

Dollarization of liabilities, fear of floating and optimal exchange rate volatility

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Recent studies have documented that countries with a flexible exchange rate are often reluctant to let their exchange rates float freely. We show, in a model in which a policymaker seeks to stabilize output and inflation around some target values, that the fear of floating is consistent with the policymaker's optimal monetary policy if the relative weight of the output goal remains below a well-defined threshold value. Key features of the model are a credit constraint for the corporate sector, a currency mismatch in firms' balance sheets and a passthrough of exchange rate changes to inflation. The model suggests that even in this environment, flexible exchange rates are an effective tool for buffering shocks. Monetary policy, however, is less efficient because the costs of the optimal output stabilization rise.
