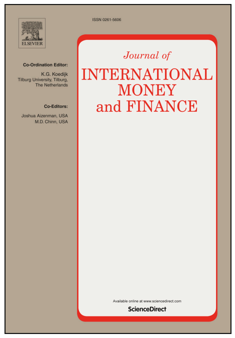
Accepted Manuscript



Sovereign default risk and state-dependent twin deficits

Patrick Hürtgen, Ronald Rühmkorf

PII: S0261-5606(14)00097-7
DOI: 10.1016/j.jimonfin.2014.05.020
Reference: JIMF 1442

To appear in: *Journal of International Money and Finance*

Sovereign default risk and state-dependent twin deficits

Patrick Hürtgen* Ronald Rühmkorf†

May 12, 2014

Abstract

This paper analyzes the impact of the government debt-to-GDP ratio on the correlation of the fiscal balance and the current account. Above a government debt-to-GDP ratio of 90 percent the correlation of the two balances decreases by 0.16 in a sample of 12 euro area countries and by 0.17 for Greece, Ireland, Portugal and Spain. This paper develops a small open economy model with defaultable government debt and riskless international capital markets to explain the empirical evidence of a state-dependent change in the correlation. In the model high public debt-to-GDP ratios raise sovereign risk premia as the default probability increases, leading to higher uncertainty about future taxes. In this case precautionary savings of households increase and partially compensate current account deficits that result from fiscal deficits. The increase in households' saving reduces the correlation of the two balances by the same magnitude as documented in the data. The model calibrated to Greece matches further business cycle moments and the empirical default frequency.

KEYWORDS: Twin Deficits, Current Account, Fiscal Limits, Sovereign Default.

JEL CLASSIFICATION: E60, F32, F34, F41, H30, H60.

* Corresponding author. Deutsche Bundesbank. *Contact details:* Research Centre, Wilhelm-Epstein-Straße 14, 60431 Frankfurt am Main, Germany, e-mail: huertgen@uni-bonn.de.

† European Central Bank. *Contact details:* Kaiserstraße 29, 60311 Frankfurt am Main, e-mail: ruehmkorf@uni-bonn.de.