

20120127 IMF: Sovereign risk, fiscal policy, and macroeconomic stability (Working Paper No. 12/33)

Source: International Monetary Fund

Summary

This paper analyzes the impact of strained government finances on macroeconomic stability and the transmission of fiscal policy. Using a variant of the model by Curdia and Woodford (2009), we study a "sovereign risk channel" through which sovereign default risk raises funding costs in the private sector. If monetary policy is constrained, the sovereign risk channel exacerbates indeterminacy problems: private-sector beliefs of a weakening economy may become self-fulfilling. In addition, sovereign risk amplifies the effects of negative cyclical shocks. Under those conditions, fiscal retrenchment can help curtail the risk of macroeconomic instability and, in extreme cases, even stimulate economic activity.

To read the full paper please click [here](#).

NovaRes Team