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Revisiting the Fiscal Theory of Sovereign Risk from the DSGE View

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Abstract : We revisit Uribe's `Fiscal Theory of Sovereign Risk' advocating that there is a trade-off between stabilizing inflation and suppressing default. We develop a class of dynamic stochastic general equilibrium (DSGE) model with nominal rigidities and compare two de facto inflation stabilization policies, optimal monetary policy and optimal monetary and fiscal policy with the minimizing interest rate spread policy which completely suppress the default. Under the optimal monetary and fiscal policy, not only the nominal interest rate but also the tax rate work to minimize welfare costs through stabilizing inflation. Under the optimal monetary both inflation and output gap are completely stabilized although those are fluctuating under the optimal monetary policy. In addition, volatility in the default rate under the optimal monetary policy is considerably lower than one under the optimal monetary policy. Thus, there is not the SI-SD trade-off. In addition, while the minimizing interest rate spread policy makes inflation rate severely volatile, the optimal monetary and fiscal policy stabilize both the inflation and the default. A trade-off between stabilizing inflation and suppressing default is not so severe what pointed out by Uribe.

Keywords : sovereign risk, optimal monetary policy, fiscal theory of the price level, DSGE
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