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Abstract

The euro area crisis has been characterized by speculative attacks reflecting the market fear that some high indebted countries could go bankrupt. What is puzzling, however, is that non-euro area countries with an equally large – and in some cases even larger - public debt-to-GDP ratios have not been subject to attacks. This fact, together with the convex non-linear behavior exhibited by interest rates, have been explained by observing that euro area countries could not rely on a lender of last resort, and this made possible the occurrence of self-fulfilling speculative attacks.

The model proposed in this article applies the target zones methodology relative to exchange rates, developed in the late 1980s-early 1990s, to the case of the interest rate, given that public debt stability will only be assured if the former does not exceed a given upper bound. The novelty of the paper is that, by considering the presence of a public debt demand stochastic shock - that may originate from different sources - it is possible to endogenize the determinants of the credibility of the interest rate target zone and, as a result, of public debt stability, something that in a previous paper, still based on the idea of interest rate target zones, had to be taken exogenously. Public debt stability, then, is shown to depend on the potential liquidity that the central bank can create thanks to its role of lender of last resort. Full/partial credibility is obtained when such liquidity is expected to be sufficient/insufficient to absorb completely the demand shock. The expected absence of liquidity determines the non-credibility of the interest rate target, while the expectation of a public debt increase produces a destabilizing non-credibility determining the convex interest rate non-linearity that characterized the euro area crisis.

Keywords: Interest rates target zones, central bank intervention, public debt, foreign debt, exchange rates target zones, speculative attacks

JEL Classification: E65, F34, F36

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