

Monetary policy and self-fulfilling sovereign debt crises

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The sovereign debt crisis in the euro area has revived the academic and policy debate on the role of monetary policy in shielding a country from belief-driven speculation in the sovereign debt market. As the ECB president of the European Central Bank put it in his Luncheon Address: Unemployment in the Euro Area, at Jackson Hole Symposium, on August 22, 2014: “Public debt is in aggregate not higher in the euro area than in the US or Japan. [T]he central bank in those countries could act and has acted as a backstop for government funding. This is an important reason why markets spared their fiscal authorities the loss of confidence that constrained many euro area governments’ market access.” The debate revolves around two crucial questions, namely: what are the mechanisms that allow a central bank to provide a monetary backstop to government debt? Under what conditions can a backstop be effective without compromising the central bank’s ability to pursue its primary objectives?

The ADEMU working paper WP 2016/035 by Corsetti and Dedola addresses these questions by studying whether, via conventional or unconventional policy, the central bank can effectively rule out sovereign default driven by self-fulfilling market beliefs. This is tantamount to establish whether the central bank can develop credible interventions policies, i.e., policies that are feasible and welfare-improving from the vantage point of monetary authorities. The wp models discretionary fiscal and monetary authorities who set their policies contemplating the possibility of either outright default on government liabilities, or inflationary debasement of nominal debt. All instruments, taxes, inflation and default, are distortionary and affect output. Ex post, the fiscal authorities set taxes and may choose outright repudiation by imposing losses (haircuts) on bond holders. Monetary authorities set inflation generating seigniorage and reducing the real value of debt. Most importantly, we model the possibility for monetary authorities to engage in (unconventional) balance sheet policy.

There are three key results. Firstly, a successful monetary backstop to government debt rests on the ability of the central bank to issue liabilities (bank reserves) that are free of outright default risk. Hence, interventions in the debt market translate into a swap of (default-) risky government debt with nominal liabilities which can always be redeemed against currency.

Secondly, monetary policymakers should be sufficiently averse to inflation, so that monetary policy is not itself a source of multiple equilibria in inflation and interest rates. Namely, conditional on a realized haircut, inflation rates should be uniquely determined, ruling out the possibility that market expectations drive interest rates and taxation to unsustainable levels in the presence of sound fiscal fundamentals and no default.

Lastly, when the central bank buys debt, prospective balance sheet losses in case of fundamental default raise the risk that monetary authorities be forced to run inefficient inflation. To rule out this problem, either the fiscal authorities must stand ready to provide “backing” to the monetary authorities - preventing these losses - or the fiscal authorities must be themselves sufficiently averse to inflation. In this case, even if central bank cannot rely on fiscal backing, fiscal authorities internalize the inflationary costs of default in their decision making: the adverse inflationary consequences of prospective losses on the central bank holdings of sovereign bonds would discourage outright default altogether.

These results are at odds with views often voiced in the public debate, arguing that the central bank may not have the ability to expand its balance sheet on a sufficient scale to effectively backstop government debt, or claiming that the central bank can freely play the role of lender of last resort to the government because, alternatively, a central bank can always consolidate its liabilities to private banks (i.e. force banks to rollover reserves indefinitely), or debase them by a bout of unexpected inflation. In light of our analysis, these views have fundamental shortcomings.

The view stressing the option for a central bank to impose financial repression over private banks, de facto introduces the possibility of a form of default on monetary liabilities, without however thinking about its consequences. If the central bank is expected to tamper with its liabilities, monetary liabilities would no longer be risk free. The logic of self-fulfilling beliefs of default would then apply to a discretionary central bank as well as to the government. Rather, the central bank can expand its balance sheet by remunerating reserves at the equilibrium risk-free nominal rate. The results from the study suggest that an effective backstop does not have to match the full scale of the government financing.



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The alternative, inflationary-debasement view downplays the social costs of running high inflation, historically conducive to financial and macro instability. If anything, in line with Calvo (1988), the analysis suggests that downplaying the costs of inflation may actually raise the prospects of self-fulfilling sovereign debt crises driven by expectations of debt debasement, rather than outright default. On the contrary, it is exactly because inflation costs are (perceived to be) socially costly, that a monetary backstop can be credible even when the central bank is responsible for its losses. Indeed, a non-trivial result from our analysis is that inflation rates are higher in an equilibrium with belief-driven outright default: an effective monetary backstop prevents rather than creating inflation instability.

The mystery of the printing press monetary policy and self-fulfilling debt crises

Corsetti, Giancarlo; Dedola, Luca (2016-07)

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This paper came out as the third phase of a multi-year study. An early version of the paper was used by Giancarlo Corsetti to deliver the Schumpeter Lecture at the 2015 Annual Congress of the European Economic Association. The working paper of the ADEMU was published by the Journal of the European Economic Association.



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