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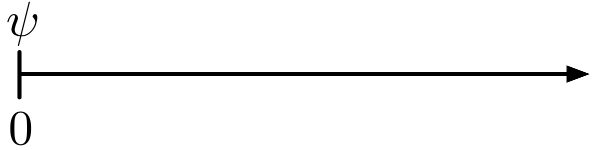
In this paper

- Model limited commitment to repayment and inflation
- Ability to inflate makes
  - Countries more vulnerable if inflation costs are low
  - Opposite if inflation costs are high

Key parameter

Cost of inflation: ψ



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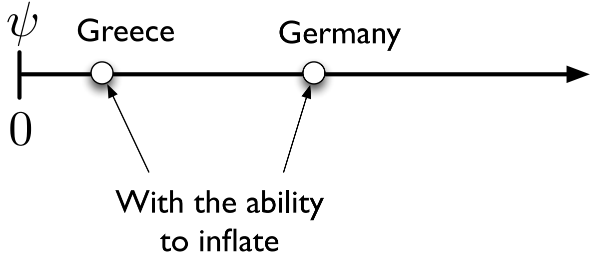

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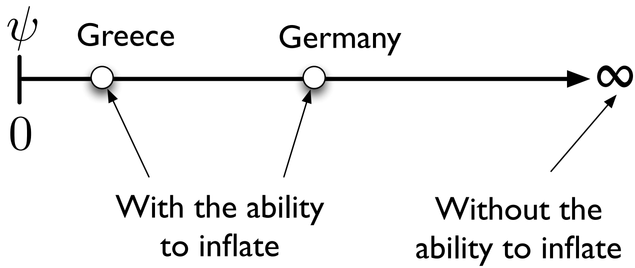

Model ingredients

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- Small open economy, world risk free rate: $r^\star$
- Constant endowment, y; and an initial level of debt
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- Government chooses c, π, and default taking as given an equilibrium interest rate schedule $r(b)$.

Lack of commitment

A. With the ability to inflate

- Government can default: value $\underline{V}$
  - loses access to international financial markets + other costs
- Government can inflate ex-post: $\psi\pi$ with $\pi \in [0, \bar{\pi}]$
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Which scenario (A vs. B) makes a country less vulnerable?

Equilibrium interest rate schedule of lenders

going back to that $r(b)$

$$r(b) = r^{\star} + \pi(b) + \lambda(b)$$

- where $\pi(b)$ is the inflation strategy of the government
- and $\lambda(b)$ is the default probability (including sunspots)

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Coordination problem of the lenders

For high values of debt:

- if each lender thinks all other lenders will roll-over, no crises
- if each lender thinks all other lenders will <u>not</u> roll-over, then debt run

Regions of Multiplicity

Constructing debt runs

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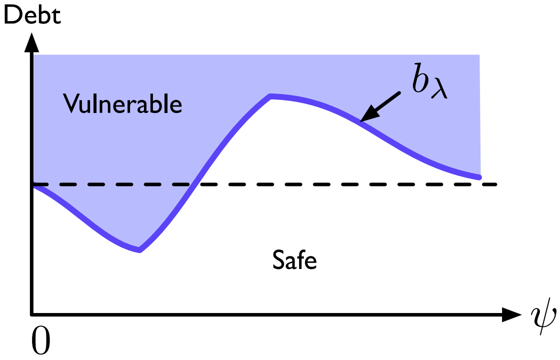
Question

- How does the vulnerability cutoff (b_λ) depend on the ability to inflate?

Vulnerability Region as a function of ψ



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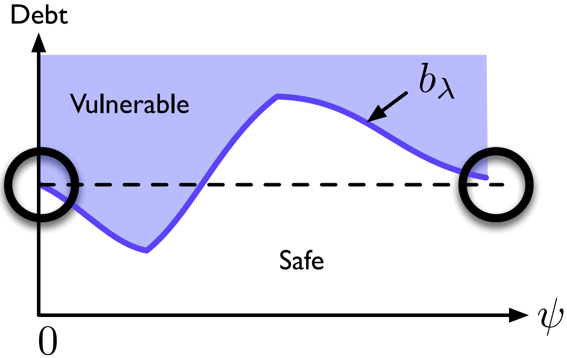

Two extremes cases: $\psi = 0$ and $\psi = \infty$

In the first: inflate all the time
In the second: never inflate
Same vulnerability: inflation is not state contingent

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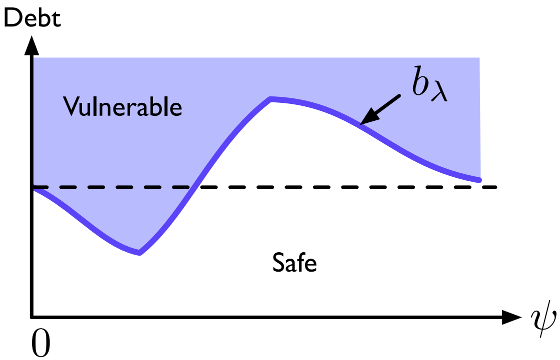

More generally two **opposite** effects when ψ increases

Increases the cost of repaying in case of a run

It may reduce equilibrium inflation
Reduces equilibrium interest rate

$\Downarrow$

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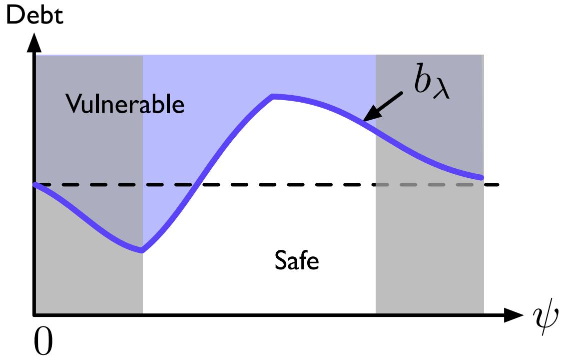

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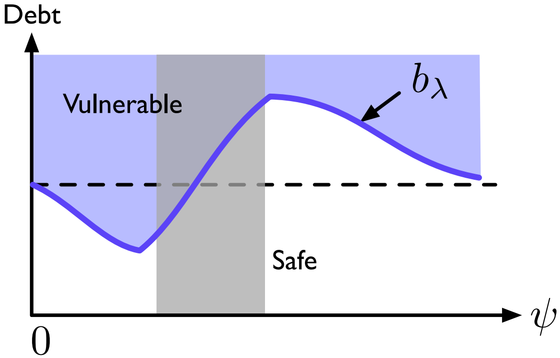

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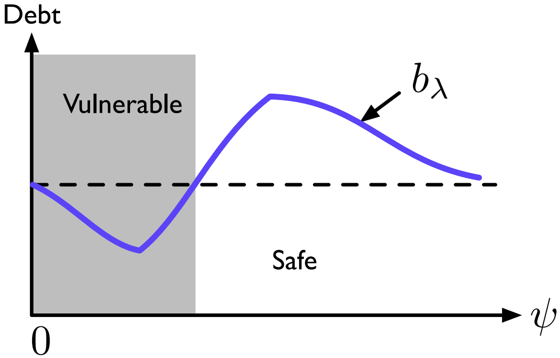

A government with low cost of inflation (shaded area) better served without the option to inflate

- It reduces vulnerability region
- Lowers the temptation for inflation
- (And raises the borrowing limit)

Conclusion

A country with low inflation costs

- is not made less vulnerable to sovereign debt crises by abandoning a monetary union

Inflation is indeed a tool that grants flexibility

- But can be misused ex-ante
- Rendering powerless ex-post