Debt crises, fast and slow

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With the Covid-19 pandemic, public debt around the world is rising to unprecedented heights in peacetime. We revisit the mechanisms by which, driven by self-fulfilling expectations, both slow-moving and rollover (fast) crises are pervasive at intermediate and high levels of debt, respectively. In both strategic-default and debt-limit models, belief-driven shifts in market as- sessment of risk translate into shifts of the market debt tolerance thresholds to such an extent that sovereigns may lose market access even if they were able to borrow risk free in a "good equilibrium". Long debt maturities may/may not shield countries from this adverse scenario. In a sunspot equilibrium, the threat of belief-driven crises may not be enough for the government to delever- age in a recession, and bring debt to default-free levels. Unless the initial debt is close enough to the critical threshold above which the country becomes vulnerable to such crises, the government will keep borrowing, gambling on economic recovery in the future.

Key words: Sovereign default, Self-fulfilling crises, Expectations, Debt sustainability

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