A General Equilibrium of Sovereign Debt Crisis in an Advanced Country

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Abstract

The conventional strategic sovereign default model is incapable to analyse the recent debt crisis in Europe. I propose instead a DSGE model which is applicable to sovereign debt crisis in advanced countries. In the model, the government issues bonds for domestic households in order to finance the budget deficit. The government falls into the state of debt crisis when its debt exceeds the fiscal limit, which is defined as the maximum amount of debt that the government can serve. Then, it takes austerity measures and the amount of import will be shrunk due to the high interest rate. My model captures important feasures of the economy such as the debt-to-GDP ratio, frequency of crisis, contraction of the economy and moments of main variables.

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