Fear of Hiking? Monetary Policy and Sovereign Risk

This paper develops a model of a currency union member whose incentives to borrow and default are shaped by the union-wide monetary policy. The central bank affects the cost of debt by setting the nominal interest rate. We decompose the effect of the interest rate on borrowing into a positive income effect and a negative substitution effect. Our main insight is that a critical level of debt to GDP exists above which the income effect is dominant, implying that a monetary tightening raises sovereign debt and the risk of a sovereign default. We quantify the threshold level and study its business cycle properties in an application of the model to the euro area.

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