Monetary Conservatism and Sovereign Default*

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Abstract

The introduction of an independent central bank is often considered to be an effective way to combat high inflation rates that result from policy makers' lack of commitment. However, many economies are subject to frictions that could undermine the success of such a reform. This paper studies the consequences of delegating monetary policy to an inflation conservative central banker *à la* Rogoff (1985) for an economy that faces (i) incomplete financial markets, (ii) risk of default and (iii) political distortions. To do so, an Arellano-Eaton-Gersovitz-type model of sovereign default is developed in which monetary and fiscal policy is set by two different authorities that cannot commit to future policies. Despite increasing the average debt burden, the frequency of default and the volatility of fiscal policy, inflation conservatism leads to welfare gains by successfully implementing lower and more stable inflation.

Keywords: Monetary Conservatism, Public Debt, Lack of Commitment, Sovereign Default, Political Economy, Markov-Perfect Equilibrium

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