

Market Sovereign Default and Haircuts: the Role of Expectations

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Abstract

We analyze the impact of haircuts— that is investors' losses, on the dynamics of public debt ex-ante and ex-post default. Default is a market event. Ex-ante, a low expected haircut is favorable to debt sustainability as it provides more space to the government to face adverse macroeconomic shocks. Once default occurs, the haircut must be high enough to ensure debt sustainability otherwise the economy may potentially face serial defaults. This finding is supported by the data.

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