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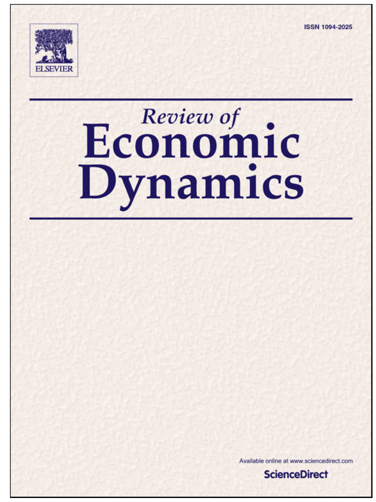

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Fiscal Discipline and Defaults *

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Abstract

We develop a general equilibrium model with a detailed structure of government expenditures and revenues, calibrate it to the Greek and German economies, and use it study the link between fiscal discipline and defaults. We show that even if the Greek government had entered the Great Recession with the same structure of government expenditures and revenues as Germany, but with the Greek level of debt, it would still have chosen to default when facing a high interest rate. Alternatively, if the Greek government had kept its structure of government expenditures and revenues, but managed to decrease its debt to the level of Germany, it would not have defaulted. The primacy of debt over the structure of government expenditures and revenues in default decisions is further emphasized by our findings that even if Germany, with a low level of debt, faced the same high interest rate as Greece did, it would still not have defaulted.

JEL Classification: H5; H6.

Keywords: Dynamic General Equilibrium Model, Fiscal Policy, Government Expenditure, Government Default.

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