Comments on

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A Theory of Fear of Floating

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- Fear of Floating: an important unresolved theoretical issue

- Main result: pegs reduce likelihood of self-fulfilling financial crises relative to floats

- Specifically, self-fulfilling financial crises exist for larger ranges of indebtedness under floats than pegs

- Environment: small open economy with occasionally binding collateral constraint (as in Bianchi AER 2021) and downward nominal wage rigidity (as in Schmitt-Grohé and Uribe JPE 2016)

$$\frac{b_{t+1}}{R} \leq \kappa(y^T + p_t y_t^N)$$

$$W_t \geq W_{t-1}$$

• The borrowing constraint: $\frac{b_{t+1}}{R} \leq \kappa(y^T + p_t y_t^N)$

• The demand for nontradables: $p_t = \frac{1-\phi}{\phi}\left(\frac{c_t^T}{y_t^N}\right)^{\frac{1}{\gamma}}$

• If $\gamma < 1$, then a real depreciation ($p_t \downarrow$), depresses NT output in terms of T goods ($p_t y_t^N \downarrow$) and hence collateral.

• Because of downward nominal wage rigidity, a real depreciation ($p_t \downarrow$) lowers unemployment ($y_t^N \uparrow$)

• Policy conflict: Real depreciation:
– raises employment in NT sector ($y_t^N \uparrow$), but
– tightens collateral constraint ($p_t y_t^N \downarrow$)

Three Monetary Policy Specifications

- Exchange rate peg, $e_t = \bar{e}$ (Fear of Floating)
- Constant money supply, $M_t = \overline{M}$ (Float 1)
- Full employment policy, $h_t = \bar{h}$ (Float 2)

Self-Fulfilling Financial Crises Exist for all 3 Policies

$$\frac{b_{t+1}}{R} \leq \kappa \left[y^T + \left(\frac{1-\phi}{\phi}\right) \left(y^T + \frac{b_{t+1}}{R} - b_t\right)^{\frac{1}{\gamma}} h_t^{1-\frac{1}{\gamma}} \right]$$

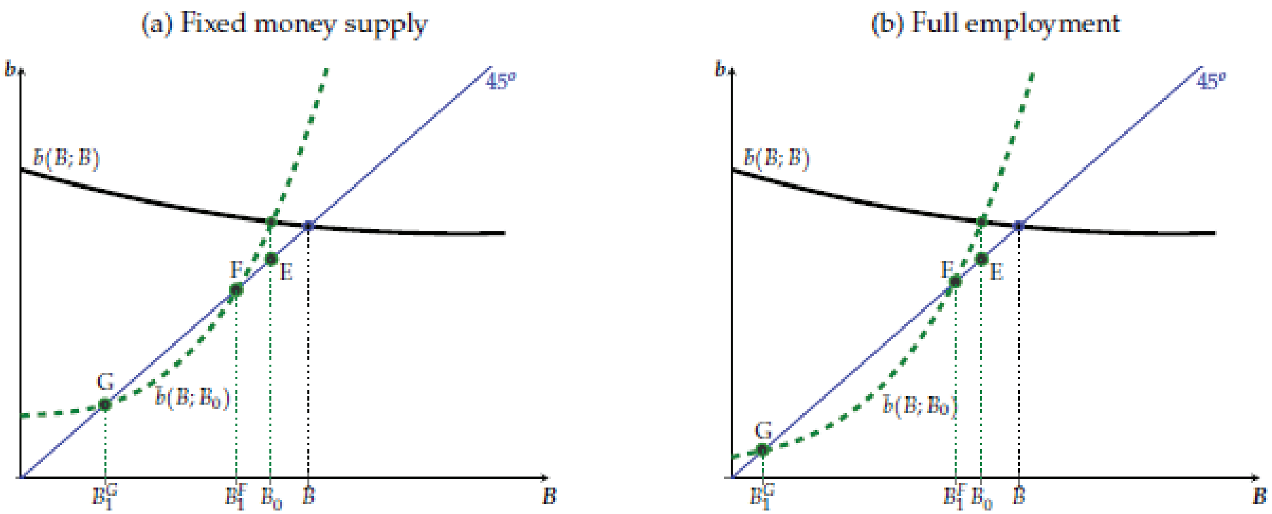


Figure 2: Equilibria under flexible exchange rate

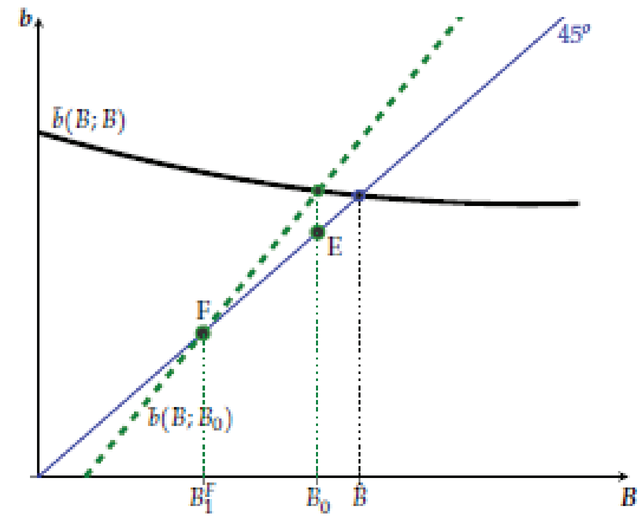


Figure 1: Equilibria under fixed exchange rat

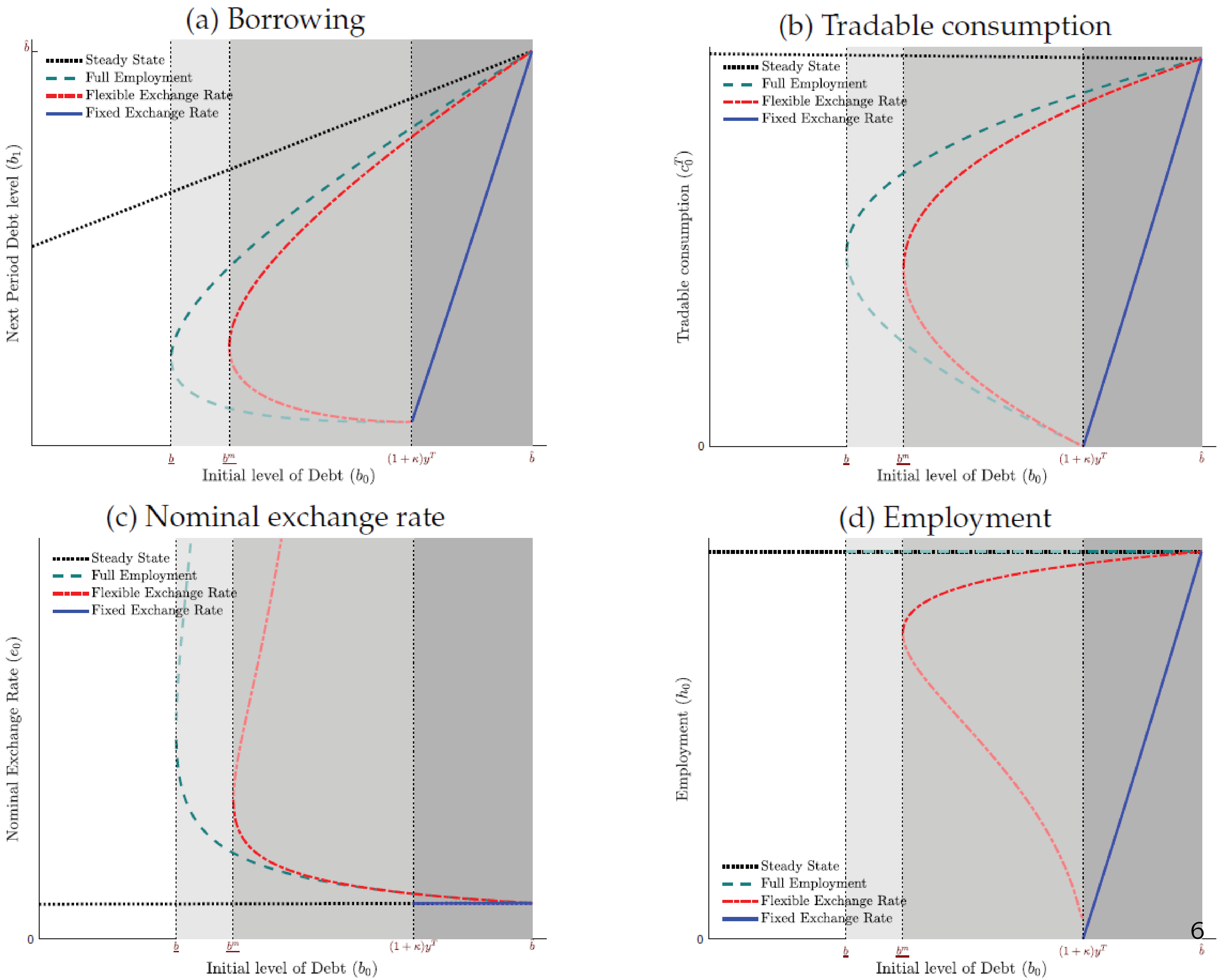
but the range of b_0 for which they exist depends on policy

Under peg range of b_0 for which self-fulfilling financial crisis is the **smallest** hinting at 'A Theory of Fear of Floating'

Why? Because effect of a depreciation on collateral value ($p_t h_t$) is smallest under the peg. Up to first order:

Under peg: $\widehat{p}_t + \widehat{h}_t = 0 + \widehat{h}_t = \widehat{c}_t^T$

Under full employment policy: $\widehat{p}_t + \widehat{h}_t = \widehat{p}_t + 0 = \frac{1}{\gamma}\widehat{c}_t^T > \widehat{c}_t^T$.


(a) Borrowing
Steady State
Full Employment
Flexible Exchange Rate
Fixed Exchange Rate
Next Period Debt level (b_1)
Initial level of Debt (b_0)
$\underline{b}$
$\underline{b}^m$
$(1+\kappa)y^T$
$\hat{b}$
(b) Tradable consumption
Tradable consumption (c_0^T)
0
(c) Nominal exchange rate
Nominal Exchange Rate (e_0)
(d) Employment
Employment (h_0)

Comment 1:

Other ways than 'fear of floating' to reduce the chance of a self-fulfilling crisis? Other ways to prop up value of collateral (than tolerating some unemployment) could be:

– consumption subsidies

– capital control taxes

In Schmitt-Grohé and Uribe (RES 2021), we show that either consumption subsidies or off-equilibrium threats of imposing large capital control taxes on speculative capital outflows can eliminate the self-fulfilling financial crisis.

Comment 2:

- In quantitative related work (not considering self-fulfilling crises), tradeoff between full-employment versus financial distortions has been explored, and, ... the tradeoff is not clearly resolved in favor of a peg.

- EX: Ottonello (JIE 2021). Optimal exchange rate and capital control tax policy. Aim was to get a theory of fear of floating.

— but ... finds that in a fundamental crisis under optimal policy the government still shows some 'love of floating.' Dynamics under optimal policy look closer to dynamics under full employment than under peg:

—Under optimal policy still large real and nominal depreciation and low unemployment contrary to peg. — Under iid shocks, however, optimal policy displays more 'fear of floating.'

— Absent interest rate shocks, also more 'fear of floating'.

— More 'fear of floating', the more indebted the country is.

Summary

- Great paper

- Speaks to an important unresolved question in economics: Why is there fear of floating and what are the economic benefits of a currency union

- New angle: Fear of floating protects country from self-fulfilling deleveraging crises.