g(\mathbf{S}_t)}_{\text{spending}} - \underbrace{T(\mathbf{S}_t)}_{\text{lump-sum}} \quad (6)$$

This budget constraint means that, given  $q^g(\mathbf{S}_t)$ , the government's choice of transfers  $T(\mathbf{S}_t)$  can be obtained as a residual from its issuance policy.

I assume that the government follows fiscal rules to determine consumption  $g_t$  and debt issuances  $B'_t$ . These are allowed to be a function of the whole state vector, and I calibrate them (see Section 5) to match observed correlations with key business cycles statistics. Finally, I assume that the government spends a constant fraction  $\vartheta_N$  of its expenditures on the nontraded good.

#### 3.3.1 Defaults and the evolution of debt

The repayment strategy of the government  $h'(\mathbf{S}_t, \xi_{t+1}, z_{t+1})$  specifies a repayment probability in each state of the following period. The government makes its default choice in period  $t + 1$  having observed the exogenous states  $(\xi_{t+1}, z_{t+1})$  and understanding which aggregate states  $\mathbf{S}_{t+1}$  result from repayment and from default. A small *iid* preference shock  $\xi^{def}$  orthogonal to all other variables plays the role of smoothing out the policy.

If there is a default in period  $t + 1$ , a haircut of  $\bar{h}$  applies to the debt of the government. This means that  $B(\mathbf{S}_{t+1}) = (1 - \bar{h})B'(\mathbf{S}_t)$ , whereas  $B(\mathbf{S}_{t+1}) = B'(\mathbf{S}_t)$  otherwise. When in default, there is a constant probability  $\theta$  of reentering financial markets.

The budget constraint (6) is designed to capture a particular tradeoff. When resources from tax collections and debt issuance are low (for instance, when spreads are high), the government chooses between default or low lump-sum transfers. I interpret this second option as an austerity plan (see Section 5 for a discussion).

### 3.4 Monetary policy

The small open economy defends a pegged exchange rate. Everywhere in the model, this assumption amounts to a normalization of the (constant) price of nontraded goods  $p_T \equiv 1$ . Importantly, I assume that the economy does not abandon the peg when it defaults.

### 3.5 Foreign borrowing and the external sector

I assume a large quantity of foreigners who have access to funds at a fixed international risk-free rate  $r^*$ . Immediately, this implies that

$$q^h(\mathbf{S}) = \frac{1}{1 + r^*} \quad (7)$$

Furthermore, if foreigners hold the government's debt in state  $\mathbf{S}$ , then by no arbitrage it has to be the case that

$$q^g(\mathbf{S}) = \frac{1}{1 + r^*} \mathbb{E} \left[ \underbrace{1_{(\zeta'=1)} (1 - \xi') \kappa}_{\text{coupon}} + \underbrace{(1 - \rho)}_{\text{depreciation}} \underbrace{(1 - \bar{h} 1_{(\zeta=1 \cap \zeta' \neq 1)})}_{\text{potential haircut}} \underbrace{q^g(\mathbf{S}')}_{\text{resale price}} \mid \mathbf{S} \right] \quad (8)$$

which reflects that debt is a claim to coupon payments while there is no default, that a default entails the haircut  $\bar{h}$ , and that the unmatured fraction  $(1 - \rho)$  of the bond can be resold in secondary markets. With respect to the coupon payments, I assume that foreigners price debt as if the coupon payment was  $(1 - \xi')\kappa$  where the stochastic process for  $\xi$  is constrained to remain within the interval  $(0, 1)$ . This assumption artificially depresses the price of government debt in order to match the home bias in holdings (see Section 4.3 for a discussion)

If the government was already in default at state  $\mathbf{S}_t$ , equation (8) specializes to

$$q^g(\mathbf{S} \mid \zeta \neq 1) = \frac{1}{1 + r^*} (\theta \mathbb{E} [1 - \xi' \mid \mathbf{S}] \kappa + (1 - \rho) \mathbb{E} [q^g(\mathbf{S}') \mid \mathbf{S}])$$

as the government reenters international markets with constant hazard  $\theta$  and it cannot default again while in the default state.

Equation (8) only holds when foreigners hold some of the debt. I assume that, as in the data, domestic demand for government debt always falls short of the total amount outstanding. I then check in simulation that this is the case.

When the small open economy is indebted with the rest of world, its consolidated intertemporal budget constraint states that the value of debt obligations must equal the expected discounted value of trade surpluses. If  $A, A^f, A^h$  denote the total amount of risk-free debt as well as those in hands of foreigners and domestic agents, respectively, and the same convention applies to government debt  $B$ , net foreign inflows are given by

$$\text{NFI}_t = \underbrace{q_t^h A_{t+1}^f + q_t^g (B_t^f - (1 - \rho)B_t^f)}_{\text{Capital inflows}} - \underbrace{(\kappa B_t^f + A_t^f)}_{\text{Capital outflows}} \quad (9)$$

where resources flow into the small open economy when domestic agents borrow from foreigners and when foreigners purchase debt. On the other hand, resources flow out when the government makes coupon payments to foreigners and when domestic agents repays their debts.

Because the distribution  $\lambda$  does not distinguish holdings of both assets separately, neither  $A_t$  nor its components are a function of the state variables  $\mathbf{S}_t$ . However, some manipulation allows to recast (9) in terms of flows as

$$\begin{aligned} \text{NFI}_t &= q_t^g B_t^f - (A_t^f + (\kappa + (1 - \rho)q_t^g)B_t^f) + q_t^h A_{t+1}^f \\ &= \int (\omega - q_t^h \phi_a - q_t^g \phi_b) d\lambda_t - \kappa B_t + q_t^g (B_t^f - (1 - \rho)B_t) \end{aligned}$$

where government debt held by foreigners equals  $B_t^f = B_t' - \int \phi_b d\lambda_t$ , private debt held by foreigners equals  $A_{t+1}^f = - \int \phi_a d\lambda_t$ , and  $\int \omega d\lambda_t = A_t^h + (\kappa + (1 - \rho)q_t^g)B_t^h$ .

Finally, market clearing requires that

$$Y_{Nt} = C_{Nt} + \frac{\vartheta_N}{p_{Nt}} G_t \quad \text{and} \quad Y_{Tt} + \text{NFI}_t = C_{Tt} + (1 - \vartheta_N) G_t \quad (10)$$

as net foreign inflows must equal the trade deficit.

### 3.6 Timing

Figure 3 summarizes the unfolding of events within a period. The past state is carried from the previous period. Then nature chooses the current level of TFP, the government decides its repayment (if it is not in default already), and foreign lenders set the price of all assets. At this point the distribution of agents is determined. The government then implements its issuance and transfer policies. Finally, firms choose employment and prices, the households make their consumption and savings choices, and the period ends.



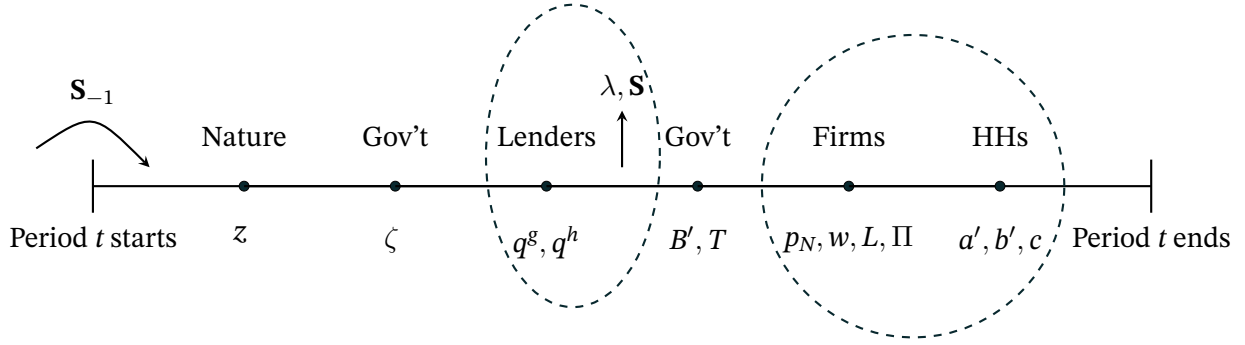


FIGURE 3: TIMELINE

Note: Dashed ellipses encircle simultaneous decisions

### 3.7 Evolution of the distribution

Before defining the equilibrium, I discuss a particular assumption that allows me to solve the model parsimoniously. In the exposition above, the state vector  $\mathbf{S}$  contains the whole distribution of agents across their idiosyncratic states, which is an infinitely-dimensional object. As is usual in heterogeneous-agents models, I proceed by solving for a bounded rationality equilibrium where agents only have limited knowledge of the distribution  $\lambda$ .

Specifically, I assume that agents believe the distribution of wealth and individual labor productivity to be jointly lognormal with

$$\begin{pmatrix} \omega_t \\ \epsilon_t \end{pmatrix} \sim \log \mathcal{N} \left( \begin{bmatrix} \mu_t \\ 0 \end{bmatrix}, \begin{bmatrix} \sigma_t & \rho_t \\ \rho_t & \sigma_\epsilon \end{bmatrix} \right) \quad (11)$$

where as of this writing, I further assume that  $\rho_t = 0$ .  $\mu_t$  and  $\sigma_t$ , however, vary over time and become state variables.

This assumption allows me to summarize  $\lambda_t$  with  $(\mu_t, \sigma_t, \rho_t)$ . As for the law of motion of the distribution, the household's policy functions need not imply that  $\lambda_{t+1}$  is exactly lognormal even if  $\lambda_t$  is. This is the key place where the approximation is taken, as I assume laws of motion for the distribution parameters.

Two approximations happen at once. The first is that I only solve for the equilibrium on a subset (the lognormal distributions) of the infinite dimensional space of all possible distributions. Bounded rationality really happens along the second approximation: whenever the policy functions imply a distribution that is not lognormal for the following period, I project it back onto the  $(\mu, \sigma, \rho)$  space by making all agents in the model expect a lognormal distribution with the same mean and variance than the one implied by the policies.

These approximations allow me to solve for the equilibrium of the model without the usual simulation step. Instead, I check in simulation that the agents' forecasting rule accurately predicts the dynamics of relevant variables.

Given all functions of the state (including the households' policy functions) and the current distribution, substituting  $\lambda_t$  for the corresponding lognormal in (12) yields a system for the joint evolution of the parameters of the distribution as well as the price of debt (which depends on the future distribution through the government's default incentives)

$$\begin{cases} R_b(\mathbf{S}_{t+1}) &= 1_{(\zeta_{t+1}=1)}\kappa + (1 - \rho)q^g(\mathbf{S}_{t+1}) \\ \int \omega d\lambda_{t+1} &= \int \phi_a(\mathbf{s}_t, \mathbf{S}_t) + R_b(\mathbf{S}_{t+1})\phi_b(\mathbf{s}_t, \mathbf{S}_t) d\lambda_t \\ \int \omega^2 d\lambda_{t+1} &= \int [\phi_a(\mathbf{s}_t, \mathbf{S}_t) + R_b(\mathbf{S}_{t+1})\phi_b(\mathbf{s}_t, \mathbf{S}_t)]^2 d\lambda_t \\ \int \omega \epsilon d\lambda_{t+1} &= \int [\phi_a(\mathbf{s}_t, \mathbf{S}_t) + R_b(\mathbf{S}_{t+1})\phi_b(\mathbf{s}_t, \mathbf{S}_t)] \epsilon' f(\epsilon_t, \epsilon') d\lambda_t \end{cases} \quad (12)$$

## 4. EQUILIBRIUM

### 4.1 Competitive equilibrium

**Definition** Given government policies  $h'(\mathbf{S}, \xi', z'), B'(\mathbf{S}), g(\mathbf{S})$ , and  $T(\mathbf{S})$  that satisfy its budget constraint (6), a *competitive equilibrium* consists of value and policy functions  $\{v, \phi_a, \phi_b, \phi_c\}(\mathbf{s}, \mathbf{S})$ , aggregates  $L_T(\mathbf{S}), L_N(\mathbf{S}), \Pi(\mathbf{S}), Y_N(\mathbf{S}), Y_T(\mathbf{S})$ , prices  $p_C(\mathbf{S}), p_N(\mathbf{S}), w(\mathbf{S}), q^g(\mathbf{S}), q^h(\mathbf{S})$ , and laws of motion for the distribution parameters  $\{\mu', \sigma'\}(\mathbf{S}, \xi', z'; h)$  such that

- The policy functions solve the household's problem (3) given prices, aggregates, and the law of motion for the distribution.
- The aggregates  $L_T(\mathbf{S}), L_N(\mathbf{S})$  maximize the firms profits given prices  $w(\mathbf{S}), p_N(\mathbf{S})$  and the quantities produced  $Y_N(\mathbf{S}), Y_T(\mathbf{S})$  satisfy the production functions (4, 5).
- Asset prices  $q^h(\mathbf{S})$  and  $q^g(\mathbf{S})$  satisfy the no-arbitrage conditions (7, 8).
- Market clearing
  1. in traded and nontraded goods (10)
  2. in labor: either  $w(\mathbf{S}) = \bar{w}$  or  $L_T(\mathbf{S}) + L_N(\mathbf{S}) = \int \epsilon d\lambda_{\mathbf{S}}$
- The laws of motion for the distribution parameters satisfy the consistency requirement (12).

### 4.2 The government's strategy

The government's objective is to maximize current welfare in the economy. I assume that it places equal weights on every agent. Without commitment, the government maximizes

$$\mathcal{W}(\mathbf{S}, h') = \int v(\mathbf{s}, \mathbf{S}) d\lambda_{\mathbf{S}}(\mathbf{s}) + 1_{(\zeta=1)} \sigma_g \xi^{def} \quad (13)$$

where  $\xi^{def} \stackrel{iid}{\sim} \mathcal{N}(0, 1)$  is a preference shock that serves the numerical purpose of smoothing the default policy. The government is subject to equilibrium conditions and its budget constraint, where the notation  $\lambda_{\mathbf{S}}$  emphasizes that the distribution is a part of the state  $\mathbf{S}$ . Importantly, the value function and the distribution correspond to the competitive equilibrium that results under the policy  $h'$ .

A policy  $h'$  for repayment is a part of an *equilibrium* if, at each  $(\mathbf{S}, z')$ , the probability of repayment satisfies

$$h'(\mathbf{S}, z') = \mathbb{P} \left( \sigma_g \xi^{def} \leq \underbrace{\mathcal{W}(\Psi(\mathbf{S}, \xi', z', \zeta' = 1), h')}_{\text{value under repayment}} - \underbrace{\mathcal{W}(\Psi(\mathbf{S}, \xi', z', \zeta' \neq 1, h'))}_{\text{value under default}} \right) \quad (14)$$

where  $\Psi(\mathbf{S}, \xi', z', \zeta') = \mathbf{S}'$  is the state that ensues when  $(\xi', z')$  are realized after  $\mathbf{S}$  and the government chooses a default state  $\zeta'$ . Equation (14) makes it clear that, after observing the realization of  $\xi'$  and  $z'$ , the government understands which state  $\mathbf{S}'$  results if it decides to default or to repay. This includes the level of debt remaining to be paid as well as the distribution induced in each case.

Section A.3 in the Appendix describes the solution method in detail.

#### 4.3 Euler equations and coupon payments

The Euler equation (15) determines a household's purchases of government bonds.

$$q^g(\mathbf{S}) \geq \beta \mathbb{E} \left[ \underbrace{R_b(\mathbf{S}, \mathbf{S}') \frac{p_C(\mathbf{S})}{p_C(\mathbf{S}')}}_{\text{real repayment}} \underbrace{\left( \frac{\phi_c(\omega', \epsilon', \mathbf{S}')}{\phi_c(\omega, \epsilon, \mathbf{S})} \right)^{-\frac{1}{\psi}}}_{\text{Intertemp. subs.}} \underbrace{\left( \frac{v(\omega', \epsilon', \mathbf{S}')}{\mathbb{E}[v(\omega', \epsilon', \mathbf{S}')^{1-\gamma} | \mathbf{S}]} \right)^{\frac{1}{\psi} - \gamma}}_{\text{Risk aversion}} \mid \mathbf{S} \right] \quad (15)$$

Comparing this equation with the pricing equation (8), it is immediate to infer that if  $\xi$  were equal to zero then the household would not buy too many government bonds. Being risk-averse, the household demands a risk premium to expose itself to the risk of the government. The shock  $\xi$  plays the role of creating a risk premium in the return of the government bond when compared to the return of the risk-free asset. This allows the model to match the high proportion of sovereign debt held by domestic agents in the data. Moreover, introducing  $\xi$  as a shock allows me to study the economy's response to increases in spreads that are not driven by changes in fundamentals of the domestic economy.

#### 4.4 The household's reaction to sovereign risk

There are at least three main ways in which sovereign risk affects the household's problem (3). The first effect concerns the aggregate income losses that happen in case of default. Conditional on default, TFP drops by  $\Delta$  in both sectors for a random amount of periods, which puts downward pressure on the

market-clearing wage. If the constraint becomes binding, then unemployment will increase. All else equal, expected labor income  $w(\mathbf{S})L(\mathbf{S})$  is lower in default than in repayment. In states with a higher default probability, the household consequently feels poorer and reduces consumption.

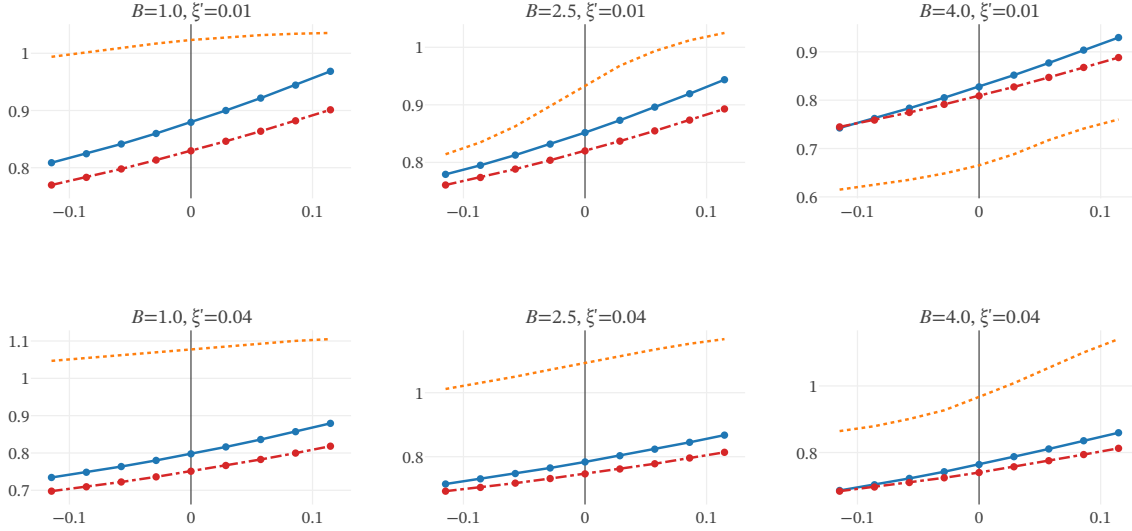


FIGURE 4: LABOR INCOME AND EXPECTED RETURNS

Note: Blue lines plot income in repayment, red dashed lines plot income in default, orange dotted lines plot the return of holding government debt

A second effect goes through the price of government bonds.  $q^g(\mathbf{S})$  reflects the default probability and shocks that make it increase also decrease the resale value of bonds. Households who purchased these bonds in the past make an immediate capital loss when  $q^g$  moves. In the aggregate, a distributional effect shifts the wealth distribution to the left when the default probability increases. The strength of this channel depends critically on the proportion of bonds held by domestic agents, as well as in the level of inequality in domestic bondholdings.

Finally, the household cares about the insurance properties of the government bond. Risk makes normal times very different from crisis times. Recall the return of a government bond

$$R_b(\mathbf{S}, \mathbf{S}') = 1_{(\zeta'=1)}\kappa + (1 - \rho) (1 - \hbar 1_{(\zeta=1) \cap (\zeta' \neq 1)}) q^g(\mathbf{S}')$$

In normal times, the variance of  $R_b$  is relatively low. Its variation comes mostly from variation in the future price  $q^g(\mathbf{S}')$ . However, as the default probability increases more and more of  $R_b$  becomes driven by variation in the repayment probability. Moreover, variation in repayment correlates with aggregate income as the government's incentive to default are larger in bad times. Hence, the conditional covariance between the bond return and the stochastic discount factor of households tends to be larger in crises. This feature makes the bond a bad hedge always but an even worse one when spreads are high.

Figure 4 shows future income and realized bond returns. Both the aggregate income losses and the savings technology effects are evident in the picture. Expected labor income is lower in default and decreasing in TFP, and the difference between default and repayment is increasing in TFP. Moreover, the variance of returns (as well as its covariance with income) increases with indebtedness.

#### 4.5 Wage rigidities and aggregate demand

When sovereign risk increases, the demand for consumption is likely to fall. This feeds back to the rest of the economy mainly through the market for nontraded goods.

In the market for traded goods, firms can supply whatever quantities they produce at the international price. Therefore, for a given wage rate  $w_t$  prevailing in the economy, traded goods-producing firms observe the current level of TFP and choose employment accordingly.

The market for nontraded goods features more action, which is summarized by its supply curve. To trace it out, suppose a decrease in the relative price of nontraded goods. According to their first-order condition (16), firms respond to this decrease by cutting down production.

$$L_N^d = \left( \alpha_N \frac{P_N}{\max\{w, \bar{w}\}} \right)^{\frac{1}{1-\alpha_N}} \quad (16)$$

When firms in the nontraded sector retract their production, they expell workers which pushes down the wage. In normal times, the wage falls and so some of these workers are absorbed by the traded goods producers while some others ‘return’ to work in the nontraded sector. When the constraint is binding, however, these second-round effects cannot happen: the fall in the price of nontradables results in an increase in the unemployment rate and in a larger fall in nontraded goods production.

Figure 5 makes this point by showing that the supply curve is flatter when the constraint on wages is binding. This means that when demand falls, quantities fall more and prices fall less than in normal times. Wage rigidities create price stickiness.

The introduction of wage rigidities in this paper departs from the traditional approach of [Schmitt-Grohé and Uribe \(2016\)](#). In it, the wage in period  $t$  is constrained be no less than  $\gamma_w w_{t-1}$ , where  $\gamma_w \leq 1$  is a parameter. I follow instead [Bianchi et al. \(2016\)](#) and set a constant lower bound  $\bar{w}$  on nominal wages. While both assumptions are similar, there are some advantages to the second formulation.

The first obvious advantage is that not having to carry the previous period wage saves one state variable. But there is a second advantage: in the traditional formulation good TFP shocks can be welfare-decreasing if they push the current wage rate too high and generate future unemployment. This is the ‘overborrowing’ externality emphasized by [Schmitt-Grohé and Uribe \(2016\)](#): individual households do not internalize that their consumption pushes up wages. In a scenario like this, where defaults also artificially depress TFP, a benevolent government might want to default on its debt only to suppress the overconsumption externality. This would lead to counterfactually many defaults in good times. If the government was allowed to choose spending and debt issuances, it would also use

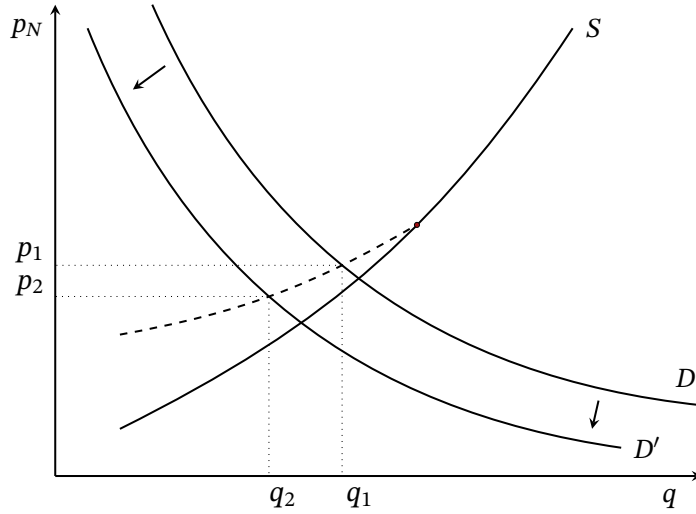


FIGURE 5: MARKET CLEARING IN THE NONTRADABLE SECTOR

fiscal policy to curtail the boom and probably would not need to default in these cases. However, I am constraining the government to follow fiscal rules. Hence, the admittedly less realistic constant lower bound on wages is preferred.

## 5. CALIBRATION

### 5.1 Fiscal rules

I estimate fiscal rules for government spending and issuances of new debt, using quarterly data for Spain. Data are taken from Eurostat and cover the period 1999Q1 to 2017Q4. In the model, government consumption and net issuances as fractions of GDP depend on the whole state vector, so in the data I regress those against endogenous variables.

Table 2 summarizes the results across various specifications. For each dependent variable, the first column contains the preferred specification. The second column contains simpler versions of the same regression.

The fit for both government consumption and debt issuances is good, with adjusted  $R^2$ s at 90% and 70%, respectively. Fiscal policy is countercyclical, with positive responses to unemployment for both spending and issuances. New issuances respond negatively to the debt-to-GDP ratio, consistent with debt stabilization.

Figure 6 shows the fitted values from the preferred specification. The predicted rules track the observed series closely. Clearly some of the fit is due to the inclusion of time fixed effects, which in the model version of the fiscal rule are absent. However I include the country fixed-effect coefficient for Spain as the intercept in the calibrated fiscal rules.

	$G_t/Y_t$		$(B'_t - (1 - \rho)B_t) / Y_t$	
	(1)	(2)	(3)	(4)
Unemployment <sub>t</sub>	0.031 (0.039)	0.073*** (0.015)	0.334** (0.158)	0.346*** (0.059)
Unemployment <sub>t</sub> <sup>2</sup>	0.002 (0.001)		0.0001 (0.006)	
$B_t/Y_t$	0.010* (0.005)	-0.017*** (0.002)	-0.010 (0.020)	0.009 (0.007)
$(B_t/Y_t)^2$	-0.0002*** (0.00004)		0.0001 (0.0001)	
Net Exports <sub>t</sub>	0.009 (0.019)	0.007 (0.012)	0.046 (0.075)	0.019 (0.046)
Net Exports <sub>t</sub> <sup>2</sup>	-0.0001 (0.001)		-0.001 (0.003)	
Mean FE	20.675	21.085	1.079	0.571
Country + Time FE	✓	✓	✓	✓
Observations	968	968	957	957
Adj. R <sup>2</sup>	0.904	0.901	0.697	0.698

Standard errors in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

TABLE 2: ESTIMATED FISCAL RULES



FIGURE 6: ESTIMATED FISCAL RULES



## 5.2 Model parameters

The full calibration of the model is still in progress. At this point I report parameters that are used to generate the figures in this draft as well as some targets that inform those quantities. I defer to the near future a discussion of how well the model can match the calibration targets.

Table 3 reports some critical parameter values. Because of the numerical complexity of the model, I rely on external calibration whenever possible. For the supply side of the economy, I closely follow Anzoategui (2017) and Stockman and Tesar (1995) and set preference parameters  $\varpi$  and  $\vartheta_N$  to match the shares of traded and nontraded goods in both private and public consumption, as well as the elasticity  $\eta$  to the elasticity of relative consumption demand.

The risk-free interest rate is set at a standard value in the literature. For the costs of default, I follow Philippon and Roldán (2018) and set the haircut and conditional TFP losses to a Greek-style default. The probability of reentry is set to give an expected duration of default of 25 quarters, on the lower end of Cruces and Trebesch (2013) estimation for large haircuts.

As for the household idiosyncratic income shocks process, I follow the estimation of D’Erasmus and Mendoza (2016) based on the Spanish income distribution for the same period that I study.

Table 4 provides details on the fit of the model. Statistics in the Model column come from a simulation of the benchmark model over 4000 quarters. I defer exhaustive comments on the ability of the model to fit the observed quantities until the calibration is complete.

## 6. RESULTS

Figure 7 shows the policy and value functions of a household. The bottom panels show the total value of savings  $q^h\phi_a(\mathbf{s}, \mathbf{S}) + q^g(\mathbf{S})\phi_b(\mathbf{s}, \mathbf{S})$  and the proportion of those that correspond to the risk-free bond.

**Fig 7 HERE**

FIGURE 7: HOUSEHOLD’S VALUE AND POLICY FUNCTIONS

Figure 7 captures the fact that as households become richer they get more risk-tolerant and more willing to hold government bonds as part of their savings.

### 6.1 Government policy

Figure 8 shows the government’s value function  $\mathcal{W}(\Psi(\mathbf{S}, \xi', \mathbf{z}', \zeta'), h')$  of the following period as function of the realization of shocks. Each panel shows welfare as a function of next period’s TFP realization  $\mathbf{z}'$ . The first row corresponds to a low realization of  $\xi'$ , while in the second row spreads are high. Finally, the columns consider different  $\mathbf{S}$  for the *current* period: initial debt increases from left to right. Higher debt levels increase the value of default relative to repayment. For intermediate amounts of

Description	Parameter	Value	Source / Target
<b>Debts and defaults</b>			
Risk-free rate	$r^*$	4% ann.	<a href="#">Anzoategui (2017)</a>
Haircut in case of default	$\bar{h}$	50%	<a href="#">Philippon and Roldán (2018)</a>
TFP loss in case of default	$\Delta$	10%	<a href="#">Philippon and Roldán (2018)</a>
Reentry probability	$\theta$	0.04	<a href="#">Cruces and Trebesch (2013)</a>
<b>Traded and nontraded goods</b>			
Share of nontraded in prod	$\varpi$	0.7397	<a href="#">Anzoategui (2017)</a>
Labor share in prod	$\alpha_N, \alpha_T$	0.67	<a href="#">Anzoategui (2017)</a>
Share of nontraded in $G$	$\vartheta_N$	88%	<a href="#">Anzoategui (2017)</a>
Elasticity of nontraded consumption	$\eta$	0.74	<a href="#">Anzoategui (2017)</a>
<b>Idiosyncratic income</b>			
Persistence log $\epsilon_{it}$	$\rho_\epsilon$	0.978	<a href="#">D'Erasmus and Mendoza (2016)</a>
Std. deviation log $\epsilon_{it}$	$\sigma_\epsilon$	0.022	<a href="#">D'Erasmus and Mendoza (2016)</a>
<b>Internally calibrated</b>			
Discount rate of HHs	$1/\beta - 1$	5.1% ann.	Moments in Table 4
Risk aversion	$\gamma$	10.775	Moments in Table 4
Progressivity of tax schedule	$\tau$	16.1%	Moments in Table 4
Wage minimum	$\bar{w}$	1.186	Moments in Table 4
TFP process	$\rho_z, \sigma_z$	(0.896, 0.025)	Moments in Table 4
Mean risk premium	$\bar{\xi}$	2.3%	Moments in Table 4
Risk premium AR(1)	$\rho_\xi, \sigma_\xi$	(0.952, 0.003)	Moments in Table 4

TABLE 3: PARAMETER VALUES

Target	Model	Data
AR(1) coef $\log(Y_t)$	0.997	0.966
Std coef $\log(Y_t)$	0.0276	0.0129
AR(1) coef $\log(C_t)$	0.996	0.962
Std coef $\log(C_t)$	0.0147	0.0166
AR(1) coef spread	0.954	0.967
Std coef spread	0.153	0.103
Avg Debt-to-GDP	57.1%	64.6%
Std Debt-to-GDP	31.8%	23.5%
Avg unemployment	17%	15.9%
Std unemployment	5.06%	6.09%
Median domestic holdings	110%	56.49%
Avg wealth-to-GDP	60.6%	94.48%

All data from Eurostat 2000Q1:2017Q4, except private consumption from OECD 2000Q1:2017Q4, domestic holdings from Banco de España, 2004Q1:2017Q4

TABLE 4: MODEL FIT

initial debt, moreover, a higher realization of future TFP raises the relative value of repayment. Higher spreads also raise the relative value of default.

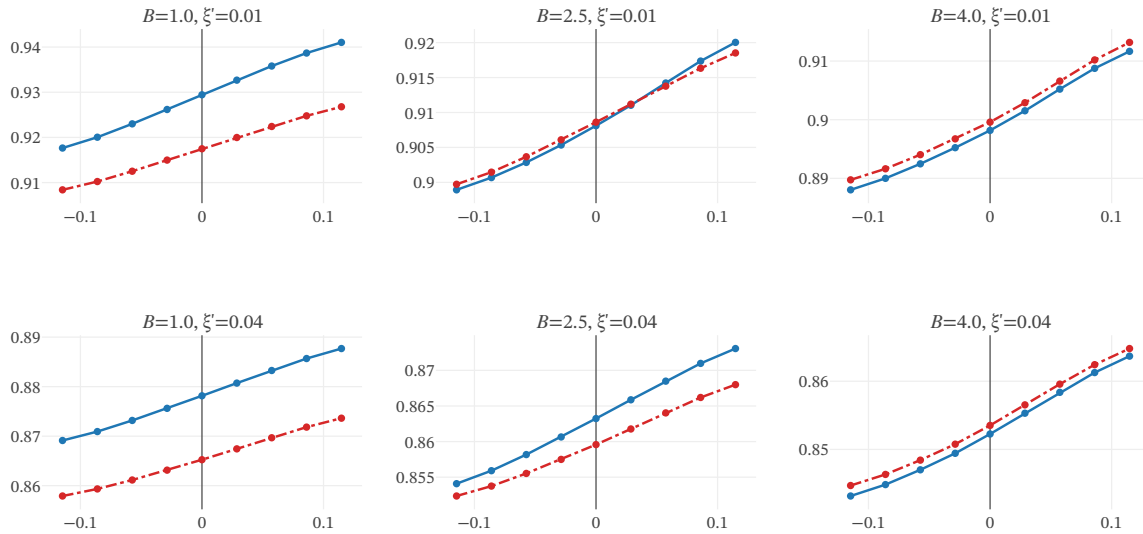


FIGURE 8: WELFARE FUNCTIONS

Note: Blue lines plot the value of repayment, red dashed lines plot the value of default

Figure 9 shows the lump-sum transfers that would clear the government's budget constraint in

states  $\Psi(\mathbf{S}, \xi', z', \zeta')$  of next period, as a function of  $(\xi', z', \zeta')$ . Unsurprisingly, high levels of indebtedness shrink the government budget constraint and force it to collect high lump-sum taxes. In repayment, a higher level of future TFP induces high lump-sum taxes as well. This effect is driven by relatively low unemployment in those states, which leaves room for the government to reduce its leverage.

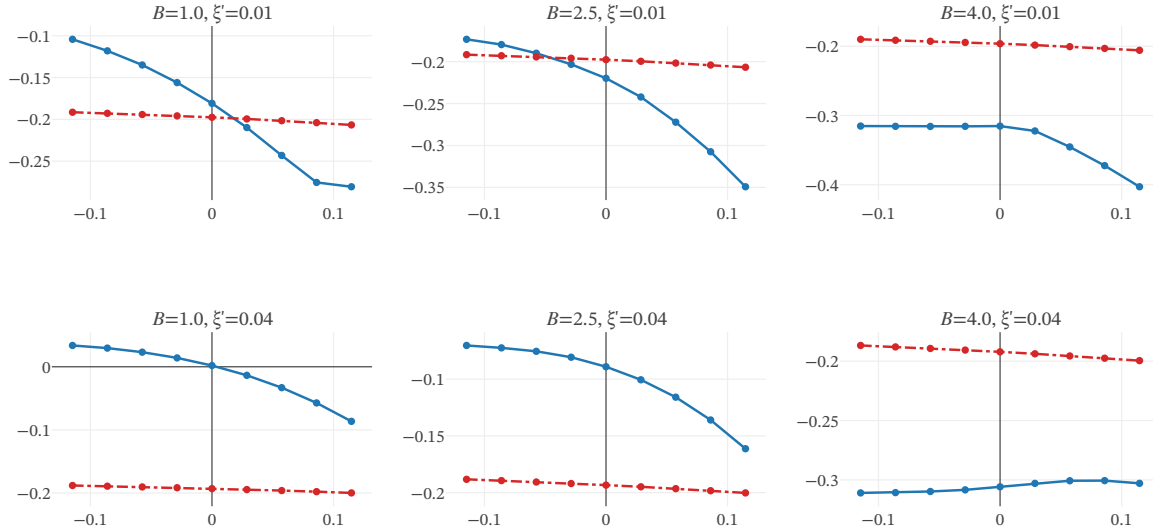


FIGURE 9: TRANSFERS

Note: Blue lines plot transfers in repayment, red dashed lines plot transfers in default

Figure 10 shows the price of debt  $q^g(\mathbf{S})$  at different states  $\mathbf{S}$ . The left panel shows that spreads rise (the price of debt falls) steeply when debt reaches a certain threshold. The effect of TFP is less stark but higher values of  $z$  are associated with lower spreads. Both of these are taken for a fixed distribution when the economy is not in default.

The right panel shows the impact of the distribution (for fixed values of  $B$  and  $z$  when the economy is not in default). Higher spreads occur when the economy is poorer and more unequal. This is because the value of autarky depends strongly on how rich the economy is: with lower aggregate wealth, more agents are close to their borrowing limit and would suffer from the loss in TFP (and hence wages and employment) that follows a default. The effect of variance also goes through the value of autarky but through a different channel: when inequality is greater, defaults become a better way to redistribute.

## 6.2 Macroeconomic conditions

The unemployment rate is shown in Figure 11. Unemployment decreases with productivity and increases with government debt. The right panel shows that unemployment is related negatively to total wealth and positively to inequality.



FIGURE 10: PRICE OF DEBT

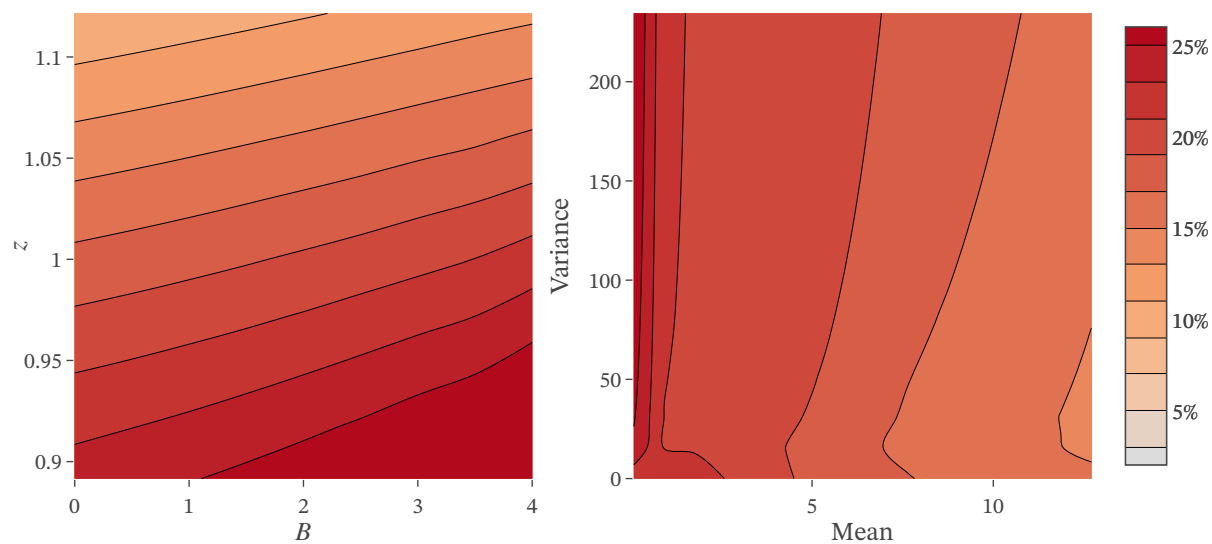


FIGURE 11: UNEMPLOYMENT

Figure 15 in Appendix A.4 shows some other endogenous functions of the state. The real exchange rate appreciates (the price of nontradables increases) when debt and productivity in tradables are lower. TFP in tradables also tends to increase the real (as well as nominal) wage as it increases labor demand (and profits).

## 7. CRISES

To investigate the effect of sovereign risk in the model economy, I simulate the model solution for 2000 years and study episodes of crisis in the simulation. I define an episode of high spreads as a period when the price of debt has been below the bottom quartile of its distribution for the past six quarters but a default did not actually happen during that time.

Figure 12 plots endogenous variables around episodes of high spreads. Time is measured in years so spreads are high between times  $-1.5$  and  $0$ . TFP, output, and consumption are significantly below their normal times values. At the same time, unemployment is high and the mean and variance of the wealth distribution are decreasing, consistent with agents finding lower-than-expected debt prices each period. Output hits a minimum of about 10% below its long-run mean, while TFP reaches about  $-8\%$  at the trough of the episode. As TFP really only affects the traded sector (which is about 20% of the economy), this is a sizeable amplification. This happens while the fiscal side of the economy is contributing very marginally to the shock: lump-sum taxes increase by less than a percent of mean GDP. Finally, in this simulation the proportion of domestic debt held by domestic agents is still too low, as the value of  $\xi$  seems insufficient to sustain holdings of debt in the crisis. However, in a calibration in which more of the debt is held domestically, an even larger response of consumption is to be expected.

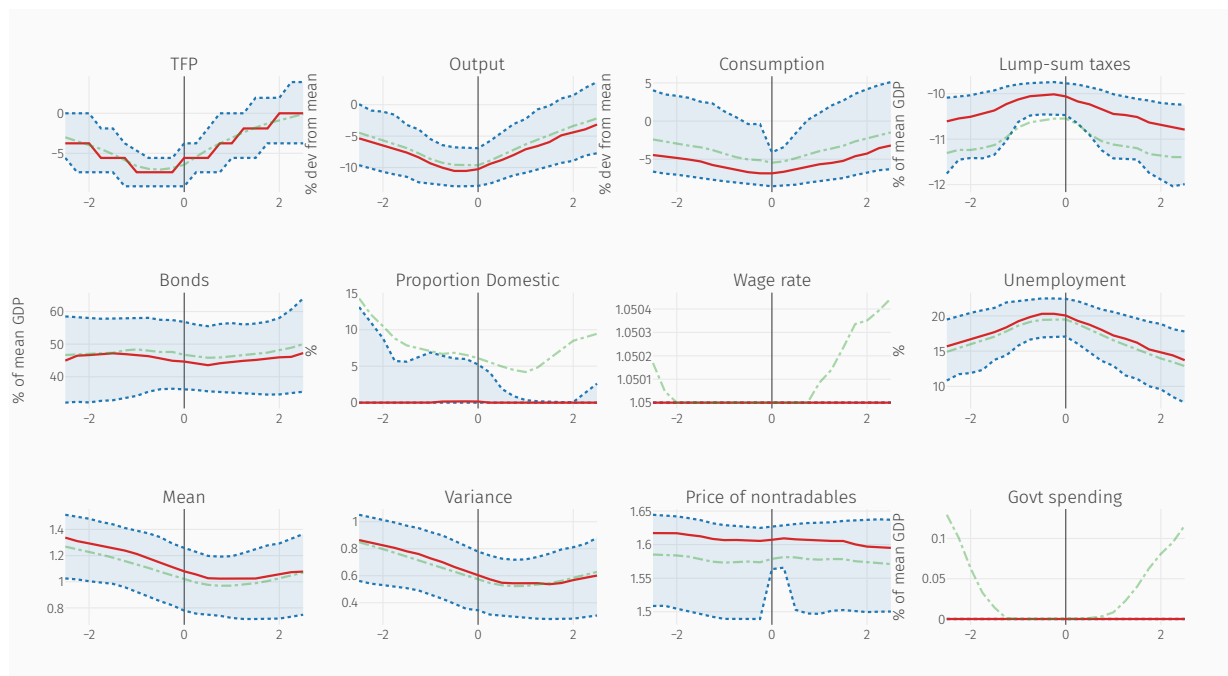
Figure 13 shows events in 2.5-year windows around the default episodes in the same simulation for comparison.

### 7.1 Amplification forces in the crisis

Figure 14 takes the same episodes of high spreads analyzed earlier and compares them with different alternative comparison models. All the comparison models feature the same policy for government default as the benchmark: they are designed to show how the private economy would react in a world where the *consequences* of default were different.

The first comparison model I consider is one in which defaults carry no aggregate losses. By setting  $\Delta$  to zero, TFP in case of default does not fall and neither does expected income when sovereign risk increases.

The second model sets  $\bar{h}$  to zero, meaning that default risk does not particularly worsen the savings technology. Without a haircut, the correlation between aggregate income and the bond return is significantly dampened. However, the bond price still moves at it does in the benchmark. Comparing



**FIGURE 12: TIMES OF HIGH SPREADS**

Red: Median, Shaded blue: [0.25, 0.75] percentiles, Dashed green: Mean

**Fig 13 HERE**

**FIGURE 13: OUTCOMES AROUND DEFAULTS**

Red: Median, Shaded blue: [0.25, 0.75] percentiles, Dashed green: Mean



this model with the benchmark then provides a lower bound on the strength of the savings technology channel. In the Appendix I discuss alternative implementations.

Fig 14 HERE

FIGURE 14: AMPLIFICATION CHANNELS

Red: Benchmark, Blue: No aggregate losses, Orange: No haircut, Green: No capital losses

Finally, in the third comparison model I shut down capital losses and the mechanical redistribution generated by bond price movements. To do this, I keep all the policies of the benchmark model but change the laws of motion of the distribution. In this comparison model, the distribution moves ‘as if’ in each period  $t$  bond prices were at their previous expected value of  $\mathbb{E}[q^g(\mathbf{S}_t)|\mathbf{S}_{t-1}]$ .

## 8. CONCLUDING REMARKS

Inspired by events in the Eurozone crisis, this paper analyzes a model in which the households’ consumption demand is negatively affected by the presence of sovereign risk. The mechanisms in the model seem capable of generating substantial amplification of underlying shocks. At the time of this writing, prominent tasks for the near future include the improvement of the model’s calibration and the comparative exercises laid out at the end of section 7. These will quantitatively assess the strength of each of the sources of amplification emphasized in the paper.

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## A. SOLUTION DETAILS

### A.1 Demand curves for nontraded goods

On the equilibrium path, the relative price of nontradables  $p_N$ , the wage rate  $w$ , and the firms' profits are exact functions of the aggregate state  $\mathbf{S}$ . Off-path, however, I need to keep track of the households' decisions at other possible values of  $p_N$  ( $w$ ,  $T$ , and  $\Pi$  can be pinned down as a function of  $p_N$  to ensure clearing of the labor market), under the assumption that such discrepancies are temporary. To allow for this, I explicitly consider the problem of the household when faced with an off-path price  $p_N$  in state  $\mathbf{S}$ .

The household's problem faced with surprising prices  $p_N$  is

$$\begin{aligned} \tilde{v}(\omega, \epsilon, \mathbf{S}, p_N) &= \max_{a', b', c} \left( (1 - \beta)c^{\frac{\psi-1}{\psi}} + \beta \mathbb{E} \left[ (v(a' + R_b(\mathbf{S}')b', \epsilon', \mathbf{S}'))^{1-\gamma} \mid \omega, \epsilon, \mathbf{S} \right]^{\frac{\psi-1}{\psi(1-\gamma)}} \right)^{\frac{\psi}{\psi-1}} \\ \text{subject to } p_C(p_N)c + q^h(\mathbf{S})a' + q^g(\mathbf{S})b' &= \omega + \ell(\mathbf{S}, p_N)\epsilon - T(\mathbf{S}, p_N) \\ \ell(\mathbf{S}, p_N) &= w(\mathbf{S}, p_N)L(\mathbf{S}, p_N)(1 - \tau) + \Pi(\mathbf{S}, p_N) \\ R_b(\mathbf{S}) &= 1_{(\zeta=1)}\kappa + (1 - \rho)q^g(\mathbf{S}) \\ b' &\geq 0 \\ a' &\geq \bar{a} \end{aligned}$$

The solution to the household's problem yields a policy function  $\tilde{\phi}_c : (\omega, \epsilon, \mathbf{S}, p_N) \mapsto \mathbb{R}$  for consumption. Total (private) demand for nontraded goods is then given by

$$D_N^h(\mathbf{S}, p_N) = \varpi \left( \frac{p_N}{p_C(p_N)} \right)^{-\eta} \int \tilde{\phi}_c(\mathbf{s}, \mathbf{S}, p_N) d\lambda_{\mathbf{S}}(\mathbf{s})$$

### A.2 The household's problem

To make the problem more tractable, I rewrite the controls in a way that eliminates the budget constraint and replaces it with inequalities that are easier to handle. Let

$$\begin{aligned} s &= q^h(\mathbf{S})a' + q^g(\mathbf{S})b' && \geq q^h \bar{a} \\ \theta_a &= \frac{q^h(\mathbf{S})(a' - \bar{a})}{s - q^h(\mathbf{S})\bar{a}} && \in [0, 1] \end{aligned}$$

where the constraint set (now a rectangle) is highlighted in red and

$$a' = \bar{a} + \theta_a \frac{s - q^h \bar{a}}{q^h}$$

$$b' = (1 - \theta_a) \frac{s - q^h \bar{a}}{q^g}$$

### A.3 Solution method

The algorithm follows closely the definition of equilibrium: to solve for an equilibrium, I solve a series of nested problems. Given government policies, I find a competitive equilibrium by finding functions of the aggregate state that describe the aggregates in the economy, in such a way that they are consistent with the household problem and policy functions.

**Algorithm** Given a policy for the government, I

1. Guess a law of motion for the distribution.
2. For each state  $\mathbf{S}$ 
  - (a) Compute  $q^g(\mathbf{S})$  from the foreigners' sdf (8).
  - (b) Guess a relative price of nontradables  $p_N$ 
    - Get the wage rate  $w$  as well as total labor demand  $L^d$  and profits of the firms  $\Pi$ .
    - Compute lump-sum taxes  $T$  from gov't budget constraint (with  $\tau wL$  in hand).
    - Solve the household's problem at prices  $w, p_N$ , profits  $\Pi$ , and transfers  $T$ .
    - Check market clearing (10) for nontraded goods.
  - (c) Iterate on the function  $p_N(\mathbf{S})$  to convergence
3. Iterate on the law of motion for the distribution using the households' policy functions.

Finally, I update the government's policy according to (14) and iterate until a policy that respects it is found.

### A.4 More model results

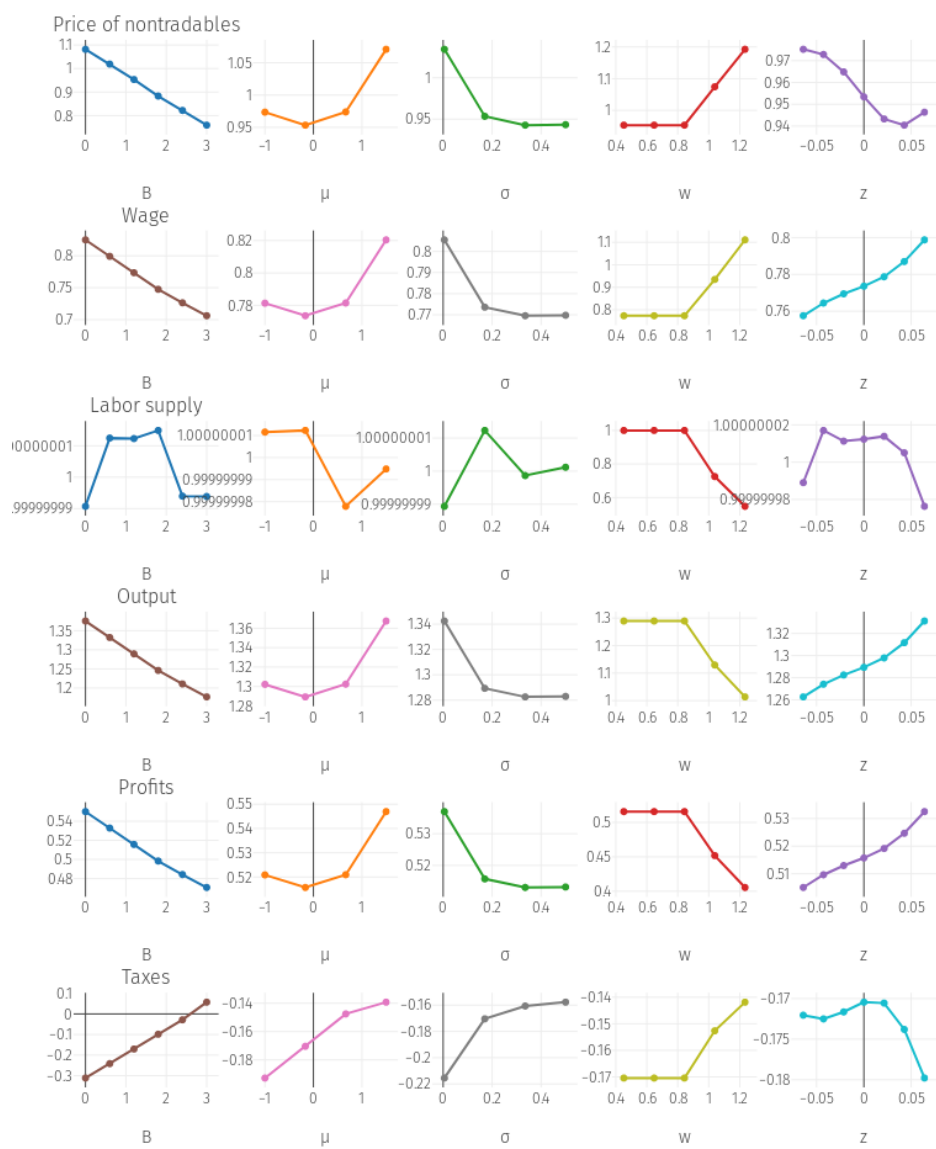


FIGURE 15: STATE FUNCTIONS

## B. SOME EXTRA EVIDENCE

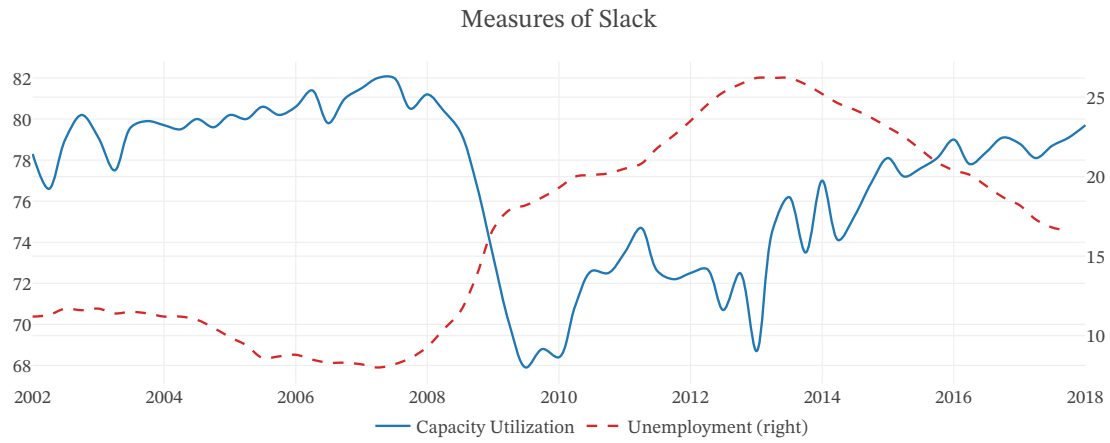


FIGURE 16: SLACK IN THE SPANISH ECONOMY

Source: Eurostat

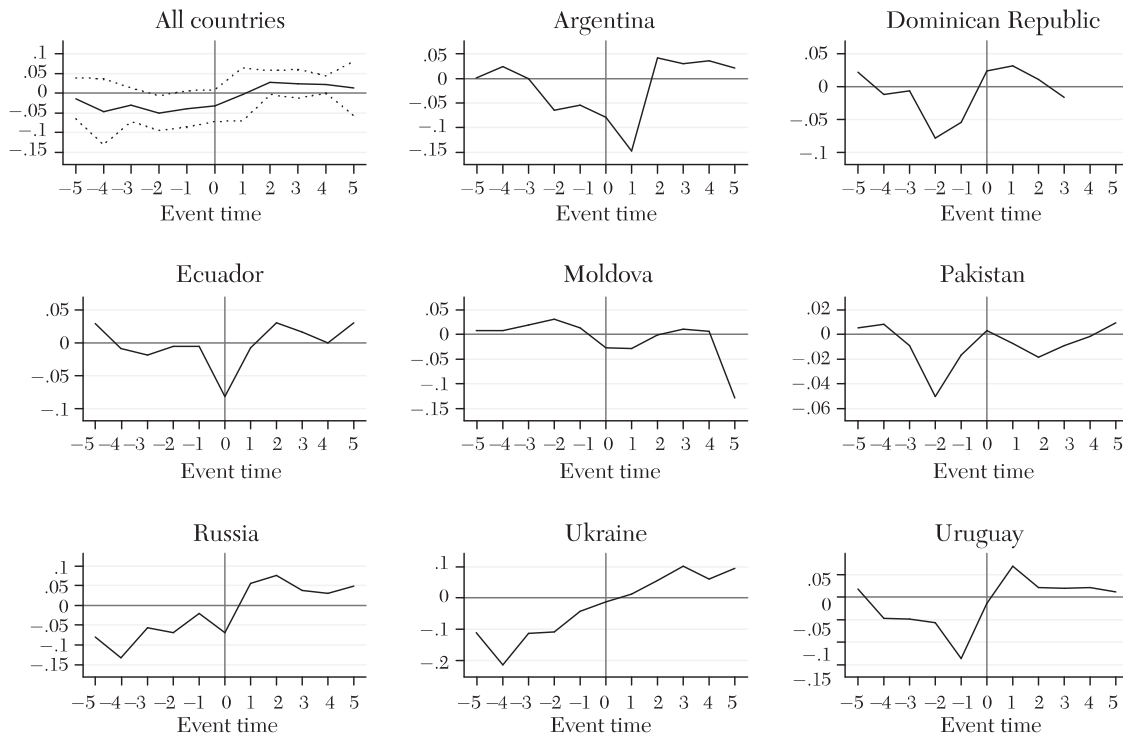


FIGURE 17: DEFAULTS AND OUTPUT GROWTH

Source: [Panizza et al. \(2009\)](#)





FIGURE 18: SPREAD OF SPANISH 10-YEAR GOVERNMENT BOND AGAINST 10-YEAR GERMAN BUND

Source: Eurostat

<i>Dependent variable:</i>										
<hr/>										
<hr/>										
	$\log Y_{jt}$					$\log C_{jt}$				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$\text{Spread}_{jt}$	-0.011*** (0.003)					-0.011*** (0.002)				
$\text{Spread}_{jt} \text{ (IV)}$		-0.048** (0.019)	-0.108 (0.074)	-0.031 (0.023)	-0.031 (0.024)		-0.088*** (0.022)	-0.040 (0.027)	-0.035** (0.017)	-0.035** (0.016)
$R^h_{jt}$				0.054*** (0.010)	0.049*** (0.011)			0.004 (0.007)		-0.009 (0.007)
$R^s_{jt}$					0.013 (0.046)					0.036 (0.031)
<hr/>										
Model	OLS	IV	IV	IV	IV	OLS	IV	IV	IV	IV
Country + Time FE	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Observations	968	968	540	540	540	968	968	540	540	540
Adj. $R^2$	0.995	0.994	0.988	0.997	0.997	0.997	0.993	0.998	0.999	0.999

Standard errors in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

TABLE 5: FEEDBACK OF SPREADS AND MACRO OUTCOMES

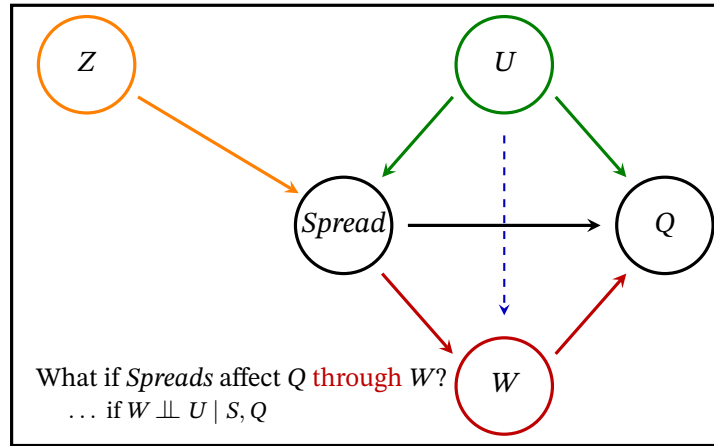


FIGURE 19: ASSUMPTIONS FOR TABLE 1

	$\sigma(C)$	$\sigma(Y)$	$\sigma(C)/\sigma(Y)$	$\sigma(C)/\sigma(Y)$ (AG)
Austria	0.716	0.782	0.916	0.870
Belgium	0.556	0.795	0.700	0.810
Denmark	1.047	1.178	0.889	1.190
Finland	1.278	1.957	0.653	0.940
France	0.780	0.773	1.009	–
Germany	0.692	0.867	0.799	–
Ireland	3.140	3.680	0.853	–
Italy	1.165	0.978	1.191	–
Netherlands	1.726	1.244	1.388	1.070
Portugal	1.827	1.576	1.160	1.020
Spain	1.901	1.396	1.362	1.110

Series logged and HP-filtered with  $\lambda = 1600$ . Std deviations in %.

TABLE 6: THE CYCLE IS THE TREND

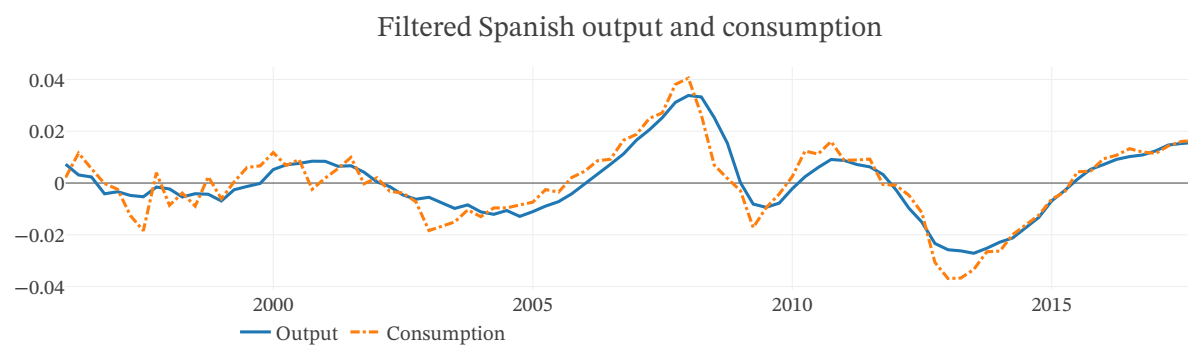


FIGURE 20: SPANISH DETRENDED OUTPUT AND CONSUMPTION IN THE 2000S

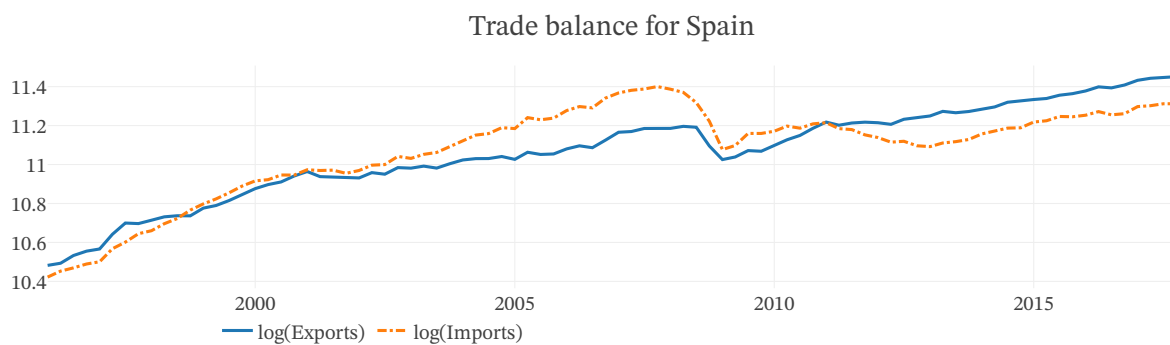


FIGURE 21: SPANISH TRADE BALANCE IN THE 2000S

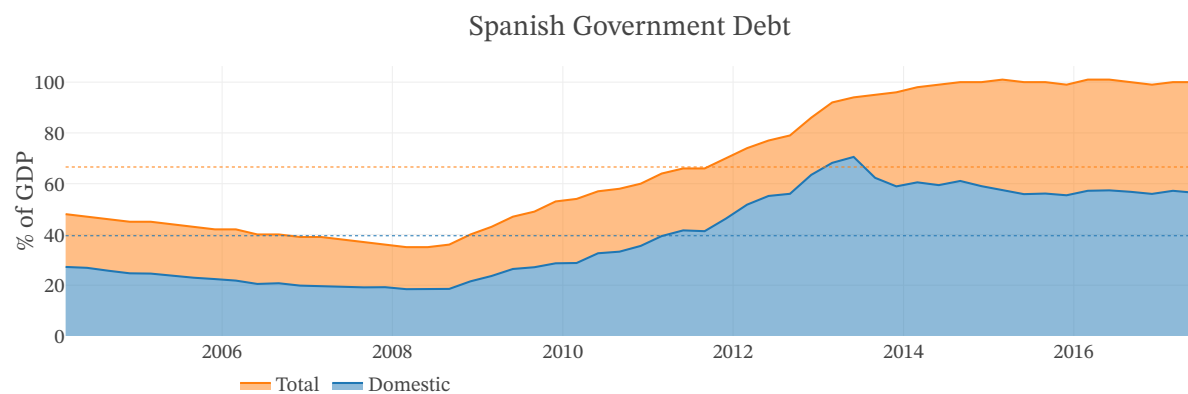


FIGURE 22: COMPOSITION OF SPANISH DEBT

Dotted lines show average levels

### C. DATA SOURCES

Variable	Source	Coverage	Code
GDP	Eurostat	1996Q1:2017Q4	namq_10_gdp
HH Consumption	OECD	1996Q1:2017Q4	
Imports	Eurostat	1996Q1:2017Q4	namq_10_gdp
Exports	Eurostat	1996Q1:2017Q4	namq_10_gdp
Government Spending	Eurostat	1996Q1:2017Q4	namq_10_gdp
Government Debt	Eurostat	1996Q1:2017Q4	gov_10q_ggdebt
Interest Rate on Gov't Bonds	Eurostat	1996Q1:2017Q4	irt_lt_mcby_q
Unemployment	Eurostat	1996Q1:2017Q4	une_rt_q
Spain's Debt Composition	Banco de España	2004Q1:2017Q4	

TABLE 7: DATA SOURCES