

Sustainable debt dynamics and the endogenous role of sovereign risk. Vicious and virtuous circles in a VECM framework

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This paper is devoted to study the public debt dynamics in different Latin American countries evidencing very asymmetric experiences. In this regard, we will focus on the “destructive” power of bearing high sovereign risk premia on debt sustainability, hand in hand with inconsistent fiscal behaviour in the context of a given exchange-rate regime. Our underlying idea consists in simulating an innovation to both sovereign spreads and fiscal deficits over GDP, and the nominal exchange rate whenever possible, in order to see how the public debt to GDP ratios respond in a given horizon. Briefly, the results of our econometric exercise provide a rationale to the Argentine vicious circle of widening spreads, low real growth, mounting debt and large fiscal imbalances. Moreover, fiscal deficit innovations (larger primary surplus in GDP%) are proved to deliver no stabilising, downward convergent paths of the debt ratios, nor decreasing spreads with the exception of Mexico. As to Brazil, it appears that a more stabilising effect from a reduction in the fiscal deficit ratio on both debt ratios and spreads is observed in the model allowing for the flexible exchange rate regime.
