Monetary Policy When the US Treasury Defaults

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PROJECT PROPOSAL

In this paper, we seek to address the question of how an independent monetary authority should respond to a partial or complete nominal default by the fiscal authority. We are primarily concerned with thinking about the US—a large economy with an independent central bank that borrows in its own currency. In case the fiscal authority defaults, what are likely macroeconomic effects, and how should an independent monetary authority respond? We analyze this question in a simple two-agent New Keynesian model along the lines of Mankiw (2000), Curdia and Woodford (2016) and Mehrotra (2018).

Preliminarily, we find that sovereign default is primarily a negative aggregate demand shock that shifts the economy's intertemporal IS curve while leaving the Phillips curve unchanged. As such, monetary policy can offset the negative aggregate demand shock via monetary expansion assuming the zero lower bound does not bind. Generically, sovereign default raises potential output by boosting capital and labor supply, providing a disinflationary impulse. In an extension with a banking system, default may lower potential output by eroding bank net worth and raising firm cost of capital (as emphasized in Bocola (2016)). However, purchases of government debt by the monetary authority can counteract the effects of sovereign default on the banking system (as in Corsetti and Dedola (2016)).

Motivation

The US has seen progressively rising levels of public debt since 2000, exacerbated by the slow recovery from the 2008 financial crisis and large expenditures during the 2020-21 global pandemic. While yields and interest expense remained low in the 2010s, the post pandemic economy has seen sharply higher interest rates and steady increases in interest expense. US interest expense is projected to exceed 3% of GDP during the 2026 fiscal year. Rising yields on long-term US government debt have prompted increasing concerns about the sustainability of US public debt.

Additionally, ever since the showdown over raising the debt ceiling in 2011, the possibility of a nominal default on US Treasuries has become a possibility for markets to consider. Credit default swaps on US Treasury debt are generally higher than for other advanced economies reflecting, in part, the possibility of a technical default driven by a standoff over the debt ceiling. The initial downgrades of US debt from AAA status took place more than a decade ago due to the debt ceiling standoff. A technical default caused by triggering the debt ceiling could lead to a broader repudiation of US public debt.

This paper considers the macroeconomic consequences of a default either triggered by failure to raise the debt ceiling or, more generally, an increase in Treasury yields that leads to extraordinary actions by the fiscal authority.

Evidence

We provide novel evidence on investor perceptions of a US fiscal crisis and, in particular, their perceptions of a nominal default (i.e. failure to pay interest or principal on US Treasury debt). We conducted a survey in July 2026 of a sample of the membership of the CFA Institute on US fiscal risks.[1] In this survey of 625 investment professionals, we found a median probability of 25 percent of a US fiscal crisis over the next decade. A fiscal crisis was defined as the US fiscal or monetary authority having to take extraordinary actions to finance the government debt.

Moreover, credit default protection on the US Treasuries are both available and traded. US 5-year (10-year) credit default swaps are currently trading at around 35 basis points (50 basis points). These instruments will pay out on a nominal default event, defined as a failure to pay, a restructuring or a repudiation. Credit default swaps, therefore, could be triggered by a debt ceiling breach but would not be triggered by a shift towards monetary financing or other potential responses to a US fiscal crisis.

Model Outline

To consider the implications of sovereign default with independent monetary policy, we build a two-agent New Keynesian (TANK) model consisting of long-lived Ricardian households and hand-to-mouth workers. Ricardian households consume, own firms, and accumulate savings via physical capital, government debt and money. Ricardian households also pay lump sum taxes and supply labor. Hand-to-mouth households work, consume and pay lump sum taxes.

[1]The CFA Institute in a non-profit organization that provides certification and continuing training for financial professionals. The CFA Institute administers the CFA (chartered financial analyst) exam.

They also accumulate some target level of safe assets (government debt and money). In steady state, hand-to-mouth households have constant real assets and consume their labor and interest income each period.

A representative firm hires labor from each type of household and rents capital from the Ricardian household. Monopolistically competitive retailers costlessly differentiate the final good purchased from the representative firm and set prices as in Calvo. This setup gives rise to the standard expectations augmented New Keynesian Phillips curve.

In an extension, we introduce a representative bank that issues deposits to both types of households and invests in government debt, money and capital. The required rate of return on loans to firms will be inversely related to bank net worth, with reductions in bank net worth raising the credit spread. A similar credit spread could emerge due to illiquidity of bank loans to firms. In this case, banks need to hold government debt and reserves at the central bank to meet household liquidity needs.

Preliminary Findings

The effects of sovereign default can be understood by examining the consumption/saving decisions of the Ricardian and hand-to-mouth households. For the Ricardian households, consumption depends on the discounted present value of non-interest income and the present value of tax liabilities. A sovereign default shock is an expectational shock. The assumption is that Ricardian households have been making consumption and saving decisions holding mistaken beliefs about future fiscal policy. We assume that under a default event, the fiscal authority must move into primary balance immediately (or primary surplus to the extent it continues to service some portion of the debt).

Sovereign default is therefore a shock that has two components: 1) reduces the value of current financial wealth, 2) changes in the future expected path of taxes. On learning of default, the net present value of human and financial wealth falls since Ricardian households expected some burden of repayment to fall on hand-to-mouth households. Holding constant the path of real interest rates and the net present value of non-interest income, desired consumption must fall since lifetime real resources have declined. To the extent that this process plays out slowly, default takes the form of repeated negative shocks to lifetime income that decrease desired consumption holding constant rates and non-interest income.

For the hand-to-mouth household, the impacts of default are more straightforward.[2] Default

[2]Given our assumption of some target saving behavior, these households are perhaps better labeled as non-Ricardian households. In the analytical case outlined below with zero savings, these households be true hand-to-mouth.

could eliminate some fraction of their financial wealth (their target stock of wealth), moving households away from their target level and raising desired saving. Additionally, any reduction in transfers (or equivalently, increase in taxes) flows through to lower consumption.

Under some simplifying assumptions: no physical capital, labor supply only from the hand-to-mouth households, no taxation of hand-to-mouth households, and no target wealth for the hand-to-mouth households, the model admits a three-equation aggregation that closely resembles the standard New Keynesian model. The Phillips curve is the standard New Keynesian Phillips curve and monetary policy is conducted by setting the policy rate in accordance with a Taylor rule or other interest rate rule. The sovereign default shock enters as a shifter of the intertemporal IS equation and is equivalent to a preference shock. Potential output is invariant to the sovereign default shock since labor is the sole input to production and is unaffected so long as taxes faced by worker households are unchanged.

In this special case, optimal monetary policy would be implemented via strict inflation targeting as divine coincidence holds. The monetary authority would respond to the fall in aggregate demand caused by the fiscal authority's default by lowering rates and raising desired consumption among Ricardian households. This would ensure that hand-to-mouth households experience no loss in current income and would keep their labor supply unchanged. The ability of the monetary authority to implement this policy would only be constrained by the zero lower bound.

This analytical model can be readily extended to consider the effects of a tax increase (or equivalently a cut in transfers) for hand-to-mouth households. If default forces a tax increase or benefit cut on hand-to-mouth households, this lowers consumption and increases labor supply via a standard wealth effect. Potential output rises and monetary policy eases now to both cushion the fall in aggregate demand for the Ricardian household and to offset the disinflationary effect of the tax increase on labor supply.

In a quantitative extension with labor supply from both households and capital accumulation, we expect that a default shock will generically increase input supply and, therefore, potential output, exerting a disinflationary effect on the economy. Negative wealth effects are expected to boost labor supply for both types of households. Increases in desired saving will raise capital accumulation as well. Divine coincidence will still hold, and optimal monetary policy will lower the policy rate to offset the negative demand shock from default and accommodate the increase in potential output.

We expect that in an extension with a banking system that intermediates credit between households and firms, a default event could now have negative effects on potential output via credit spreads. A default now erodes bank net worth and lowers bank liquidity, raising the cost of making loans to firms. The rise in the cost of capital to firms lowers labor demand. If this channel is large enough relative to wealth effect on labor supply and the desire for

increased capital accumulation, then potential output could fall.

We conjecture that monetary policy would now have two independent dimensions of policy. First, taking the decline in bank net worth as given, the monetary authority would again implement optimal policy by adjusting the policy rate to keep output at potential. Depending on the rise in firms' cost of capital, potential output could fall and the policy rate may rise. However, now potential output could also be affected via credit policy; if the monetary authority makes capital injections via acquiring defaulted government debt, the rise in credit spreads would be mitigated along with the fall in potential output. Again, the model suggests that the fallout from a sovereign default could be managed via a combination of easing the policy rate and bank capital injections.

Further extensions include consideration of the moral hazard aspects of monetary policy intervention and the possibility of currency disintermediation. One risk of monetizing the government debt is currency flight or a shift towards an alternative medium of exchange. Such a shift would raise the price level in dollars and weaken monetary policy ability to offset shocks to aggregate demand.

Another result we anticipate is that monetary policy should draw a sharp distinction between purchasing outstanding government debt versus monetizing ongoing primary deficits. A credible commitment against financing ongoing primary deficits would prevent inflation expectations from rising and guard against currency flight. By contrast, purchasing repudiated government debt offsets the negative aggregate demand and net worth effects without necessarily obligating the monetary authority to financing any new expenditures.

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