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# Internal Debt Crises and Sovereign Defaults*

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## Abstract

Internal and sovereign debt crises occur together and happen more frequently in economies with weak bankruptcy institutions. This paper provides a novel explanation. Internal crises arise because of the inability to liquidate private debtors when many default. In an optimal contract, a successful entrepreneur repays yet an unsuccessful one defaults and liquidates his assets. The bounds on liquidation generate, however, a second equilibrium where domestic borrowers default because others are also defaulting. During these coordinated defaults tax collections fall which increases sovereign default risk. In the model joint debt crises are an optimal response to informational problems in private-sector lending.

Keywords: Default, self-fulfilling debt crisis, optimal contracting

JEL classification: F3, G1

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