

HKUST ECON Seminar

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Overreactions, Debt Accumulations, and Sovereign Crises

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Abstract:

Sovereign defaults are typically preceded by sizable debt accumulations and only moderate output contractions—patterns that standard rational-expectations (RE) models struggle to reproduce, as they predict deleveraging in response to adverse fundamentals. We resolve this puzzle by embedding diagnostic expectations (DE) into a standard sovereign default framework. In both a tractable two-period model and a quantitative Eaton–Gersovitz economy, we show that who overreacts is central: diagnostic lenders generate news-contingent pricing that relaxes credit after favorable news, inducing rational borrowers to take on more debt, whereas borrower-side diagnosticity is quantitatively negligible and, if anything, disciplining. The lender-DE channel replicates the joint dynamics of rising debt and mild output declines around default episodes that the RE benchmark misses. Using IMF WEO forecasts for seven emerging economies, we also document patterns consistent with lender DE: spreads and debt-to-GDP predict positive forecast errors, which in turn predict subsequent reversals in growth, debt, and spreads.