Research Working Papers

Sovereign Default and Monetary Policy Tradeoffs

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As the probability of sovereign default surges, the spread between the risky and risk-free interest rates can force policymakers to choose between stabilizing inflation and stabilizing output.

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How do the effects of routine monetary operations designed to achieve macroeconomic stabilization change when the economy moves from a debt to GDP level where the probability of default is nil to the "fiscal limit," where the default probability is non-negligible? We find that the specification of the monetary policy rule plays a critical role. By targeting the risky rate, the central bank accommodates default risk, amounting to an implicit relaxation in the inflation target as the economy approaches its fiscal limit. A transitory monetary policy contraction leads to a sustained rise in inflation, even though monetary policy actively targets inflation, and fiscal policy passively adjusts taxes to stabilize debt. If the central bank targets the risk-free rate, on the other hand, the central bank keeps its inflation target unchanged even as sovereign default risk surges. As a result, output endures most of the macroeconomic cost of fiscal adjustment in response to high debt.

JEL Classification: H60, E30, E62, H30

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Related Research

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