

Sovereign-Risk Doom Loops in the Post-Pandemic Era

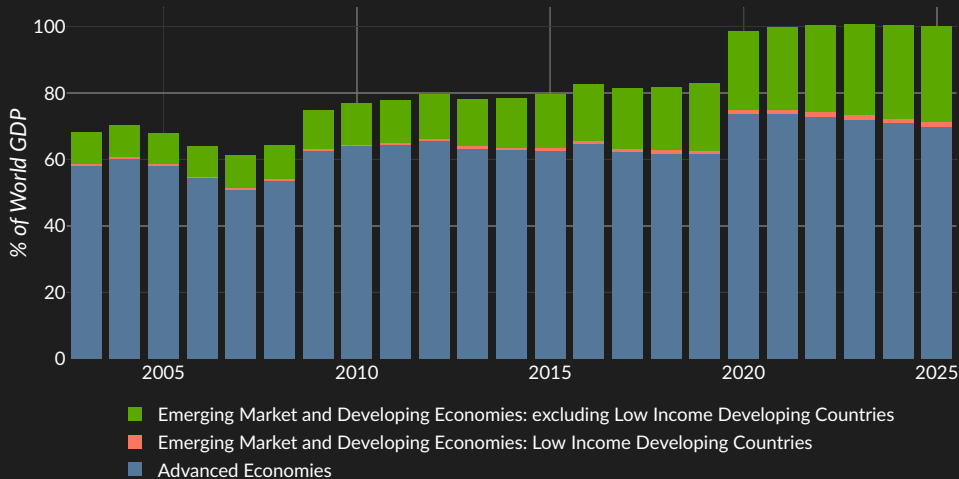
Francisco Roldán
RES

iLab Spark Series
December 2020

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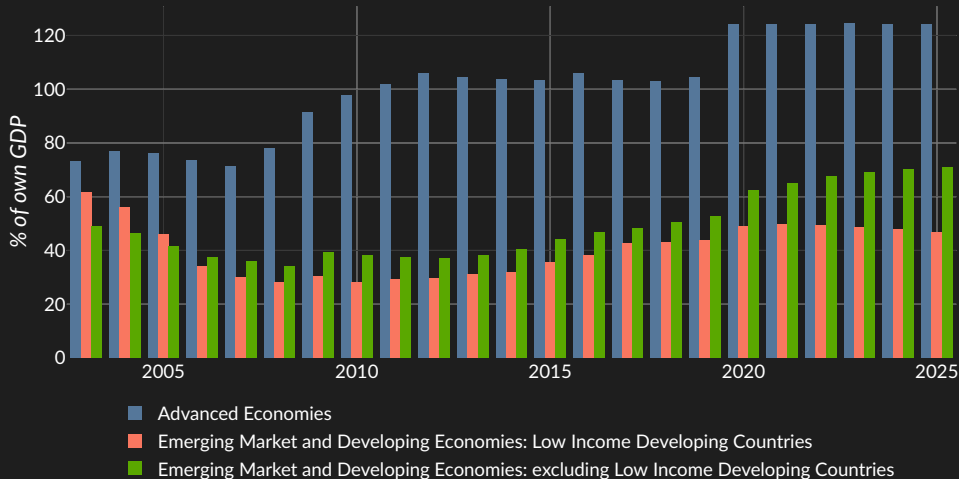
Large increases in debt to fight Covid-19 worldwide

Government debts globally (WEO Oct 2020)



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But

- Can sovereign risk be at the center of the next **wave** of crises?
- Recent research has learned from the experience of the **euro** crisis
 - With an eye for *mitigating* or *amplifying* factors

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Costs of sovereign risk

- Three sources of costs of sovereign risk

Fiscal
deterioration

Aggregate
demand

Investment

Even without default!

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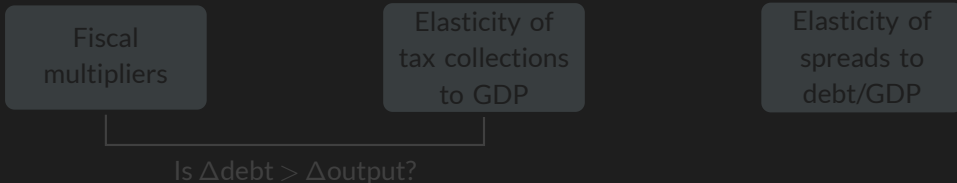
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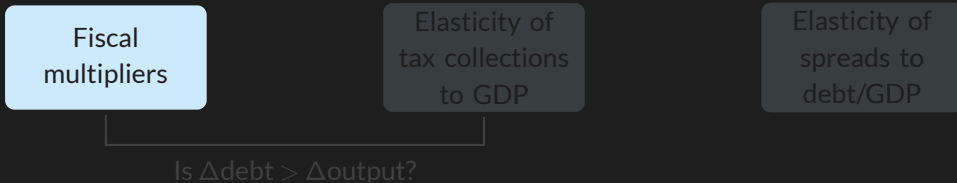
Fiscal

- Anzoategui (2020); Bianchi, Ottonello, and Presno (2020); Philippon and Roldán (2018)
- In a crisis, need to control **debt-to-GDP** ratio
- Aggressive fiscal **consolidation** *can be* self-defeating by deepening the recession



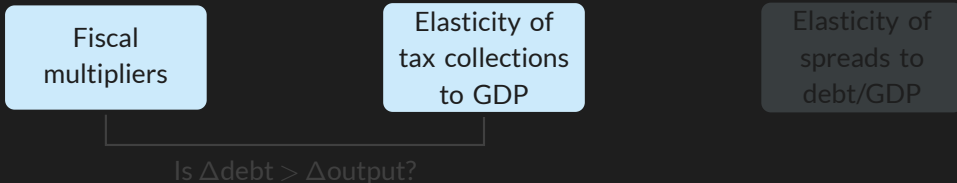
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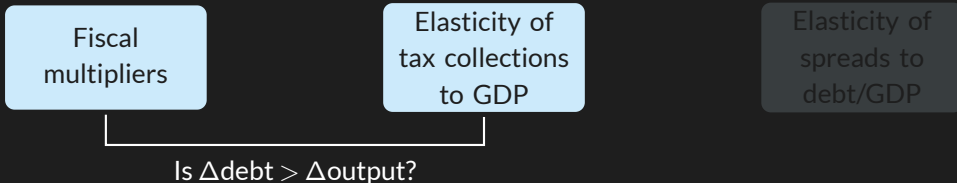
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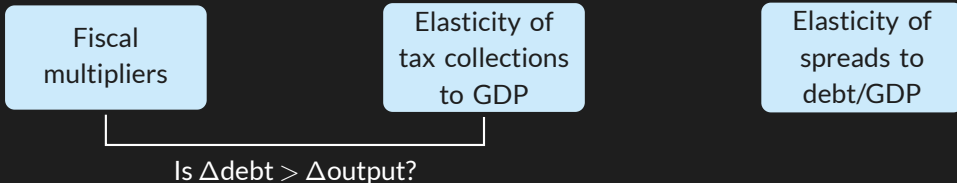
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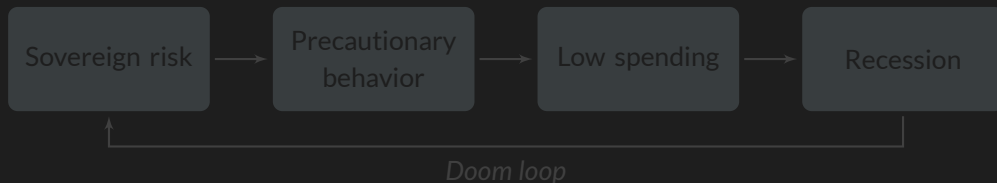
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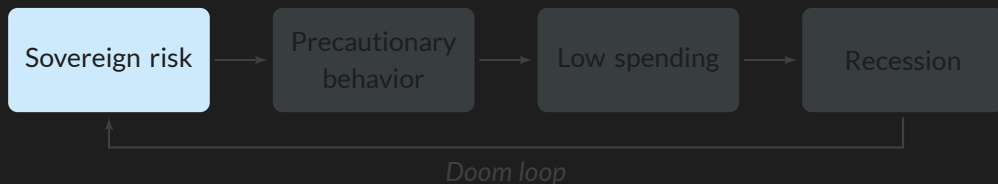
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- Roldán (2020); Arellano, Bai, and Mihalache (2020)
- Households take **precautions** against default when default likely
- Defaults would shrink incomes even more \implies no consumption **smoothing**



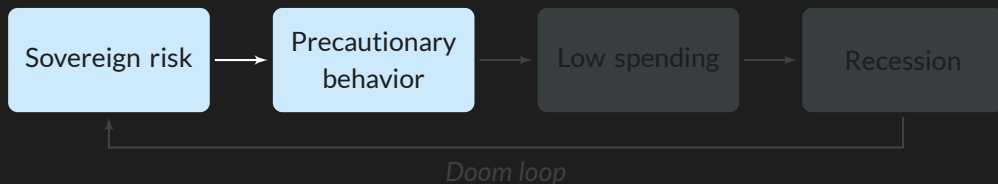
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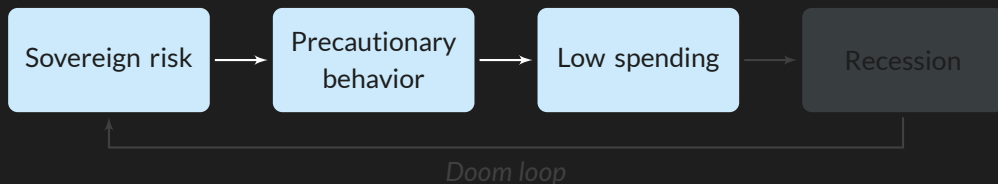
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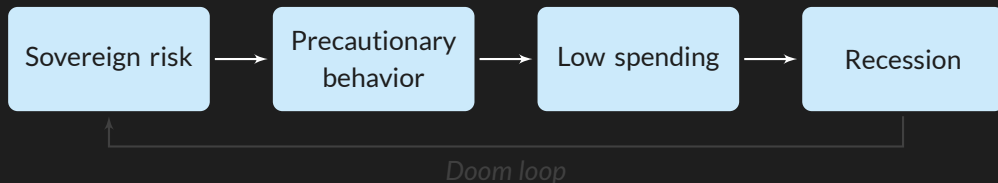
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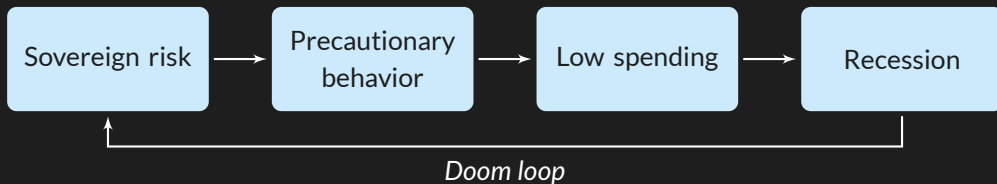
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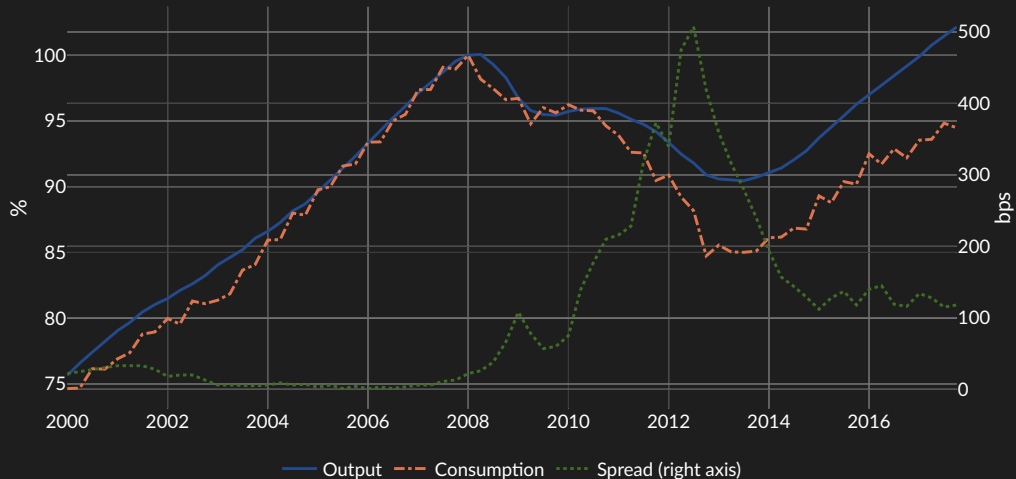
Investment

- Bocola (2016); Arellano, Bai, and Bocola (2019)
- Sovereign risk causes lower **risk-appetite**
- Banks curb lending → lower investment → lower growth

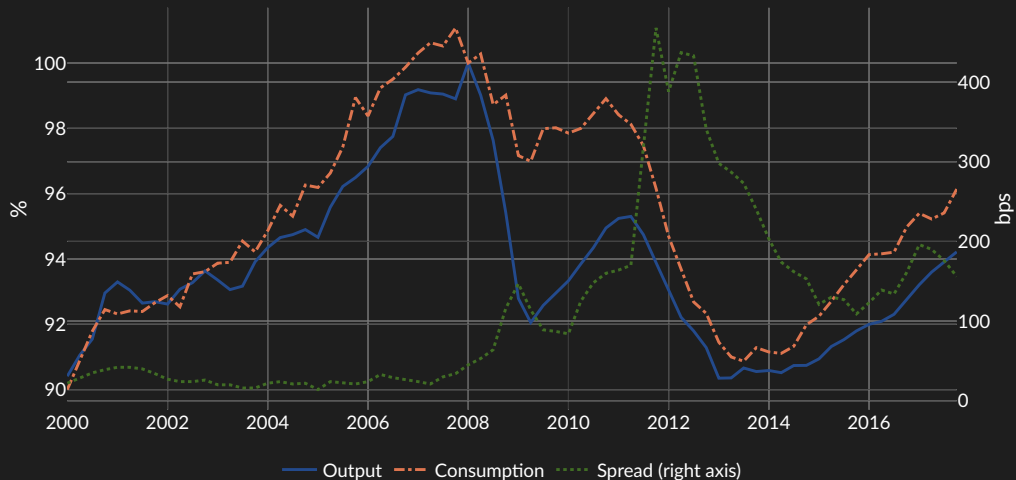
Consequence

- Providing **liquidity** support to banks can help
- Does not fix the **risk-off** problem

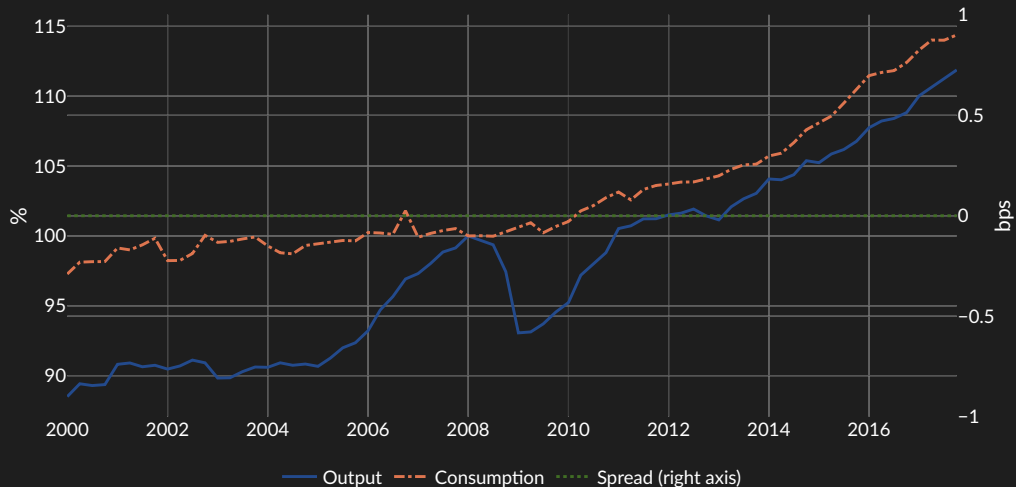
Output and Consumption in Spain



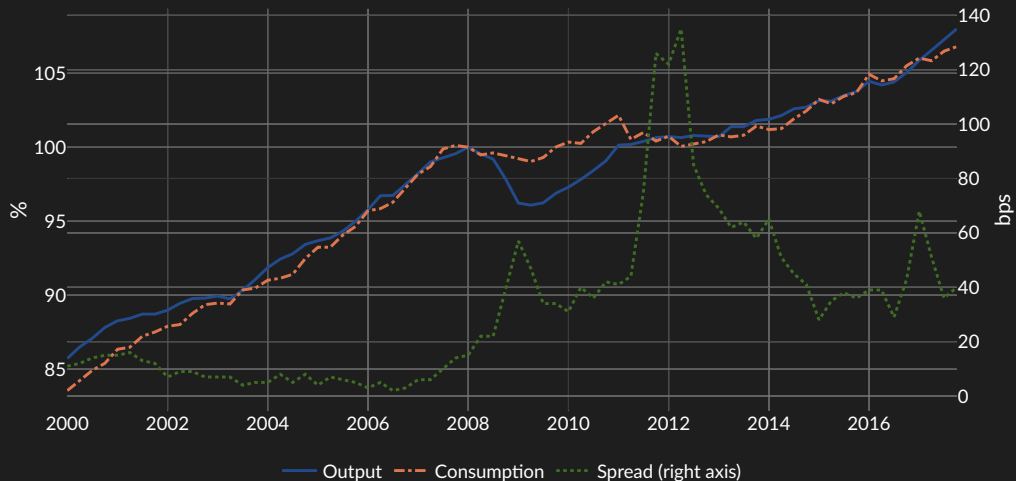
Output and Consumption in Italy



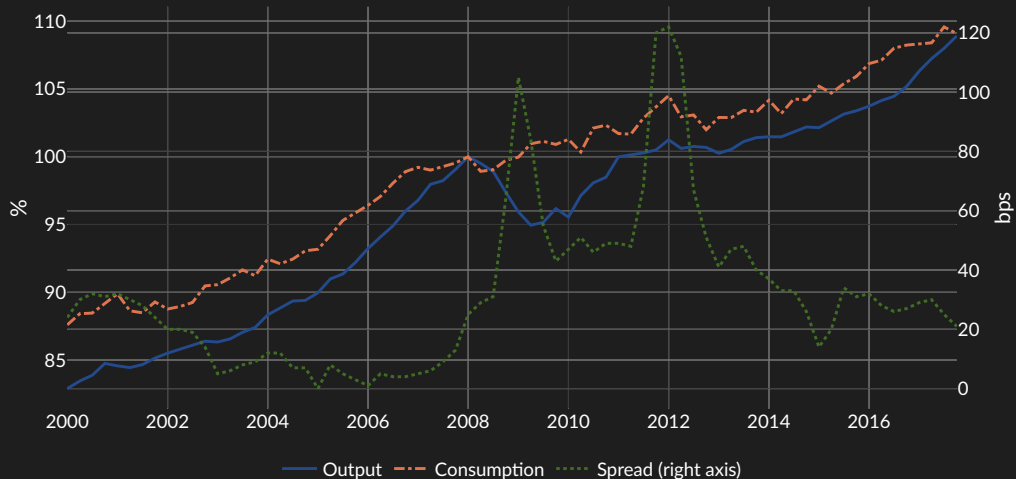
Output and Consumption in Germany



Output and Consumption in France



Output and Consumption in Austria



- Lessons of the euro crisis

1. No gamble for resurrection

- No “learning to live with” sovereign risk

2. Value in resolving debt crises quickly

- Removing **uncertainty**

Role of the IMF

- Debt **sustainability** assessments
- Coordinator of last resort?

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