

Sargent-Wallace Meets Krugman-Flood-Garber, or: Why Sovereign Debt Swaps do not Avert Macroeconomic Crises

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Abstract

This paper argues that the frequent failure of the debt swaps follows from fundamental forces driven by the market's assessment of the scarcity of fiscal revenue relative to the demand for fiscal outlays. As a country approaches the range of partial default, swaps may not provide the expected breathing room and could even bring the crisis forward. Our methodology combines three independent themes: exchange rate crises as the manifestation of excessive monetary injections, the fiscal theory of inflation and sovereign debt. The integrated framework derives devaluation and external debt repudiation as part of a public-finance optimising problem.

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