

Accepted Manuscript

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PII: S0261-5606(16)30149-8
DOI: <http://dx.doi.org/10.1016/j.jimonfin.2016.12.001>
Reference: JIMF 1733

To appear in: *Journal of International Money and Finance*

Received Date: 12 April 2016
Revised Date: 17 October 2016
Accepted Date: 19 December 2016

Please cite this article as: A. Çufadar, F. Özatay, Sovereign risk, public debt, dollarization, and the output effects of fiscal austerity, *Journal of International Money and Finance* (2016), doi: <http://dx.doi.org/10.1016/j.jimonfin.2016.12.001>

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Sovereign risk, public debt, dollarization, and the output effects of fiscal austerity

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Abstract

The goal of this paper is to investigate effects of fiscal policy on output as a response to an external shock at different levels and currency compositions of public debt. Central to our analysis is the mutual relationship between sovereign risk and public debt on the one hand, and the linkage between sovereign risk and private credit spreads on the other. We show that fiscal austerity is conducive to real economic activity when initial government debt is high, its foreign currency share is important, and the link between sovereign and corporate spreads is strong.

JEL classification: E52; E62; E63; F34; H63

Keywords: Recession, Fiscal austerity, Sovereign risk, Liability dollarization.

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