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Keep in mind

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We develop a small open economy model with sectorial balance sheets that are exchange rate exposed and with sectorial stock and flow consistency. The model is perturbed by a shock to investor sentiment and a sudden stop to capital inflow. It is used to evaluate the claims that usually back the fear of floating strategy: the effect of the exchange rate on foreign debt, and the pass-through of the exchange rate to inflation. The conclusion is drawn that fear of floating, the policy that is intended to stabilize foreign debt, is precisely the policy that increases the government debt to GDP ratio. The reason is that, in order to control the exchange rate, the authorities increase interest rates. A lower depreciation does contain the level of debt; however, higher interest rates produce two effects. First, they increase the cost of interest on the debt. Second, they decrease tax revenue through recession. Both effects increase the change in the debt to GDP ratio. The pass-through does not seem to be an important argument for fear of floating either. We also find that during a sudden stop, regardless of whether the exchange rate is maintained or not, the economy as a whole runs a surplus. Under fear of floating, nonetheless, the government runs a deficit that overburdens the private sector. The policy implication is that during a sudden stop the exchange rate should be allowed to float. A case can be made for fear of floating if there are plans to reduce inflation.

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