Confidence Crises and Public Debt Management

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Under free capital mobility, confidence crises can result in devaluations even when fixed exchange rates are viable, if fiscal authorities can obtain temporary money financing. During a crisis, domestic interest rates increase reflecting the expected devaluation. Rather than selling debt at punitive rates, fiscal authorities will turn to temporary money financing, leading to equilibria with positive probability of devaluation. These equilibria can be ruled out if the amount of debt maturing during the crisis is sufficiently small- a condition that can be met by reducing the stock of public debt, lengthening its average maturity and/or smoothing the time distribution of maturing issues.

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Dornbusch, Rudiger and Mario Draghi (eds.) Public debt management: Theory and history. Cambridge; New York and Melbourne: Cambridge University Press, 1990.

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