

The Self-Fulfilling Default Model: Its Validity, Applicability, and Implications

Michinao Okachi

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Abstract

This paper investigates expectation-driven sovereign debt crises, focusing on the Greek experience, through a self-fulfilling default framework. We first analytically characterize the model's micro-foundations, proving the existence of distinct debt thresholds that partition the state space into Safe, Crisis, and Default zones, thereby endogenously ruling out opportunistic default deviations. Quantitatively, we challenge the standard reliance on the Simulated Method of Moments, which forces unrealistic parameterizations and yields artificially low debt levels. By calibrating core parameters directly to empirical data and extending the model to feature long-term bonds, a partial default mechanism, and persistent market exclusion, we successfully replicate key empirical moments, notably the high debt-to-GDP ratios and realistic default frequencies of advanced economies. Finally, counterfactual simulations reveal that while forced austerity inflicts substantial short-term pain, it is strictly welfare-improving over the long run compared to a baseline of serial defaults. Because gradual macroeconomic improvements cannot restore debt sustainability, we conclude that external interventions are essential; their strict conditionality acts as a vital commitment device to enforce deleveraging and eliminate self-fulfilling risks. (JEL Classification: F34, H63)

Key words: Self-fulfilling Sovereign Default, Advanced Economies

An associate professor at Graduate School of Arts and Sciences, the University of Tokyo (E-mail: michinao.okachi@waka.c.u-tokyo.ac.jp), and a visiting associate professor at Policy Design Lab, Tohoku University.