

# Self-inflicted debt crises\*

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## **Abstract**

Sovereign debt crises are often self-inflicted through myopic consumption and investment decisions and followed by prolonged episodes of debt relief. We propose a dynamic model that explains why countries often get pulled back in a debt crisis and how bailout agencies optimally deal with borrower myopia. The debt relief policy critically depends on the effectiveness of a tight-leash policy vis-à-vis the severity of outright default. Myopia is punished when borrower moral hazard is severe and accommodated when renegotiation frictions and spillovers are high. The model generates sovereign credit spreads that are large and highly sensitive to fundamentals. Standard market-based credit metrics are poor proxies for sovereign default risk.

JEL: H63, G01, G4, D86

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