

The Mystery of the Printing Press: Self-fulfilling debt crises and monetary sovereignty

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Does monetary sovereignty reduce the need for default conditional on weak fundamentals and/or shield government debt markets from self-fulfilling speculative runs? Building on Calvo (1988), we specify a stochastic monetary economy where discretionary policymakers can default on debt holders through surprise inflation or by imposing discrete haircuts, at the cost of both output and budgetary losses. We show that the resort to the printing press per se rules out neither fundamental default nor default caused by self-fulfilling runs. What matters is the ability of the central bank to issue (interest-bearing) nominal assets (e.g., bank reserves) on which, different from government debt, no haircut is applied. The scope for successful central bank purchases of government debt to eliminate runs is however not unconstrained. We characterise conditions that must be met for this strategy to be credible, i.e. feasible and welfare improving.