THE MYSTERY OF THE PRINTING PRESS MONETARY POLICY AND SELF-FULFILLING DEBT CRISES

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Abstract
We study the conditions under which unconventional (balance-sheet) monetary policy can rule out self-fulfilling sovereign default in a model with optimizing but discretionary fiscal and monetary policymakers. When purchasing sovereign debt, the central bank effectively swaps risky government paper for monetary liabilities only exposed to inflation risk, thus yielding a lower interest rate. As central bank purchases reduce the (ex ante) costs of debt, we characterize a critical threshold beyond which, absent fundamental fiscal stress, the government strictly prefers primary surplus adjustment to default. Because default may still occur for fundamental reasons, however, the central bank faces the risk of losses on sovereign debt holdings, which may generate inefficient inflation. We show that these losses do not necessarily undermine the credibility of a backstop, nor the monetary authorities' ability to pursue its inflation objectives. Backstops are credible if either the central bank enjoys fiscal backing or fiscal authorities are sufficiently averse to inflation. (JEL: E58, E63, H63)

Keywords: Sovereign risk and default, Lender of last resort, Seigniorage, inflationary financing.

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