

[Is Inflation Default? The Role of Information in Debt Crises](#)

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The sovereign borrowing experience of advanced economies in the aftermath of the financial crisis of 2008 has once again highlighted the important role of the currency in which debt is denominated. Countries which had control over their monetary policy, such as the United States, the United Kingdom, and Japan, were able to borrow at extremely low rates throughout the episode, even though they experienced very high deficit/GDP ratios (the UK) or debt/GDP ratios (Japan). In contrast, peripheral Eurozone countries were either unable to borrow from the market (Portugal, Ireland) or faced volatile interest rates when doing so (Italy, Spain).

Our goal is to study one source of frictions that may make the price of a country's debt less sensitive to adverse news on the government solvency. A premise of our analysis is that a domestic currency partially insulates a country from default risk, as the government may be able to lean on the central bank to act as a residual claimant on government debt securities. However, the resulting increase in the money supply would be bound to generate inflation, so that default risk would be replaced by inflation risk and we might expect interest rates to spike similarly under the two scenarios. Yet in practice inflation expectations, as well as the behavior of actual inflation, are very sluggish compared to the speed with which default crises, such as Greece's, unfold.

To reconcile these facts, we study an economy where private agents have dispersed and heterogeneous information about the government's ability to repay its debt. While debt is purchased by sophisticated bondholders, with comparatively more precise information about the state of government finances, cash is used by a much larger and less informed population. When debt is issued in foreign currency, or a currency which is not under domestic control (as the Euro), creditors are concerned about default risk, which is reflected in trades among sophisticated parties. When instead debt is issued in domestic currency, creditors are concerned about inflationary prospects, which involve the inflation expectations of the less informed population. Even though under both scenarios debt is sold to sophisticated traders in the primary market, we show that the asymmetry about subsequent risks makes domestic-currency debt more resilient to bad news.

Our results confirm that heterogeneity between a small, sophisticated group of bond traders and a large, less informed population that drives the aggregate price level can explain why domestic-currency debt may be less information-sensitive than foreign-currency debt. This result can account for why a country which starts from a favorable prior condition may be able to better withstand the arrival of bad news. Conversely, our results also suggest that a country who is perceived as very likely to default may find it easier to borrow in foreign currency in the few instances in which its fundamentals are comparatively more favorable: sophisticated bond traders would find it easier to spot the presence of such conditions, while a pessimistic population may immediately fear (and trigger) hyperinflation. This could be an alternative explanation for the "original sin."