

NBER WORKING PAPER SERIES

COORDINATION AND POLICY TRAPS

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Working Paper 9767  
<http://www.nber.org/papers/w9767>

NATIONAL BUREAU OF ECONOMIC RESEARCH  
1050 Massachusetts Avenue  
Cambridge, MA 02138  
June 2003

For encouragement and helpful comments, we are thankful to Daron Acemoglu, Andy Atkeson, Gadi Barlevy, Marco Bassetto, Olivier Blanchard, Ricardo Caballero, V.V. Chari, Eddie Dekel, Glenn Ellison, Paul Heidhues, Patrick Kehoe, Robert Lucas Jr., Narayana Kocherlakota, Kiminori Matsuyama, Stephen Morris, Nancy Stokey, Jean Tirole, Jaume Ventura, Ivan Werning, and seminar participants at AUEB, Carnegie-Mellon, Harvard, Iowa, Lausanne, LSE, Mannheim, MIT, Northwestern, Stanford, Stony Brook, Toulouse, UCLA, the Minneapolis Fed, the 2002 SED annual meeting, and the 2002 UPF workshop on coordination games. The views expressed herein are those of the authors and not necessarily those of the National Bureau of Economic Research.

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Coordination and Policy Traps

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NBER Working Paper No. 9767

June 2003

JEL No. C72, D82, D84, E5, E6, F31

**ABSTRACT**

This paper examines the ability of a policy maker to control equilibrium outcomes in an environment where market participants play a coordination game with information heterogeneity. We consider defense policies against speculative currency attacks in a model where speculators observe the fundamentals with idiosyncratic noise. The policy maker is willing to take a costly policy action only for moderate fundamentals. Market participants can use this information to coordinate on different responses to the same policy action, thus resulting in policy traps, where the devaluation outcome and the shape of the optimal policy are dictated by self-fulfilling market expectations. Despite equilibrium multiplicity, robust policy predictions can be made. The probability of devaluation is monotonic in the fundamentals, the policy maker adopts a costly defense measure only for a small region of moderate fundamentals, and this region shrinks as the information in the market becomes precise.

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*As Mr. Greenspan prepares to give a critical new assessment of the monetary policy outlook in testimony to Congress on Wednesday, the central bank faces a difficult choice in grappling with the economic slowdown. If it heeds the clamour from much of Wall Street and cuts rates now ... it risks being seen as panicky, jeopardizing its reputation for policy-making competence. But if it waits until March 20, it risks allowing the economy to develop even more powerful downward momentum in what could prove a crucial three weeks.* (Financial Times, February 27, 2001)

## 1 Introduction

Economic news anxiously concentrate on the information that different policy choices convey about the intentions of the policy maker and the underlying economic fundamentals, how markets may interpret and react to different policy measures, and whether government intervention can calm down animal spirits and ease markets to coordinate on desirable courses of actions. This paper investigates the ability of a policy maker to influence market expectations and control equilibrium outcomes in environments where market participants play a coordination game with information heterogeneity.

A large number of economic interactions are characterized by strategic complementarities, can be modeled as coordination games, and often exhibit multiple equilibria sustained by self-fulfilling expectations. Prominent examples include self-fulfilling bank runs (Diamond and Dybvig, 1983), debt crises (Calvo, 1988; Cole and Kehoe, 1996), financial crashes (Freixas and Rochet, 1997; Chari and Kehoe, 2003a,b), and currency crises (Flood and Garber, 1984; Obstfeld, 1986, 1996).<sup>1</sup> Building on the *global-games* work of Carlsson and Van Damme (1993), Morris and Shin (1998, 2000) have recently argued that equilibrium multiplicity in such coordination environments is merely “the unintended consequence” of assuming common knowledge of the fundamentals of the game, which implies that agents can perfectly forecast each others’ beliefs and actions in equilibrium. When instead different agents have different private information about the fundamentals, players

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<sup>1</sup>Strategic complementarities arise also in economies with restricted market participation (Azariadis, 1981), production externalities (Benhabib and Farmer, 1994; Bryant, 1983), demand spillovers (Murphy, Shleifer and Vishny, 1989), thick-market externalities (Diamond, 1982), credit constraints (Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997), incomplete risk sharing (Angeletos and Calvet, 2003) and imperfect product market competition (Milgrom and Roberts, 1990; Vives 1999). The reader can refer to Cooper (1999) for an overview of coordination games in macroeconomics.

are uncertain about others' beliefs and actions, and thus perfect coordination is no longer possible. Iterated deletion of strictly dominated strategies then eliminates all but one equilibrium outcome and one system of beliefs.<sup>2</sup>

This argument has been elegantly illustrated by Morris and Shin (1998) in the context of currency crises. When it is common knowledge that a currency is sound but vulnerable to a large speculative attack, two equilibria coexist: One in which all speculators anticipate a crisis, attack the currency and cause a devaluation, which in turn confirms their expectations; another in which speculators refrain from attacking, hence vindicating their beliefs that the currency is not in danger. On the contrary, a unique equilibrium survives when speculators receive noisy idiosyncratic signals about the willingness and ability of the monetary authority to defend the currency against a speculative attack (the fundamentals). Devaluation then occurs if and only if the fundamentals fall below a critical state. This unique threshold in turn depends on all financial and policy variables affecting the payoffs of the speculators. Morris and Shin hence argue that, "in contrast to multiple equilibrium models, [their] model allows analysis of policy proposals directed at curtailing currency attacks." For example, raising domestic interest rates, imposing capital controls, or otherwise increasing the opportunity cost of attacking the currency, reduces the set of fundamentals for which devaluation occurs.

However, when the fundamentals are so weak that the collapse of the currency is inevitable, there is no point in raising domestic interest rates or adopting other costly defense measures. Similarly, when the fundamentals are so strong that the size of the attack is minuscule and the currency faces no threat, there is no need to intervene. Therefore, whenever the bank raises the interest rate, the market can infer that the fundamentals are neither too weak nor too strong. This information in turn may permit coordination in the market on multiple courses of action, thus interfering with the ability of the policy maker to fashion equilibrium outcomes.

In this paper, we analyze endogenous policy in a global coordination game. To settle in a particular environment, we add a first stage to the speculative currency attacks model of Morris and Shin (1998). The central bank moves first, setting the domestic interest rate. Speculators move second, taking a position in the exchange rate market on the basis of their idiosyncratic noisy signals about the fundamentals, as well as their observation of the interest rate set by the central bank. Finally, the bank observes the fraction of speculators attacking the currency and decides whether to defend the currency or devalue.

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<sup>2</sup>See Morris and Shin (2001) for an extensive overview of this literature. Earlier uniqueness results are in Postlewaite and Vives (1987) and Chamley (1999).

The main result of the paper (Theorem 1) establishes that the endogeneity of the policy leads to multiple equilibrium policies and multiple devaluation outcomes, even when the fundamentals are observed with idiosyncratic noise. Different equilibria are sustained by different modes of coordination in the reaction of the market to the same policy choice. Let  $\theta$  denote the fundamentals and  $r$  the interest rate. As long as the value of defending the peg is increasing with  $\theta$  and the size (or the cost) of an attack is decreasing with  $\theta$ , the central bank is willing to incur the cost of a high interest rate in order to defend the currency only for intermediate values of  $\theta$ . The observation of an increase in the interest rate thus signals that the fundamentals are neither too low nor too high, in which case multiple courses of action may be sustained in the market, creating different incentives for the policy maker. If speculators coordinate on the same response to any level of the policy, the bank never finds it optimal to raise the interest rate. Hence, there exists an *inactive policy equilibrium*, in which the bank sets the same low interest rate  $\underline{r}$  for all  $\theta$  and speculators play the Morris-Shin continuation equilibrium in the foreign exchange market. If instead speculators coordinate on a lenient continuation equilibrium (not attacking the currency) when the bank raises the interest rate sufficiently high, and otherwise play an aggressive continuation equilibrium (attacking the currency for sufficiently low private signals), the bank finds it optimal to raise the interest rate for an intermediate range of fundamentals. Hence, there also exists a *continuum of active-policy equilibria*, in which the bank sets a high interest rate  $r^* > \underline{r}$  for  $\theta \in [\theta^*, \theta^{**}]$ , and devaluation occurs if and only if  $\theta < \theta^*$ . Which equilibrium is played, how high is the rate  $r^*$  the bank needs to set in order to be spared from an attack, and what is the threshold  $\theta^*$  below which devaluation occurs, are all determined by self-fulfilling market expectations. This result thus manifests a kind of *policy traps*: In her attempt to fashion the equilibrium outcome, the policy maker reveals information that market participants can use to coordinate on multiple courses of action, and finds herself trapped in a position where both the effectiveness of any particular policy choice and the shape of the optimal policy are dictated by arbitrary market sentiments.

The second result of the paper (Theorem 2) establishes that information heterogeneity significantly reduces the equilibrium set as compared to common knowledge and enables meaningful policy predictions despite the existence of multiple equilibria. In all *robust* equilibria, the probability of devaluation is monotonic in the fundamentals, the policy maker is “anxious to prove herself” by raising the interest rate only for a small region of moderate fundamentals, and the “anxiety region” vanishes as the information in the market becomes precise. None of these predictions could be made if the fundamentals were common knowledge.

In the benchmark model, the policy maker faces no uncertainty about the aggressiveness of

market expectations and the effectiveness of any particular policy choice. We relax this assumption in Section 5 by introducing sunspots on which speculators may condition their response to the policy. The same equilibrium interest rate may now lead to different devaluation outcomes. These results thus reconcile the fact documented by Kraay (2003) and others that raising interest rates does not systematically affect the outcome of a speculative attack – a fact that *prima facie* contradicts the policy prediction of Morris and Shin (1998). Moreover, these results help make sense of the Financial Times quote: The market may be equally likely to “interpret” a costly policy intervention either as a signal of strength, in which case the most desirable outcome may be attained, or as a signal of panic, in which case the policy maker’s attempt to coordinate the market on the preferable course of action proves to be in vain.

On a more theoretical ground, this paper represents a first attempt to introduce *signaling* in *global coordination games*. The receivers (speculators) use the signal (policy) as a coordination device to switch between lenient and aggressive continuation equilibria in the global coordination game, thus creating different incentives for the sender (policy maker) and resulting in different equilibria in the policy game (policy traps). Our multiplicity result is thus different from the multiplicity result in standard signaling games. It is sustained by different modes of coordination, not by different systems of out-of-equilibrium beliefs, and it survives standard forward induction refinements, such as the *intuitive criterion test* of Cho and Kreps (1987). The multiplicity result in this paper is also different from the multiplicity that arises in standard global coordination games with exogenous public signals (e.g., Morris and Shin, 2001; Hellwig, 2002). In our environment, the informational content of the public signal (the policy) is endogenous and it is itself the result of the self-fulfilling expectations of the market. Most importantly, our policy-traps result is not merely about the possibility of multiple continuation equilibria in the coordination game given any realization of the policy; it is rather about how endogenous coordination in the market makes the effectiveness of the policy depend on arbitrary market sentiments and leads to multiple equilibria in the policy game.

Finally, our policy traps are different from the *expectation traps* that arise in Kydland-Prescott-Barro-Gordon environments (e.g., Obstfeld, 1986, 1996; Chari, Christiano and Eichenbaum, 1998; Albanesi, Chari and Christiano, 2002). In these works, multiple equilibria originate in the government’s lack of commitment and would disappear if the policy maker could commit to a fixed policy rule. In our work, instead, equilibrium multiplicity originates in endogenous coordination and is orthogonal to the commitment problem; what is more, despite the risk of falling into a policy trap, the government need *not* have any incentive *ex ante* to commit to a particular interest rate.

The rest of the paper is organized as follows: Section 2 introduces the model and the equilibrium concept. Section 3 analyzes equilibria in the absence of uncertainty over the aggressiveness of market expectations. Section 4 examines to what extent meaningful and robust policy predictions can be made despite the presence of multiple equilibria. Section 5 introduces sunspots to examine equilibria in which the policy maker faces uncertainty over market reactions. Section 6 concludes.

## 2 The Model

### 2.1 Model Description

The economy is populated by a continuum of speculators (market participants) of measure one, indexed by  $i$  and uniformly distributed over the  $[0, 1]$  interval. Each speculator is endowed with one unit of wealth denominated in domestic currency, which he may either invest in a domestic asset or convert to foreign currency and invest it in a foreign asset. In addition, there is a central banker (the policy maker), who controls the domestic interest rate and seeks to maintain a fixed peg, or some kind of managed exchange-rate system.<sup>3</sup> We let  $\theta \in \Theta$  parametrize the cost and benefits the bank associates with maintaining the peg, or equivalently her willingness and ability to defend the currency against a potential speculative attack.  $\theta$  is private information to the bank and corresponds to what Morris and Shin (1998) refer to as “the fundamentals.” For simplicity, we let  $\Theta = \mathbb{R}$  and the common prior shared by the speculators be a degenerate uniform.<sup>4</sup>

The game has three stages. In stage 1, the central banker learns the value of maintaining the peg  $\theta$  and fixes the domestic interest rate  $r \in \mathcal{R} = [\underline{r}, \bar{r}]$ . In stage 2, speculators choose their portfolios after observing the interest rate  $r$  set by the central bank and after receiving private signals  $x_i = \theta + \varepsilon \xi_i$  about  $\theta$ . The scalar  $\varepsilon \in (0, \infty)$  parametrizes the precision of the speculators’ private information about  $\theta$  and  $\xi_i$  is noise, i.i.d. across speculators and independent of  $\theta$ , with absolutely continuous c.d.f.  $\Psi$  and density  $\psi$  strictly positive and continuously differentiable over the entire real line (unbounded full support) or a closed interval  $[-1, +1]$  (bounded support).

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<sup>3</sup>We adopt the convention of using female pronouns for the central banker and masculine pronouns for the speculators.

<sup>4</sup>That the fundamentals of the economy coincide here with the type of the central bank is clearly just a simplification. Our results remain true if one reinterprets  $\theta$  as the policy maker’s perception of the fundamentals of the economy, and  $x_i$  as the signal speculator  $i$  receives about the information of the policy maker. Also, our results hold for any interval  $\Theta \subseteq \mathbb{R}$  and any strictly positive and continuous density over  $\Theta$ , provided that the game remains “global.” We refer to Morris and Shin (2001) for a discussion of the role of degenerate uniform and general common priors in global coordination games.

Finally, in stage 3, the central bank observes the aggregate demand for the foreign currency and decides whether to maintain the peg. Note that stages 2 and 3 of our model correspond to the global speculative game of Morris and Shin (1998); our model reduces to theirs if  $r$  is exogenously fixed. On the other hand, if the fundamentals were common knowledge ( $\varepsilon = 0$ ), stages 2 and 3 would correspond to the speculative game examined by Obstfeld (1986, 1996).

We normalize the foreign interest rate to zero and let the pay-off for a speculator be

$$u(r, a_i, D) = (1 - a_i)r + a_i D \pi,$$

where  $a_i \in [0, 1]$  is the fraction of his wealth converted to foreign currency (equivalently, the probability that he attacks the peg),  $\pi > 0$  is the devaluation premium, and  $D$  is the probability the peg is abandoned. That is, a speculator who does not to attack ( $a_i = 0$ ) enjoys  $r$  with certainty, whereas a speculator who attacks the peg ( $a_i = 1$ ) earns  $\pi$  if the peg is abandoned and zero otherwise.

We denote with  $\alpha$  the aggregate demand for the foreign currency (equivalently, the measure of speculators who attack the peg) and let the payoff for the central bank be

$$U(r, \alpha, D, \theta) = (1 - D)V(\theta, \alpha) - C(r).$$

$V(\theta, \alpha)$  is the net value of defending the currency against an attack of size  $\alpha$  and  $C(r)$  the cost of raising the domestic interest rate at level  $r$ .  $V$  is increasing in  $\theta$  and decreasing in  $\alpha$ ,  $C$  is increasing in  $r$ , and both  $V$  and  $C$  are continuous.<sup>5</sup>

Let  $\underline{\theta}$  and  $\bar{\theta}$  be defined by  $V(\underline{\theta}, 0) = V(\bar{\theta}, 1) = 0$ . For  $\theta < \underline{\theta}$  it is dominant for the bank to devalue, whereas for  $\theta > \bar{\theta}$  it is dominant to maintain the peg. The interval  $[\underline{\theta}, \bar{\theta}]$  thus represents the ‘‘critical range’’ of  $\theta$  for which the peg is sound but vulnerable to a sufficiently large attack. Also, let  $\underline{x} \equiv \inf \{x : \Pr(\theta < \underline{\theta}|x) < 1\}$  and  $\bar{x} \equiv \sup \{x : \Pr(\theta < \bar{\theta}|x) > 0\}$ ; if the noise  $\xi$  has bounded support  $[-1, +1]$ ,  $\underline{x} = \underline{\theta} - \varepsilon$  and  $\bar{x} = \bar{\theta} + \varepsilon$ , whereas  $\underline{x} = -\infty$  and  $\bar{x} = +\infty$  if the noise has unbounded full support. Next, note that  $\underline{r} > 0$  represents the efficient, or cost-minimizing, interest rate. We normalize  $C(\underline{r}) = 0$  and, without any loss of generality, let the domain of the interest rate be  $\mathcal{R} = [\underline{r}, \bar{r}]$ , where  $\bar{r}$  solves  $C(\bar{r}) = \max_{\theta} \{V(\theta, 0) - V(\theta, 1)\}$ ;  $\bar{r}$  represents the maximal interest rate the bank is ever willing to set in order to deter an attack. To make things interesting, we assume  $\bar{r} < \pi$ , which ensures that it is too costly for the bank to raise the interest rate to totally offset the devaluation premium. Finally, to simplify the exposition, we let  $V(\theta, \alpha) = \theta - \alpha$ . It follows that  $\underline{\theta} = 0 = C(\underline{r})$  and  $\bar{\theta} = 1 = C(\bar{r})$ .

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<sup>5</sup>That the bank has no private information about the cost of raising the interest rate is not essential.

## 2.2 Equilibrium Definition

In the analysis that follows, we restrict attention to *perfect Bayesian equilibria* that are not sensitive to whether the idiosyncratic noise in the observation of the fundamentals has bounded or unbounded (full) support. We refer to equilibria that can be sustained under both specifications of the information structure as *robust equilibria*. We will also verify that all robust equilibria satisfy the *intuitive criterion* refinement, first introduced in Cho and Kreps (1987). As the global coordination game described in Section 2.1 is very different from the class of signaling games examined in the literature, it is useful to formalize the equilibrium concept and the intuitive criterion test for the strategic context of this paper.

**Definition 1** A *perfect Bayesian equilibrium* is a set of functions  $r : \Theta \rightarrow \mathcal{R}$ ,  $D : \Theta \times [0, 1] \times \mathcal{R} \rightarrow [0, 1]$ ,  $a : \mathbb{R} \times \mathcal{R} \rightarrow [0, 1]$ ,  $\alpha : \Theta \times \mathcal{R} \rightarrow [0, 1]$ , and  $\mu : \Theta \times \mathbb{R} \times \mathcal{R} \rightarrow [0, 1]$ , such that:

$$r(\theta) \in \arg \max_{r \in \mathcal{R}} U(r, \alpha(\theta, r), D(\theta, \alpha(\theta, r), r), \theta); \quad (1)$$

$$a(x, r) \in \arg \max_{a \in [0, 1]} \int_{\Theta} u(r, a, D(\theta, \alpha(\theta, r), r)) d\mu(\theta|x, r) \quad \text{and} \quad \alpha(\theta, r) = \int_{-\infty}^{+\infty} a(x, r) \psi\left(\frac{x-\theta}{\varepsilon}\right) dx; \quad (2)$$

$$D(\theta, \alpha, r) \in \arg \max_{D \in [0, 1]} U(r, \alpha, D, \theta); \quad (3)$$

$$\mu(\theta|x, r) = 0 \text{ for all } \theta \notin \Theta(x) \text{ and } \mu(\theta|x, r) \text{ satisfies Bayes' rule for any } r \in r(\Theta(x)), \quad (4)$$

where  $\Theta(x) \equiv \{\theta : \psi\left(\frac{x-\theta}{\varepsilon}\right) > 0\}$  is the set of fundamentals  $\theta$  consistent with signal  $x$ .

$r(\theta)$  is the policy of the bank and  $D(\theta, \alpha, r)$  is the probability of devaluation.  $\mu(\theta|x, r)$  is a speculator's posterior belief about  $\theta$  conditional on private signal  $x$  and interest rate  $r$ ,  $a(x, r)$  is the speculator's position in the foreign-exchange market, and  $\alpha(\theta, r)$  the associated aggregate demand for foreign currency.<sup>6</sup> Conditions (1) and (3) mean that the interest rate set in stage 1 and the devaluation decision in stage 3 are sequentially optimal for the bank, whereas condition (2) means that the portfolio choice in stage 2 is sequentially optimal for the speculators, given beliefs  $\mu(\theta|x, r)$  about  $\theta$ . Finally, condition (4) requires that beliefs do not assign positive measure to fundamentals  $\theta$  that are not compatible with the private signals  $x$ , and are pinned down by Bayes' rule on the equilibrium path. To simplify notation, in what follows we will also refer to  $D(\theta) = D(\theta, r(\theta), \alpha(\theta, r(\theta)))$  as the equilibrium devaluation probability for type  $\theta$ .

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<sup>6</sup>That  $\alpha(\theta, r) = \int_{-\infty}^{+\infty} a(x, r) \psi\left(\frac{x-\theta}{\varepsilon}\right) dx$  represents the fraction of speculators attacking the currency follows directly from the Law of Large Numbers when there are countable infinitely many agents; with a continuum, see Judd (1985).

**Definition 2** A perfect Bayesian equilibrium is **robust** if and only if the same policy  $r(\theta)$  and devaluation outcome  $D(\theta)$  can be sustained with both bounded and unbounded idiosyncratic noise in the speculators' observation of  $\theta$ .

As it will become clear in Section 4, this refinement simply eliminates strategic effects that depend critically on whether the speculators' private information has bounded or unbounded full support over the fundamentals. Note that robustness imposes no restriction on the precision of the signals.

**Definition 3** Let  $U(\theta)$  denote the equilibrium payoff of the central bank when the fundamentals are  $\theta$ , and define  $\Theta(r)$  as the set of  $\theta$  for whom the choice  $r$  is dominated in equilibrium by  $r(\theta)$  and  $\mathcal{M}(r)$  as the set of posterior beliefs that assign zero measure to any  $\theta \in \Theta(r)$  whenever  $\Theta(r) \subset \Theta(x)$ .<sup>7</sup> A perfect Bayesian equilibrium survives the **intuitive criterion test** if and only if, for any  $\theta \in \Theta$  and any  $r \in \mathcal{R}$ ,  $U(\theta) \geq U(r, \alpha(\theta, r), D(\theta, \alpha(\theta, r), r), \theta)$ , for  $\alpha(\theta, r)$  satisfying (2) with  $\mu \in \mathcal{M}(r)$ .

In words, a perfect Bayesian equilibrium fails the intuitive criterion test when there is a type  $\theta$  that would be better off by choosing an interest rate  $r \neq r(\theta)$  should speculators' reaction not be sustained by out-of-equilibrium beliefs that assign positive measure to types for whom  $r$  is dominated in equilibrium by  $r(\theta)$ . Such beliefs are often highly implausible, although consistent with the definition of perfect Bayesian equilibria. In our game, all robust equilibria pass the intuitive criterion test.

### 2.3 Model Discussion

The particular pay-off structure and many of the institutional details of the specific coordination environment we consider in this paper are not essential for our results. For example, the cost of the interest rate can be read as the cost of implementing a particular policy; this may depend also on the fundamentals of the economy, as well as the aggregate response of the market. Similarly, the value of maintaining the peg represents the value of coordinating the market on a particular action; this may depend, not only on the underlying fundamentals and the reaction of the market, but also on the policy itself.

That stage 3 is strategic is also not essential. Given the payoff function of the central bank, the devaluation policy is sequentially optimal if and only if  $D(\theta, r, \alpha) = 1$  whenever  $V(\theta, \alpha) < 0$  and

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<sup>7</sup>Formally,  $\Theta(r) \equiv \{\theta \text{ such that } U(\theta) > U(r, \alpha(\theta, r), D(\theta, \alpha(\theta, r), r), \theta) \text{ for any } \alpha(\theta, r) \text{ satisfying (2) and (4) with } \mu \in \mathcal{M}(r)\}$ , where  $\mathcal{M}(r) \equiv \{\mu \text{ satisfying (4) and such that } \mu(\theta|x, r) = 0 \text{ for any } \theta \in \Theta(r) \text{ if } \Theta(r) \subset \Theta(x)\}$ .

$D(\theta, r, \alpha) = 0$  whenever  $V(\theta, \alpha) > 0$ , for any  $r$ . All our results would hold true if the currency were exogenously devalued for any  $\theta$  and  $\alpha$  such that  $V(\theta, \alpha) \leq 0$ , as in the case the bank has no choice but to abandon the peg whenever the aggregate demand of foreign currency ( $\alpha$ ) exceeds the amount of foreign reserves ( $\theta$ ). Indeed, although described as a three-stage game, the model essentially reduces to a two-stage game, where in the first stage the policy maker signals information about  $\theta$  to the market and in the second stage speculators play a global coordination game in response to the action of the policy maker. Stage 3 serves only to introduce strategic complementarities in the actions of market participants.<sup>8</sup>

In short, we suggest that our model may well fit a broader class of environments in which a stage of endogenous information transmission (signaling) is followed by a global coordination game, such as, for example, in the case of a government offering an investment subsidy in an attempt to stimulate the adoption of a new technology, or a telecommunications company undertaking an aggressive advertising campaign in attempt to persuade consumers to adopt her service.

### 3 Policy Traps

#### 3.1 Exogenous versus Endogenous Policy

Suppose for a moment that the interest rate  $r$  is exogenously fixed, say  $r = \underline{r}$ . Our model then reduces to the model of Morris and Shin (1998). The lack of common knowledge over the fundamentals eliminates any possibility of coordination and iterated deletion of strongly dominated strategies selects a unique equilibrium profile and a unique system of equilibrium beliefs.

**Proposition 1 (Morris-Shin)** *In the speculative game with exogenous interest rate policy, there exists a unique perfect Bayesian equilibrium, in which a speculator attacks if and only if  $x < x_{MS}$  and the bank devalues if and only if  $\theta < \theta_{MS}$ . The thresholds  $x_{MS}$  and  $\theta_{MS}$  are defined by*

$$\theta_{MS} = \frac{\pi - \underline{r}}{\pi} = \Psi \left( \frac{x_{MS} - \theta_{MS}}{\varepsilon} \right) \quad (5)$$

and are decreasing in  $\underline{r}$ .

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<sup>8</sup>Note that, if the bank could commit never to devalue in stage 3, there would be no speculation in stage 2, and the market would not play a coordination game. Such lack of commitment is essential for the literature on *policy discretion* and *expectation traps*, but not for our results. What is essential for the kind of policy traps we identify in this paper is that the game the market plays in response to the action of the policy maker is a global coordination game; the origin of strategic complementarities is irrelevant.

**Proof.** Uniqueness is established in Morris and Shin (1998). Here, we only characterize  $x_{MS}$  and  $\theta_{MS}$  in our setting. Given that  $D(\theta) = 1$  if  $\theta < \theta_{MS}$  and  $D(\theta) = 0$  otherwise, a speculator with signal  $x$  finds it optimal not to attack if and only if  $\pi\mu(\theta < \theta_{MS}|x) \leq \underline{r}$ , where  $\mu(\theta < \theta_{MS}|x) = \int_{\theta < \theta_{MS}} d\mu(\theta|x)$ . By Bayes rule,  $\mu(\theta < \theta_{MS}|x) = 1 - \Psi\left(\frac{x - \theta_{MS}}{\varepsilon}\right)$ . Thus,  $x_{MS}$  solves the indifference condition  $\pi \left[1 - \Psi\left(\frac{x_{MS} - \theta_{MS}}{\varepsilon}\right)\right] = \underline{r}$ . The fraction of speculators attacking is then  $\alpha(\theta, \underline{r}) = \Pr(x < x_{MS}|\theta) = \Psi\left(\frac{x_{MS} - \theta}{\varepsilon}\right)$ . It follows that  $V(\theta, \alpha(\theta, \underline{r})) < 0$ , and hence the bank devalues, if and only if  $\theta < \theta_{MS}$ , where  $\theta_{MS}$  solves  $V(\theta_{MS}, \alpha(\theta_{MS}, \underline{r})) = 0$ , that is,  $\theta_{MS} = \Psi\left(\frac{x_{MS} - \theta_{MS}}{\varepsilon}\right)$ . Combining the indifference condition for the speculators with that for the central bank gives (5). It is then immediate that  $x_{MS}$  and  $\theta_{MS}$  are both decreasing in  $\underline{r}$ . ■

The larger the return on the domestic asset, or the higher the cost of short-selling the domestic currency, the less attractive it is for a speculator to take the risk of attacking the currency. It follows that  $x_{MS}$  and  $\theta_{MS}$  are decreasing functions of  $\underline{r}$ , which suggests that the monetary authority should be able to reduce the likelihood and severity of a currency crisis by simply raising the domestic interest rate, or more generally reducing the speculators' ability and incentives to attack.

Indeed, that would be the end of the story if the policy did not convey any information to the market. However, since raising the interest rate is costly, a high interest rate signals that the bank is willing to defend the currency and hence that the fundamentals are not too weak. On the other hand, as long as speculators do not attack when their private signal is sufficiently high, the bank faces only a small attack when the fundamentals are sufficiently strong, in which case there is no need to raise the interest rate. Therefore, any attempt to defend the peg by increasing the interest rate is interpreted by the market as a signal of intermediate fundamentals,<sup>9</sup> in which case speculators may coordinate on either an aggressive or a lenient course of action. Different modes of coordination then create different incentives for the policy maker and result in different equilibria. At the end, which equilibrium is played, how high is the level of the policy the bank needs to set in order to be spared from a crisis, and what is the critical value of the fundamentals below which a devaluation occurs, are all determined by self-fulfilling market expectations.

**Theorem 1 (Policy Traps)** *In the speculative game with endogenous policy, there exist multiple perfect Bayesian equilibria for any  $\varepsilon > 0$ .*

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<sup>9</sup>This interpretation of the information conveyed by a high interest rate follows from Bayes' rule if the observed level of the interest rate is on the equilibrium path, and from forward induction (the intuitive criterion) otherwise.

(a) *There is an **inactive-policy equilibrium**: The bank sets the cost-minimizing interest rate  $\underline{r}$  for all  $\theta$  and devaluation occurs if and only if  $\theta < \theta_{MS}$ .*

(b) *There is a continuum of **active-policy equilibria**: Let  $\tilde{r}$  solve  $C(\tilde{r}) = \frac{\pi - \underline{r}}{\pi}$ ; For any  $r^* \in (\underline{r}, \tilde{r}]$ , there is an equilibrium in which the bank sets either  $\underline{r}$  or  $r^*$ , raises the interest rate at  $r^*$  only for  $\theta \in [\theta^*, \theta^{**}]$ , and devalues if and only if  $\theta < \theta^*$ , where*

$$\theta^* = C(r^*) \quad \text{and} \quad \theta^{**} = \theta^* + \varepsilon \left[ \Psi^{-1} \left( 1 - \frac{r}{\pi - \underline{r}} \theta^* \right) - \Psi^{-1}(\theta^*) \right]. \quad (6)$$

*The threshold  $\theta^*$  is independent of  $\varepsilon$  and can take any value in  $(\underline{\theta}, \theta_{MS}]$ , whereas the threshold  $\theta^{**}$  is increasing in  $\varepsilon$  and converges to  $\theta^*$  as  $\varepsilon \rightarrow 0$ .*

*All the above equilibria are robust, satisfy the intuitive criterion, and can be supported by strategies for the speculators that are monotonic in  $x$ .*

The proof of Theorem 1 follows from Propositions 2 and 3, which we present in the next two sections. Theorem 1 states that there is a continuum of equilibria, which contrasts with the uniqueness result and the policy conjecture of Morris and Shin. The policy maker is subject to *policy traps*: In her attempt to use the interest rate so as to fashion the size of a currency attack, the monetary authority reveals information that the fundamentals are neither too weak nor too strong. This information facilitates coordination in the market, sustains multiple self-fulfilling market responses to the same policy choice, and leads to a situation where the effectiveness of any particular policy (the eventual devaluation outcome) and the shape of the optimal policy are dictated by the arbitrary aggressiveness of market expectations. In the *inactive-policy equilibrium*, speculators expect the bank never to raise the interest rate and play the same continuation equilibrium (attacking if and only if  $x < x_{MS}$ ) for any  $r$ . Anticipating this, the bank finds it pointless to raise the interest rate, which in turn vindicates market expectations. In an *active-policy equilibrium* instead, speculators expect the bank to raise the interest rate at  $r^*$  only for  $\theta \in [\theta^*, \theta^{**}]$ , coordinate on an aggressive response for any  $r < r^*$  and on a lenient one for any  $r \geq r^*$ . Again, the bank can do no better than simply conforming to the arbitrary self-fulfilling expectations of the market.

All equilibria in Theorem 1 can be supported by simple threshold strategies for the speculators that are monotonic in  $x$ . That is, given any policy choice  $r$ , a speculator attacks the currency if and only his private signal about the fundamentals falls below a threshold which depends on the particular equilibrium played by the market.

Finally, note that all active-policy equilibria in Theorem 1 share the following properties. First, the devaluation outcome is monotonic in the fundamentals. Second, the devaluation threshold

is determined by self-fulfilling market expectations, but never exceeds the devaluation threshold that would prevail under policy inaction. Third, when the fundamentals are either very weak, or sufficiently strong, the market can easily recognize this, in which case there is no value for the policy maker to raise the interest rate; it is then only for a small range of moderate fundamentals that the market is likely to be “uncertain” or “confused” about eventual devaluation outcomes, and it is thus only for moderate fundamentals that the policy maker is “anxious to prove herself” by taking a costly policy action. Fourth, the “anxiety region” shrinks as the precision of market information increases. In Section 4, we further discuss the *robustness* of these policy predictions.

### 3.2 Inactive Policy Equilibrium

When the interest rate is endogenous, the Morris-Shin outcome survives as an inactive policy equilibrium, in which the interest rate remains uninformative about the probability the currency will be devalued.

**Proposition 2 (Perfect Pooling)** *There is a robust inactive policy equilibrium, in which the central bank sets  $\underline{r}$  for all  $\theta$ , speculators attack if and only if  $x < x_{MS}$ , independently of the interest rate chosen by the central bank, and devaluation occurs if and only if  $\theta < \theta_{MS}$ . The thresholds  $x_{MS}$  and  $\theta_{MS}$  are defined as in (5).*

**Proof.** Since in equilibrium all  $\theta$  set  $r = \underline{r}$ , the observation of  $\underline{r}$  conveys no information about the fundamentals  $\theta$  and hence the continuation game starting after the bank sets  $r = \underline{r}$  is isomorphic to the Morris-Shin game: There is a unique continuation equilibrium, in which a speculator attacks if and only if  $x < x_{MS}$  and the central bank devalues if and only if  $\theta < \theta_{MS}$ . Equilibrium beliefs are then pinned down by Bayes’ rule.

Next, consider out-of-equilibrium interest rates. Note that  $\tilde{r}$  solves  $C(\tilde{r}) = V(\theta_{MS}, 0)$ . Any  $r > \tilde{r}$  is dominated in equilibrium by  $\underline{r}$  for all types: For  $\theta < \theta_{MS}$ ,  $V(\theta, 0) - C(r) < 0$ ; for  $\theta \geq \theta_{MS}$ ,  $C(r) > \theta_{MS} > \alpha(\theta, \underline{r})$  and thus  $V(\theta, 0) - C(r) < V(\theta, \alpha(\theta, \underline{r}))$ . On the other hand, any  $r \in (\underline{r}, \tilde{r})$  is dominated in equilibrium by  $r(\theta)$  for any  $\theta$  such that  $\theta < C(r)$  or  $\alpha(\theta, \underline{r}) < C(r)$ , where  $C(r) \leq C(\tilde{r}) = \theta_{MS}$ . Therefore, for any out-of-equilibrium  $r \neq \tilde{r}$ , one can construct out-of-equilibrium beliefs  $\mu$  that satisfy (4) and the intuitive criterion, i.e.  $\mu \in \mathcal{M}(r)$ , and such that  $\mu(\theta < \theta_{MS} | x, r)$  is non-increasing in  $x$  and satisfies  $\pi\mu(\theta < \theta_{MS} | x, r) = r$  at  $x = x_{MS}$ . For such beliefs, a speculator finds it optimal to attack if and only if  $x < x_{MS}$ , forcing devaluation to occur if and only if  $\theta < \theta_{MS}$ . Finally, for  $r = \tilde{r}$ ,<sup>10</sup> let  $\mu(\theta_{MS} | x, \tilde{r}) = 1$  for all  $x$  such that  $\theta_{MS} \in \Theta(x)$ , and

<sup>10</sup>Note that  $\tilde{r}$  is dominated in equilibrium by  $\underline{r}$  for all  $\theta \neq \theta_{MS}$ .

$\mu(\theta|x, \tilde{r}) = \mu(\theta|x)$  otherwise, so that again (4) and the intuitive criterion are satisfied. Then, there is a mixed-strategy equilibrium for the continuation game following  $r = \tilde{r}$ , in which a speculator attacks if and only if  $x < x_{MS}$  and type  $\theta_{MS}$  devalues with probability  $\tilde{r}/\pi$ .

Given that speculators attack if and only if  $x < x_{MS}$  for any  $r$ , it is optimal for the central bank to set  $r(\theta) = \underline{r}$  for all  $\theta$ . Finally, consider robustness in the sense of Definition 2. Given  $\theta_{MS} = \frac{\pi - \underline{r}}{\underline{r}} \in (0, 1)$ , (5) is satisfied for any  $\varepsilon > 0$  and any c.d.f.  $\Psi$ , with either bounded or unbounded support, by simply letting  $x_{MS} = \theta_{MS} + \varepsilon \Psi^{-1}(\theta_{MS})$ . It follows that the policy  $r(\theta) = \underline{r}$  for all  $\theta$ , and the devaluation outcome  $D(\theta) = 1$  for  $\theta < \theta_{MS}$  and  $D(\theta) = 0$  otherwise, can be sustained as a robust equilibrium. ■

The inactive policy equilibrium is illustrated in Figure 1.  $\theta$  is on the horizontal axis,  $\alpha$  and  $C$  on the vertical one. The devaluation threshold  $\theta_{MS}$  is the point of intersection between the value of defending the peg  $\theta$  and the size of the attack  $\alpha(\theta, \underline{r})$ . Figure 1 also illustrates the intuitive criterion. Note that the equilibrium payoff is  $U(\theta) = 0$  for all  $\theta \leq \theta_{MS}$  and  $U(\theta) = \theta - \alpha(\theta, \underline{r}) > 0$  for all  $\theta > \theta_{MS}$ . Consider a deviation to some  $r' \in (\underline{r}, \tilde{r})$  and let  $\theta'$  and  $\theta''$  solve  $\theta' = C(r') = \alpha(\theta'', \underline{r})$ . Note that  $C(r') > \theta$  if and only if  $\theta < \theta'$  and  $C(r') > \alpha(\theta, \underline{r})$  if and only if  $\theta > \theta''$ , which implies that  $r'$  is dominated in equilibrium by  $\underline{r}$  if and only if  $\theta \notin [\theta', \theta'']$ . Hence, if  $\theta \in [\theta', \theta'']$  and the bank deviates to  $r'$ , the market “learns” that  $\theta \in [\theta', \theta'']$ .<sup>11</sup> Furthermore, since  $\theta_{MS} \in [\theta', \theta'']$ , one can construct beliefs that are compatible with the intuitive criterion for which speculators continue to attack whenever  $x < x_{MS}$ , in which case it is pointless for the bank to raise the interest rate at  $r'$ .

Insert Figure 1 here

Clearly, any system of beliefs and strategies such that  $\alpha(\theta, r) \geq \alpha(\theta, \underline{r})$  for all  $r > \underline{r}$  sustains policy inaction as an equilibrium; the bank has then no choice but to set  $r(\theta) = \underline{r}$  for all  $\theta$ , confirming the expectations of the market. Note that a higher interest rate increases the opportunity cost of attacking the currency and, other things equal, reduces the speculators’ incentives to attack. In an inactive-policy equilibrium, however, this portfolio effect is offset by the higher probability speculators attach to a final devaluation. The particular beliefs we consider in the proof of Proposition 2 have the property that these two effects *just* offset each other, in which case speculators use the

<sup>11</sup>Throughout the paper, the expression “the market learns  $X$  by observing  $Y$ ” means that the event  $X$  becomes *common  $p = 1$  belief* among the speculators given that  $Y$  is common knowledge; see Monderer and Samet (1989) and Kajii and Morris (1995).

same strategy on and off the equilibrium path and condition their behavior *only* on their private information. It is then as if speculators do not pay attention to the policy of the bank.<sup>12</sup>

### 3.3 Active Policy Equilibria

We now prove the existence of robust active-policy equilibria in which the bank raises the interest rate at  $r^*$  for every  $\theta \in [\theta^*, \theta^{**}]$ .

**Proposition 3 (Two-Threshold Equilibria)** *For any  $r^* \in (\underline{r}, \tilde{r}]$ , there is a two-threshold equilibrium in which the central bank sets  $r^*$  for all  $\theta \in [\theta^*, \theta^{**}]$  and  $\underline{r}$  otherwise; speculators attack if and only if either  $r < r^*$  and  $x < x^*$ , or  $r \geq r^*$  and  $x < \underline{x}$ ; finally, devaluation occurs if and only if  $\theta < \theta^*$ .  $x^*$  solves  $\pi\mu(\theta < \theta^* | x^*, \underline{r}) = \underline{r}$ , whereas  $\theta^*$  and  $\theta^{**}$  are given by (6). A two-threshold equilibrium exists if and only if  $r^* \in (\underline{r}, \tilde{r}]$  or, equivalently, if and only if  $\theta^* \in (\underline{\theta}, \theta_{MS}]$ . All two-threshold equilibria are robust.*

**Proof.** Let  $\hat{\theta} \in [\theta^*, \theta^{**}]$  solve  $V(\hat{\theta}, \alpha(\hat{\theta}, \underline{r})) = 0$ , where  $\alpha(\hat{\theta}, \underline{r}) = \Psi\left(\frac{x^* - \hat{\theta}}{\varepsilon}\right)$ , and note that, for any  $r < r^*$ , speculators trigger devaluation if and only if  $\theta < \hat{\theta}$ .

Consider first the behavior of the speculators. When  $r = \underline{r}$ , beliefs are pinned down by Bayes' rule for all  $x$ , since (6) ensures  $\Theta(x) \not\subseteq [\theta^*, \theta^{**}]$  for all  $x$ .<sup>13</sup> Therefore,

$$\mu(D(\theta) = 1 | x, \underline{r}) = \mu(\theta < \hat{\theta} | x, \underline{r}) = \mu(\theta < \theta^* | x, \underline{r}) = \frac{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right)}{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right) + \Psi\left(\frac{x - \theta^{**}}{\varepsilon}\right)},$$

which is decreasing in  $x$ . We let  $x^*$  be the unique solution to  $\mu(\theta < \theta^* | x^*, \underline{r}) = \underline{r}/\pi$ . For any  $r \in (\underline{r}, r^*)$ , we consider out-of-equilibrium beliefs  $\mu$  such that  $\mu(\theta < \hat{\theta} | x, r)$  is non-increasing in  $x$  and  $\pi\mu(\theta < \hat{\theta} | x, r) = r$  at  $x = x^*$ . Furthermore, if for some  $\theta \in \Theta(x)$ ,  $r$  is not dominated in equilibrium by  $r(\theta)$ , i.e., if  $C(r) \leq \min\{\alpha(\theta, \underline{r}), \theta\}$ , then we further restrict  $\mu$  to satisfy  $\mu(\theta | x, r) = 0$  for all  $\theta \in \Theta(x)$  such that  $\theta < C(r)$  or  $\alpha(\theta, \underline{r}) < C(r)$ . When  $r = r^*$ , Bayes' rule implies  $\mu(\theta \in [\theta^*, \theta^{**}] | x, r^*) = 1$  for all  $x$  such that  $\Theta(x) \cap [\theta^*, \theta^{**}] \neq \emptyset$ . Finally, for any  $(x, r)$  such that either  $r = r^*$  and  $\Theta(x) \cap [\theta^*, \theta^{**}] = \emptyset$ , or  $r > r^*$ , we let  $\mu(\theta \geq \underline{\theta} | x, r) = 1$  for all  $x \geq \underline{x}$  and  $\mu(\theta \geq \underline{\theta} | x, r) = 0$  otherwise. Given these beliefs, (4) is satisfied,  $\mu \in \mathcal{M}(r)$  for any  $r$ , and the strategy of the speculators is sequentially optimal.

<sup>12</sup>Moreover, speculators do not need to “learn” how to behave off the equilibrium path; they simply continue to play the same strategy they “learned” to play in equilibrium.

<sup>13</sup>When the noise is unbounded, this is immediate; when it is bounded, it follows from the fact that  $|\theta^{**} - \theta^*| < 2\varepsilon$  and  $\Theta(x) = [x - \varepsilon, x + \varepsilon]$ , for any  $x$ .

Consider next the central bank. Given the strategy of the speculators, the bank clearly prefers  $\underline{r}$  to any  $r \in (\underline{r}, r^*)$  and  $r^*$  to any  $r > r^*$ .  $\theta^*$  is indifferent between setting  $r^*$  (and not being attacked) and setting  $\underline{r}$  (and being forced to devalue) if and only if  $V(\theta^*, 0) - C(r^*) = 0$ , i.e.  $\theta^* = C(r^*)$ . Similarly,  $\theta^{**}$  is indifferent between setting  $r^*$  (and not being attacked) and setting  $\underline{r}$  (and being attacked without devaluing) if and only if  $V(\theta^{**}, 0) - C(r^*) = V(\theta^{**}, \alpha(\theta^{**}, \underline{r}))$ , i.e.  $C(r^*) = \alpha(\theta^{**}, \underline{r})$ , where  $\alpha(\theta^{**}, \underline{r}) = \Psi\left(\frac{x^* - \theta^{**}}{\varepsilon}\right)$ . For any  $\theta < \theta^*$ ,  $\underline{r}$  is optimal; for any  $\theta \in (\theta^*, \theta^{**})$ ,  $\alpha(\theta, \underline{r}) > \alpha(\theta^{**}, \underline{r}) = C(r^*)$  and thus  $r^*$  is preferred to  $\underline{r}$ , whereas the reverse is true for any  $\theta > \theta^{**}$ . From the indifference conditions for  $\theta^*$ ,  $\theta^{**}$ , and  $x^*$ , we obtain  $x^* = \theta^{**} + \varepsilon\Psi^{-1}(\theta^*)$  and

$$\theta^{**} = \theta^* + \varepsilon \left[ \Psi^{-1} \left( 1 - \frac{\underline{r}}{\pi - \underline{r}} \theta^* \right) - \Psi^{-1}(\theta^*) \right]. \quad (7)$$

It follows that  $\theta^* \leq \theta^{**}$  if and only if  $\theta^* \leq (\pi - \underline{r})/\pi = \theta_{MS}$ . Using  $\theta^* = C(r^*)$  and  $\theta_{MS} = C(\tilde{r})$ , we infer that a two threshold equilibrium exists if and only if  $\theta^* \in (\underline{\theta}, \theta_{MS}]$ , or equivalently  $r^* \in (\underline{r}, \tilde{r}]$ . Finally, consider robustness in the sense of Definition 2. For any  $r^* \in (\underline{r}, \tilde{r})$ , let  $\theta^* = C(r^*)$  and take any arbitrary  $\theta^{**} > \theta^*$ . For any c.d.f.  $\Psi$  with either bounded support  $[-1, +1]$  or unbounded full support  $\mathbb{R}$ , we have that  $\kappa \equiv \left[ \Psi^{-1} \left( 1 - \frac{\underline{r}}{\pi - \underline{r}} \theta^* \right) - \Psi^{-1}(\theta^*) \right] \in (0, \infty)$  since  $(1 - \frac{\underline{r}}{\pi - \underline{r}} \theta^*) \in (\theta^*, 1)$ . Hence, for any  $\theta^{**} > \theta^*$  and for any  $\kappa$ , condition (7) can always be satisfied by letting  $\varepsilon = \frac{\theta^{**} - \theta^*}{\kappa} \in (0, \infty)$ . For  $r^* = \tilde{r}$ ,  $\theta^* = \theta^{**} = \theta_{MS}$  and (7) holds for every  $\varepsilon$  and every  $\Psi$ . The indifference condition for the speculators is then clearly satisfied at  $x^* = \theta^{**} + \varepsilon\Psi^{-1}(\theta^*)$ . It follows that the policy  $r(\theta) = r^*$  if  $\theta \in [\theta^*, \theta^{**}]$  and  $r(\theta) = \underline{r}$  otherwise, and the devaluation outcome  $D(\theta) = 1$  if  $\theta < \theta^*$  and  $D(\theta) = 0$  otherwise, can be sustained as a robust equilibrium. ■

A two-threshold equilibrium is illustrated in Figure 2. Like in the inactive policy equilibrium, the observation of any interest rate  $r > \underline{r}$  is interpreted by market participants as a signal of intermediate fundamentals. However, contrary to the inactive policy equilibrium, speculators switch from playing aggressively (attacking if and only if  $x < x^*$ ) to playing leniently (attacking if and only if  $x < \underline{x}$ ) whenever the policy meets market expectations ( $r \geq r^*$ ). Anticipating this reaction by market participants, the bank finds it optimal to raise the interest rate to defend the currency whenever the fundamentals are strong enough that the net value of defending the currency offsets the cost of raising the interest rate ( $\theta \geq \theta^*$ ), but not so strong that the cost of facing a small and unsuccessful attack is lower than the cost of raising the interest rate ( $\theta \leq \theta^{**}$ ). The thresholds  $\theta^*$  and  $\theta^{**}$  are determined by the indifference conditions  $\theta^* = C(r^*)$  and  $\alpha(\theta^{**}, \underline{r}) = C(r^*)$ , as illustrated in Figure 2. Finally, note that, in any two-threshold equilibrium, the exact fundamentals  $\theta$  never become common knowledge among speculators. What the market “learns” from equilibrium policy

observations is only whether  $\theta \in [\theta^*, \theta^{**}]$  or  $\theta \notin [\theta^*, \theta^{**}]$ , but this is enough to facilitate coordination.

Insert Figure 2 here

There are other out-of-equilibrium beliefs and strategies for the speculators that also sustain the same two-threshold equilibria. For example, we could have assumed speculators coordinate on the *most* aggressive continuation equilibrium (attack if and only if  $x < \bar{x}$ ) whenever the policy falls short of market expectations ( $\underline{r} < r < r^*$ ). Nonetheless, the beliefs and strategies we consider in the proof of Proposition 3 have the appealing property that the speculators' strategy is the same for all  $r < r^*$ . It is then as if speculators simply “ignore” any attempt of the policy maker that falls short of market expectations and continue to play exactly as if there had been no intervention.

For any  $r^*$ , the devaluation threshold  $\theta^*$  is independent of  $\varepsilon$ , whereas  $\theta^{**}$  is increasing in  $\varepsilon$  and  $\theta^{**} \rightarrow \theta^*$  as  $\varepsilon \rightarrow 0$ . As private information becomes more precise, the bank needs to raise the interest rate only for a smaller measure of fundamentals. At the limit, the interest rate policy has a spike at an arbitrary devaluation threshold  $\theta^* \in (\underline{\theta}, \theta_{MS}]$  dictated by market expectations. Note also that a two-threshold equilibrium exists if and only if  $\theta^* \leq \theta_{MS}$ . The intuition behind this result is as follows. From the bank's indifference conditions,  $\theta^* = C(r^*) = \alpha(\theta^{**}, \underline{r})$ , we infer that a higher  $r^*$  raises both the devaluation threshold  $\theta^*$  and the size of the attack at  $\theta^{**}$ . The latter is given by  $\Pr(x \leq x^* | \theta^{**})$ , which is also equal to  $\Pr(\theta \geq \theta^{**} | x^*)$ . Therefore,  $\Pr(\theta \geq \theta^{**} | x^*)$  increases with  $r^*$ . For a marginal speculator to be indifferent between attacking and non attacking conditional on  $r = \underline{r}$ , it must be that  $\Pr(\theta \leq \theta^* | x^*)$  also increases with  $r^*$ . It follows that  $\Delta\theta(r^*) \equiv \theta^{**} - \theta^*$  is decreasing in  $r^*$ . Obviously,  $\Delta\theta(r^*)$  is also continuous in  $r^*$ . A two-threshold equilibrium exists if and only if  $\Delta\theta(r^*) \geq 0$ . By the monotonicity of  $\Delta\theta(r^*)$ , there exists at most one  $\tilde{r}$  such that  $\Delta\theta(\tilde{r}) = 0$ , and  $\Delta\theta(r^*) > 0$  if and only if  $r^* < \tilde{r}$ . But  $\Delta\theta(\tilde{r}) = 0$  if and only if  $\theta^* = \theta^{**}$ , in which case the continuation game following  $\underline{r}$  is (essentially) the Morris-Shin game and therefore  $\theta^* = \theta^{**} = \theta_{MS}$ . It follows that  $\tilde{r}$  solves  $C(\tilde{r}) = V(\theta_{MS}, 0) = \frac{\pi - \underline{r}}{\pi}$  and a two-threshold equilibrium exists if and only if  $r^* \in (\underline{r}, \tilde{r}]$ , or equivalently, if and only if  $\theta^* \in (\underline{\theta}, \theta_{MS}]$ . In Section 4, we will establish that these properties extends to *all* robust equilibria of the game.

### 3.4 Discussion

We conclude this section with a few remarks about the role of coordination, signaling, and commitment in our environment.

First, consider environments where the market does *not* play a coordination game in response

to the policy maker, such as when the bank (sender) interacts with a single speculator (receiver).<sup>14</sup> In such environments, the policy can be non-monotonic if the receivers have access to exogenous information that allows to separate very high from very low types of the sender (Feltovich, Harbaugh and To, 2002). Moreover, multiple equilibria could possibly be supported by different out-of-equilibrium beliefs. However, a *unique* equilibrium would typically survive the intuitive criterion or other proper refinements. To the contrary, the multiplicity we have identified in this paper does not depend in any critical way on the specification of out-of-equilibrium beliefs, originates merely in endogenous coordination, and would not arise in environments with a single receiver. The comparison is sharp if we consider  $\varepsilon \rightarrow 0$ . The limit of all equilibria of the game with a single speculator would have the latter attacking the currency if and only if  $x < \bar{\theta}$ , and the bank devaluing if and only if  $\theta < \bar{\theta}$ . Contrast this with our findings in Theorem 1, where the devaluation threshold  $\theta^*$  can take any value in  $(\underline{\theta}, \theta_{MS}]$ .

Second, consider environments where there is no signaling, such as standard global coordination games. As shown in Morris and Shin (2001) and Hellwig (2002), these games may exhibit multiple equilibria if market participants observe sufficiently informative *public* signals about the underlying fundamentals. The multiplicity of equilibria documented in Theorem 1, however, is substantially different from the kind of multiplicity in that literature. The policy in our model does generate a public signal about the fundamentals. Yet, the informational content of this signal is endogenous, as it depends on the particular equilibrium played in the market. Moreover, Theorem 1 is not about the possibility of multiple continuation equilibria in the coordination game that follows a given realization of the public signal; it is rather about how endogenous coordination in the market makes the effectiveness of the policy depend on arbitrary market sentiments and leads to multiple equilibria in the signaling game.

Third, note that policy introduces a very specific kind of signal. The observation of active policy reveals that the fundamentals are neither too weak nor too strong, and it is this particular kind of information that restores the ability of the market to coordinate on different courses of action. In this respect, an interesting extension is to consider the possibility the policy itself is observed with noise. It can be shown that all equilibria of Theorem 1 are robust to the introduction of small bounded noise in the speculators' observation of the policy, whether the noise is aggregate or idiosyncratic.<sup>15</sup>

Lastly, consider the role of commitment. Note that policy traps arise in our environment *because*

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<sup>14</sup>See, for example, Drazen (2001).

<sup>15</sup>The proof of this claim is available upon request.

the policy maker moves first, thus revealing valuable information about the fundamentals, which market participants use to coordinate their response to the policy choice. This raises the question of whether the policy maker would be better off committing to a certain level of the policy before observing  $\theta$ , thus inducing a unique continuation equilibrium in the coordination game. To see that commitment is not necessarily optimal, suppose the noise  $\xi$  has full support and consider  $\varepsilon \rightarrow 0$ . If the policy maker commits ex ante to some interest rate  $r$ , she incurs a cost  $C(r)$  and ensures that devaluation will occur if and only if  $\theta < \widehat{\theta}(r) \equiv \frac{\pi-r}{\pi}$ ; moreover, for all  $\theta > \widehat{\theta}(r)$ ,  $\alpha(\theta, r) \rightarrow 0$  as  $\varepsilon \rightarrow 0$ .<sup>16</sup> Hence, the ex ante payoff from committing to  $r$  is  $U(r) = \Pr(\theta \geq \widehat{\theta}(r))\mathbb{E}[\theta | \theta \geq \widehat{\theta}(r)] - C(r)$ . Let  $U_c = \max_r U(r)$  and  $\theta_c = \min\{\widehat{\theta}(r_c) | r_c \in \arg \max_r U(r)\}$ . If instead the policy maker retains the option to fashion the policy contingent on  $\theta$ , the ex ante payoff depends on the particular equilibrium  $(r^*, \theta^*, \theta^{**})$  the policy maker expects to be played.<sup>17</sup> As  $\varepsilon \rightarrow 0$ ,  $\theta^{**} \rightarrow \theta^*$  and  $\alpha(\theta, r) \rightarrow 0$  for all  $\theta \geq \theta^{**}$ , meaning the bank pays  $C(r^*)$  only for a negligible measure of  $\theta$ . It follows that the ex ante value of discretion is  $U_d = \Pr(\theta \geq \theta^*)\mathbb{E}[\theta | \theta \geq \theta^*]$ . But note that  $\theta_c > \underline{\theta}$ , and therefore any  $\theta^* \in (\underline{\theta}, \theta_c)$  necessarily leads to  $U_d > U_c$ . A similar argument holds for arbitrary  $\varepsilon$ . We conclude that, even when perfect commitment is possible, the government will prefer discretion ex ante as long as she is not too pessimistic about future market sentiments.

## 4 Robust Policy Predictions

Propositions 2 and 3 left open the possibility that there also exist other equilibria outside the two classes of Theorem 1, which would only strengthen our argument that policy endogeneity facilitates coordination and leads to policy traps. Nonetheless, we are also interested in identifying equilibria that are not sensitive to the particular assumptions about the underlying information structure of the game, in which case “robust” policy predictions can be made.

We first note that, when the noise has unbounded full support, for any  $r^* \in (\underline{r}, \bar{r}]$  one can construct a one-threshold equilibrium, in which speculators threaten to attack the currency whenever they observe any  $r < r^*$ , no matter how high their private signal  $x$ , thus forcing the bank to raise the interest rate at  $r^*$  for all  $\theta$  above the devaluation threshold  $\theta^*$ , where  $\theta^*$  solves  $V(\theta^*, 0) = C(r^*)$ . This threat is sustained by beliefs such that speculators interpret any failure of the bank to raise the interest rate as a signal of devaluation independently of their private information about the

<sup>16</sup>These results follow from Proposition 1, replacing  $\underline{r}$  with an arbitrary  $r$ .

<sup>17</sup>Note that the payoff for the policy maker associated with the pooling equilibrium of Proposition 2 equals the payoff associated with the two-threshold equilibrium in which  $\theta^* = \theta_{MS}$ .

fundamentals. It seems more plausible, however, that speculators remain confident that the peg will be maintained when they observe sufficiently high  $x$  even if the bank fails to raise the interest rate, in which case all one-threshold equilibria disappear. This is necessarily true when the noise is bounded: For  $x > \bar{x} \equiv \bar{\theta} + \varepsilon$  speculators find it dominant not to attack, which implies that for all  $\theta > \bar{x} + \varepsilon$  the bank faces no attack and hence sets  $\underline{r}$ .

On the other hand, when the noise has a bounded support, it is possible for the market to separate types that set the same interest rate. For example, suppose that for some  $\theta_1, \theta_2, \theta_3, \theta_4$  with  $\theta_1 < \theta_2 < \theta_2 + 2\varepsilon < \theta_3 < \theta_4$ , the bank sets  $r(\theta) = r'$  for any  $\theta \in [\theta_1, \theta_2] \cup [\theta_3, \theta_4]$  and  $r(\theta) \neq r'$  otherwise. Since  $[\theta_1, \theta_2]$  and  $[\theta_3, \theta_4]$  are sufficiently apart and the noise is bounded, whenever  $r'$  is observed in equilibrium, it is common  $p = 1$  belief among the speculators whether  $\theta \in [\theta_1, \theta_2]$  or  $\theta \in [\theta_3, \theta_4]$ . In principle, the possibility for the market to separate different subsets of types who set the same interest rate may lead to equilibria different from the ones in Theorem 1. However, this possibility critically depends on small bounded noise and disappears with large bounded or unbounded supports, whatever the precision of the noise.

We conclude that unbounded noise introduces strategic effects that are not robust to bounded noise, and vice versa. It is these considerations that motivated the refinement in Definition 2. We seek to identify equilibrium predictions that are robust to whether the noise is bounded or unbounded. The following then provides the converse to Theorem 1.

**Theorem 2 (Robust Equilibria)** *Every robust perfect Bayesian equilibrium belongs to one of the two classes of Theorem 1. If the distribution of the noise satisfies the monotone likelihood ratio property, any robust active-policy equilibrium is a two-threshold equilibrium as in Proposition 3.*

We sketch the intuition for Theorem 2 here and present the formal proof in the Appendix. Consider any perfect Bayesian equilibrium of the game. If all  $\theta$  set  $\underline{r}$ , we have perfect pooling. Otherwise, let

$$\theta' = \inf\{\theta : r(\theta) > \underline{r}\} \quad \text{and} \quad \theta'' = \sup\{\theta : r(\theta) > \underline{r}\}$$

be, respectively, the lowest and highest type who raise the interest rate. Since there is no aggregate uncertainty, the central bank can perfectly anticipate whether she will devalue and hence is willing to pay the cost of an interest rate  $r > \underline{r}$  only if this leads to no devaluation. It follows that any equilibrium observation of  $r > \underline{r}$  necessarily signals that there will be no devaluation and induces any speculator not to attack. If there were more than one interest rates above  $\underline{r}$  played in equilibrium, and the noise were unbounded, the bank could always ensure no devaluation by

setting the lowest equilibrium interest rate above  $\underline{r}$ . Since  $C(r)$  is strictly increasing, it follows that at most one interest rate above  $\underline{r}$  is played in any robust equilibrium. Let  $r^*$  denote this interest rate and define  $\theta^*$  and  $\theta^{**}$  as in Theorem 1. Obviously, it never pays to raise the interest rate for any  $\theta < \theta^*$ . Hence, in any robust equilibrium,  $\theta' \geq \theta^*$ . If the noise were bounded, all  $\theta > \bar{x} + \varepsilon = \bar{\theta} + 2\varepsilon$  would necessarily set  $\underline{r}$ . Hence, in any robust equilibrium,  $\theta'' < \infty$ . Compare now the strategy of the speculators in any such equilibrium with the strategy in the corresponding two-threshold equilibrium. Any  $\theta > \theta^*$  necessarily does not devalue as it can guarantee herself a positive payoff by setting  $r = r^*$ . If there also exist types  $\theta < \theta^*$  who do not devalue, then the incentives to attack when observing  $\underline{r}$  are lower than when *all*  $\theta < \theta^*$  devalue. Similarly, if there exist types  $\theta \in [\theta^*, \theta'']$  who do not raise the interest rate at  $r^*$ , then the observation of  $r = \underline{r}$  is less informative of devaluation than in the case where *all*  $\theta \in [\theta^*, \theta'']$  set  $r^*$ . Hence, speculators are most aggressive at  $\underline{r}$  when  $D(\theta) = 1$  for all  $\theta < \theta^*$  and  $r(\theta) = r^*$  for all  $[\theta^*, \theta'']$ , which, by definition of  $\theta^{**}$ , is possible if and only if  $\theta'' = \theta^{**}$ . Equivalently, the size of the attack in the two-threshold equilibrium corresponding to  $r^*$  represents an upper bound on the size of the attack in any active-policy equilibrium in which  $r^*$  is played. It follows that, in any robust equilibrium,  $\theta'' \leq \theta^{**}$ . Since  $\theta^{**} < \theta^*$  whenever  $r^* > \tilde{r}$ , this immediately rules out the possibility of equilibria in which  $r^* > \tilde{r}$ . On the other hand, for any  $r^* \leq \tilde{r}$ , we have

$$\theta^* \leq \theta' \leq \theta'' \leq \theta^{**}.$$

It follows that the anxiety region of any robust equilibrium is bounded by the anxiety region of the corresponding two-threshold equilibrium. By iterated deletion of strictly dominated strategies, one can also show that all  $\theta < \theta^*$  necessarily devalue and that  $\theta' = \theta^*$ , which proves the first part of Theorem 2.

Observe next that the monotonicity of the devaluation policy implies monotonicity of the speculators' strategy as long as the posterior probability of devaluation is monotonic in the speculators' private signals. The latter is necessarily true when the noise distribution satisfies the monotone likelihood ratio property (MLRP), that is, when  $\psi'(z)/\psi(z)$  is decreasing in  $z$ . In this case, the size of the attack  $\alpha(\theta, \underline{r})$  is decreasing in  $\theta$ , and therefore all  $\theta \in [\theta^*, \theta'']$  raise the interest rate at  $r^*$ . But then  $\theta'' = \theta^{**}$  and  $r(\theta) = r^*$  if and only if  $\theta \in [\theta^*, \theta^{**}]$ , which completes the second part of the theorem. When instead the speculators' posteriors fail to be monotonic in  $x$ , we can not exclude the possibility there also exist active-policy equilibria different from the two-threshold equilibria, namely equilibria in which the policy maker raises the interest rate at  $r^*$  only for a subset of  $[\theta^*, \theta^{**}]$ . Nevertheless, in any such equilibrium, it remains true that devaluation occurs if

and only if  $\theta < \theta^*$  and the policy is active *only* for  $\theta \in [\theta^*, \theta^{**}]$ . Finally, we earlier noted that the perfect-pooling and two-threshold equilibria can be supported by strategies for the speculators that are monotonic in the private information  $x$ . If one restricts attention to such simple  $x$ -monotonic strategies, the MLRP condition in the second part of Theorem 2 can be dispensed.

Recall that in an inactive-policy equilibrium  $r$  is dominated by  $\underline{r}$  for every  $\theta$  if and only if  $r > \tilde{r}$ . In other words,  $\tilde{r}$  represents the maximal interest rate that the bank would ever be tempted to deviate to in the inactive-policy equilibrium. Following Theorems 1 and 2, the policy in *any* robust equilibrium is bounded above by  $\tilde{r}$ . Equivalently, the devaluation threshold with active policy is always lower than the one with inactive policy.

An immediate corollary of Theorem 2 is that as private information becomes more precise, the anxiety region in any robust active-policy equilibrium shrinks. In the limit, the policy converges to a spike around the devaluation threshold dictated by market sentiments.

**Corollary 1 (Limit)** *The limit of any robust equilibrium as  $\varepsilon \rightarrow 0$  is such that the policy is  $r(\theta) = \underline{r}$  for all  $\theta \neq \theta^*$ , for any arbitrary  $\theta^* \in (\underline{\theta}, \theta_{MS}]$ , and devaluation occurs if and only if  $\theta < \theta^*$ .*

At this point, it is interesting to compare the above results with the set of equilibrium policies that would arise if fundamentals were common knowledge.

**Proposition 4 (Common Knowledge)** *Suppose  $\varepsilon = 0$ . An interest rate policy  $r : \Theta \rightarrow \mathcal{R}$  can be part of a subgame perfect equilibrium if and only if  $C(r(\theta)) \leq V(\theta, 0)$  for  $\theta \in [\underline{\theta}, \bar{\theta}]$  and  $r(\theta) = \underline{r}$  for  $\theta \notin [\underline{\theta}, \bar{\theta}]$ . Similarly, a devaluation outcome  $D : \Theta \rightarrow [0, 1]$  can be part of a subgame perfect equilibrium if and only if  $D(\theta) \in [0, 1]$  for  $\theta \in [\underline{\theta}, \bar{\theta}]$ ,  $D(\theta) = 1$  for  $\theta < \underline{\theta}$ , and  $D(\theta) = 0$  for  $\theta > \bar{\theta}$ .*

**Proof.** The second part is obvious, so consider the interest rate policy. For  $\theta < \underline{\theta}$ , it is dominant for the bank to set  $\underline{r}$  and devalue and for speculators to attack. Similarly, for  $\theta > \bar{\theta}$ , the bank never devalues, speculators do not attack, and there is no need to raise the interest rate. Finally, take any  $\theta \in [\underline{\theta}, \bar{\theta}]$ . The continuation game following any interest rate  $r$  is a coordination game with two (extreme) continuation equilibria, no attack and full attack. Let  $r(\theta)$  be the minimal  $r$  for which speculators coordinate on the no-attack continuation equilibrium, i.e. they attack if and only if  $r < r(\theta)$ . Clearly, it is optimal for the bank to set  $r(\theta) > \underline{r}$  if and only if  $V(\theta, 0) - C(r(\theta)) \geq 0$ , or equivalently  $C(r(\theta)) \leq \theta$ . ■

That is, if the fundamentals were common knowledge, the equilibrium policy  $r(\theta)$  could take essentially any shape in the critical range  $[\underline{\theta}, \bar{\theta}]$ . For example, it could have multiple discontinuities and multiple non-monotonicities. Similarly, the devaluation outcome  $D(\theta)$  could also take any shape in  $[\underline{\theta}, \bar{\theta}]$  and need not be monotonic. These results contrast sharply with our results in Theorem 2 and Corollary 1. When the information about fundamentals is very precise (i.e.  $\varepsilon$  is small but positive), the policy is active only for a small range of intermediate fundamentals  $[\theta^*, \theta^{**}]$ , this range vanishes as  $\varepsilon \rightarrow 0$ , and the devaluation outcome is necessarily monotonic in  $\theta$ . We conclude that introducing small idiosyncratic noise in the observation of the fundamentals *does* reduce significantly the equilibrium set, as compared to the common knowledge case. The global-game methodology thus maintains a strong selection power even in our multiple-equilibria environment.

Another interesting implication of Corollary 1 is that, in the limit, all active-policy equilibria are observationally equivalent to the inactive-policy equilibrium in terms of the interest rate policy, although they are very different in terms of the devaluation outcome. An econometrician may then fail to predict the probability of devaluation on the basis of information on the fundamentals and the policy of the monetary authority. An even sharper dependence of observable outcomes on unobservable market sentiments arises if one introduces sunspots, as we discuss next.

## 5 Uncertainty over the Aggressiveness of Market Expectations

The analysis so far assumed the policy maker was able to anticipate perfectly the aggressiveness of market expectations, which we identify with the threshold  $r^*$  at which speculators switch from an aggressive to a lenient response to the policy. In reality, however, market expectations are hard to predict, even when the underlying economic fundamentals are perfectly known to the policy maker. To capture this possibility, we introduce payoff-irrelevant sunspots, on which speculators may condition their responses to the actions of the policy maker. Instead of modelling explicitly the sunspots, we assume directly that  $r^*$  is a random variable with c.d.f.  $\Phi$  over a compact support  $\mathcal{R}^* \subseteq \mathcal{R}$ . The realization of the random variable  $r^*$  is common knowledge among the speculators, but is unknown to the bank when it sets the policy. Uncertainty over the aggressiveness of market expectations then generates random variation in the effectiveness of any given policy choice and leads to random variation in the devaluation outcome. Different sunspot equilibria are associated with different distributions  $(\Phi, \mathcal{R}^*)$  and result in different equilibrium policies  $r(\theta)$ .

**Proposition 5** *Take any random variable  $r^*$  with compact support  $\mathcal{R}^* \subseteq (\underline{r}, \tilde{r})$  and distribution  $\Phi$ . For  $\varepsilon > 0$  sufficiently small,<sup>18</sup> there exist thresholds  $\theta^* \in (\underline{\theta}, \theta_{MS})$  and  $\theta^{**} \in (\theta^*, \bar{\theta})$  and a robust equilibrium such that: The central bank follows a non-monotonic policy with  $r(\theta) = \underline{r}$  for  $\theta \notin [\theta^*, \theta^{**}]$ , and  $r(\theta) \in \mathcal{R}^*$  with  $r(\theta)$  non-decreasing in  $\theta$  for  $\theta \in [\theta^*, \theta^{**}]$ ; devaluation occurs with certainty for  $\theta < \theta^*$ , with probability less than one and non-increasing in  $\theta$  for  $\theta \in [\theta^*, \theta^{**}]$ , and never occurs for  $\theta > \theta^{**}$ . Finally,  $\theta^*$  is independent of  $\varepsilon$ , whereas  $\theta^{**} \rightarrow \theta^*$  as  $\varepsilon \rightarrow 0$ .*

The sunspot equilibria of Proposition 5 are qualitatively similar to the two-threshold equilibria of Proposition 3. The policy maker is anxious to prove herself only for a small range of moderate fundamentals, and this range vanishes as  $\varepsilon \rightarrow 0$ . The interval  $\mathcal{R}^*$  represents the set of random thresholds  $r^*$  such that speculators coordinate on an aggressive response whenever  $r < r^*$  and on a lenient one whenever  $r \geq r^*$ . When  $\theta < \theta^*$ , raising the policy to any level in  $\mathcal{R}^*$  is too costly compared to the expected value of defending the peg, in which case the bank finds it optimal to set  $\underline{r}$  and devalue with certainty. When instead  $\theta \in [\theta^*, \theta^{**}]$ , it pays to raise the interest rate at some level in  $\mathcal{R}^*$  so as to lower the probability of a speculative attack. Since the value from defending the currency is increasing in  $\theta$ , so is the optimal policy in the range  $[\theta^*, \theta^{**}]$ . Finally, for  $\theta \geq \theta^{**}$ , the size of the attack at  $\underline{r}$  is so small that the bank prefers the cost of such an attack to the cost of a high interest rate. The thresholds  $\theta^*$  and  $\theta^{**}$  are again given by the relevant indifference conditions for the bank, but differ from the ones we derived in the absence of sunspots. The definition of the thresholds and the complete proof of the above proposition are provided in the Appendix.<sup>19</sup>

With random variation in the aggressiveness of market expectations, policy traps take an even stronger form. Not only the policy maker has to adopt a policy that simply confirms market expectations, but also the equilibrium outcome of any given policy action is determined by animal spirits and market sentiments. Empirical evidence suggests that raising interest rates does not systematically prevent an exchange-rate collapse. Kraay (1993), for example, studies the behavior of interest rates and other measures of monetary policy during 192 episodes of successful and unsuccessful speculative attacks and finds a “striking lack of any systematic association whatsoever between interest rates and the outcome of speculative attacks,” even after controlling for various observable fundamentals. This evidence is hard to reconcile with Morris and Shin’s (1998) predic-

<sup>18</sup>The assumption that  $\varepsilon$  is sufficiently small is not essential; it ensures  $\theta^{**} < \bar{\theta}$ , which we use only to simplify the construction of these equilibria (see the Appendix).

<sup>19</sup>If one takes a sequence of sunspot equilibria such that  $\mathcal{R}^*$  converges to a single point  $r^*$ , the thresholds  $\theta^*$  and  $\theta^{**}$  in Proposition 5 converge to the ones given in (6). That is, the two-threshold equilibria of Proposition 3 can be read as the limit of sunspot equilibria.

tion that defense policies decrease the probability of devaluation, but is consistent with the sunspot equilibria of Proposition 5, where the same combination of interest rates and fundamentals may lead in equilibrium to either no devaluation or a collapse of the currency.

Finally, the results of this section help understand and formalize the kind of arguments that commonly appear in the popular press, like the one we quoted from Financial Times in the beginning of the paper. Once the policy maker has taken a costly policy action in an attempt to achieve a favorable outcome, the market may be equally likely to “interpret” this action either as a signal of strength, in which case market participants coordinate on the desirable course of action, or as a signal of panic, in which case the policy maker’s attempt proves in vain.

## 6 Concluding Remarks

In this paper we investigated the ability of a policy maker to influence market expectations and control equilibrium outcomes in economies where agents play a global coordination game. We found that policy endogeneity leads to multiple self-fulfilling equilibria, even when the fundamentals are observed with idiosyncratic noise. The multiple equilibria take the form of policy traps, where the policy maker is forced to conform to the arbitrary expectations of the market instead of being able to fashion the equilibrium outcome. There is an inactive-policy equilibrium in which market participants coordinate on “ignoring” any attempt of the policy maker to affect market behavior, as well as a continuum of active-policy equilibria in which market participants coordinate on the level of the policy beyond which they “reward” the policy maker by playing a favorable continuation equilibrium. Despite equilibrium multiplicity, information heterogeneity significantly reduces the equilibrium set as compared to the case of common knowledge and enables robust policy predictions.

Although this paper focused on the particular example of self-fulfilling currency attacks, our approach may extend to other environments where policy can serve as a coordination device among market participants. Monetary policy in economies with staggered pricing, fiscal and growth policies in economies with investment complementarities, and stabilization policies or regulatory intervention during financial or debt crises, are only a few examples where our results might be relevant.

## Appendix

**Proof of Theorem 2.** When no interest rate other than  $\underline{r}$  is played in equilibrium, we have the pooling equilibrium in (a) of Theorem 1. Hence, in what follows, we consider equilibria in which  $r(\theta) > \underline{r}$  for some  $\theta$  and we let

$$\theta' = \inf\{\theta : r(\theta) > \underline{r}\} \quad \text{and} \quad \theta'' = \sup\{\theta : r(\theta) > \underline{r}\}.$$

We prove the result in a sequence of five lemmas.

**Lemma 1.** In any robust equilibrium, there is at most one interest rate  $r^* > \underline{r}$  played in equilibrium and  $\theta'' < \infty$ .

*Proof.* Any interest rate  $r > \underline{r}$  is played in equilibrium only if it leads to no devaluation, i.e. only if  $D(\theta) = 0$ ; all types who devalue set  $r = \underline{r}$ . Speculators attack if and only if the expected devaluation premium is higher than the interest rate differential, i.e.  $\pi \int_{\Theta} D(\theta) d\mu(\theta|x, r) \geq r$ . If the noise is unbounded, any equilibrium interest rate  $r > \underline{r}$  results in a posterior  $\mu(\Theta_0|x, r) = 1$  for all  $x$ , where  $\Theta_0 \equiv \{\theta : D(\theta) = 0\}$  is the set of fundamentals for which devaluation does not occur. Hence, no speculator ever attacks when he observes an equilibrium  $r > \underline{r}$ , and thus  $\alpha(\theta, r) = 0$  for any equilibrium  $r > \underline{r}$ . Since  $C(r)$  is strictly increasing in  $r$ , this also implies that, in any robust equilibrium, at most one interest rate  $r^* \neq \underline{r}$  will be chosen by the central bank, which proves the first part of the lemma. Next, if the noise were bounded, it would be dominant for a speculator not to attack whenever  $x > \bar{x} \equiv \bar{\theta} + \varepsilon$ , in which  $\alpha(\theta, r) = 0$  for all  $r$  whenever  $\theta > \bar{x} + \varepsilon$  and thus  $r(\theta) = \underline{r}$  for all  $\theta > \bar{x} + \varepsilon$ . Therefore, an equilibrium with  $\theta'' = \infty$  could never be sustained with bounded noise, which proves the second part of the lemma.  $\square$

Given any  $r^* \in (\underline{r}, \bar{r}]$ , define the thresholds

$$\theta^* = C(r^*) \quad \text{and} \quad \theta^{**} = \theta^* + \varepsilon \left[ \Psi^{-1} \left( 1 - \frac{r^*}{\pi - \underline{r}} \theta^* \right) - \Psi^{-1}(\theta^*) \right],$$

and note that  $\theta^{**} > \theta^*$  when  $r^* < \tilde{r}$ ,  $\theta^{**} = \theta^*$  when  $r^* = \tilde{r}$ , and  $\theta^{**} < \theta^*$  when  $r^* > \tilde{r}$ . For the rest of the proof, it suffices to consider unbounded noise.

**Lemma 2.** For any  $r^* \in (\underline{r}, \bar{r}]$ ,  $\theta^* \leq \theta'$  and  $\theta'' \leq \theta^{**}$ .

*Proof.* Since for any  $\theta < \theta^*$ ,  $r^*$  is strictly dominated by  $\underline{r}$ , it immediately follows that  $\theta' \geq \theta^*$ . On the other hand, any  $\theta > \theta^*$  can always set  $r^*$ , face no attack, and ensure a payoff  $V(\theta, 0) - C(r^*) > 0$ . Therefore, necessarily  $D(\theta) = 0$  for all  $\theta > \theta^*$ . However, there may exist types  $\theta < \theta^*$  that also

do not devalue in equilibrium. Define  $\delta(x)$  as the probability, conditional on  $x$ , that  $\theta < \theta^*$  and  $D = 0$ . Further, define  $p(x)$  as the probability, conditional on  $x$ , that  $\theta \in [\theta^*, \theta'']$  and  $r(\theta) = \underline{r}$ . Then, the probability of devaluation conditional on  $x$  and  $\underline{r}$  is given by

$$\mu(D = 1|x, \underline{r}) = \frac{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right) - \delta(x)}{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right) + p(x) + \Psi\left(\frac{x - \theta''}{\varepsilon}\right)}.$$

Clearly, a speculator never attacks at  $\underline{r}$  whenever  $\mu(D = 1|x, \underline{r}) < \underline{r}/\pi$ . Define

$$F(x; \theta^*, \theta'') \equiv \frac{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right)}{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right) + \Psi\left(\frac{x - \theta''}{\varepsilon}\right)} = \left[1 + \frac{\Psi\left(\frac{x - \theta''}{\varepsilon}\right)}{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right)}\right]^{-1}.$$

Note that  $F(x; \theta^*, \theta'')$  is strictly decreasing in  $x$ , and let  $\hat{x}(\theta^*, \theta'')$  solve

$$F(\hat{x}; \theta^*, \theta'') = \underline{r}/\pi. \quad (8)$$

Since  $\delta(x) \geq 0$  and  $p(x) \geq 0$ , we have  $\mu(D = 1|x, \underline{r}) \leq F(x; \theta^*, \theta'')$  for all  $x$ . It follows that, whenever  $x > \hat{x}(\theta^*, \theta'')$ ,  $\mu(D = 1|x, \underline{r}) \leq F(x; \theta^*, \theta'') < F(\hat{x}; \theta^*, \theta'') = \underline{r}/\pi$ , and therefore any speculator with  $x > \hat{x}(\theta^*, \theta'')$  does not attack in equilibrium. That is, in any equilibrium in which  $r^*$  is played, speculators are necessarily at most as aggressive as they would be if it were the case that  $D(\theta) = 1$  for all  $\theta < \theta^*$  and  $r(\theta) = r^*$  for all  $\theta \in [\theta^*, \theta'']$ . This is intuitive for (i) a positive probability that  $D(\theta) = 0$  for some  $\theta < \theta^*$  reduces the incentives to attack for every  $x$ , and (ii) a positive probability that  $r(\theta) = \underline{r}$  for some  $\theta \in [\theta^*, \theta'']$  reduces the probability that the observation of  $\underline{r}$  signals devaluation and therefore also reduces the incentives to attack conditional on  $\underline{r}$  and  $x$ . It follows that for any  $\theta$ ,  $\alpha(\theta, \underline{r}) \leq \Psi\left(\frac{\hat{x}(\theta^*, \theta'') - \theta}{\varepsilon}\right)$ . From the indifference condition for  $\theta''$ , we have that  $\alpha(\theta'', \underline{r}) = C(r^*)$ . Since  $C(r^*) = \theta^*$ , it follows that  $\theta^* \leq \Psi\left(\frac{\hat{x}(\theta^*, \theta'') - \theta''}{\varepsilon}\right)$ . From the indifference conditions of Proposition (3), and using  $\hat{x}(\theta^*, \theta^{**}) = x^*$ , we also have that  $\theta^* = \Psi\left(\frac{\hat{x}(\theta^*, \theta^{**}) - \theta^{**}}{\varepsilon}\right)$ . Hence, in any equilibrium in which  $r^*$  is played,  $\theta''$  must satisfy

$$\hat{x}(\theta^*, \theta^{**}) - \theta^{**} \leq \hat{x}(\theta^*, \theta'') - \theta''.$$

From (8),  $\hat{x}(\theta^*, \theta'') - \theta''$  is decreasing in  $\theta''$ , and hence we conclude that  $\theta'' \leq \theta^{**}$ .  $\square$

Recall that  $\theta^* \leq \theta^{**}$  if and only if  $r^* \leq \tilde{r} \equiv C^{-1}(\theta_{MS})$ . For any  $r^* > \tilde{r}$ , Lemma 2 implies  $\theta'' \leq \theta^{**} < \theta^* \leq \theta'$ , which is a contradiction, since by definition  $\theta' \leq \theta''$ . Therefore, there exists no robust equilibrium with  $r^* \in (\tilde{r}, \bar{r}]$ . On the other hand, in any robust equilibrium where  $r^* \in (\underline{r}, \tilde{r}]$  is played, necessarily  $\theta^* \leq \theta' \leq \theta'' \leq \theta^{**}$ .

Next, we show, by iterated deletion of strictly dominated strategies, that in any robust equilibrium in which  $r^*$  is played, devaluation occurs if and only if  $\theta < \theta^*$ , which in turn implies that  $\theta' = \theta^*$ .

**Lemma 3.**  $D(\theta) = 1$  for all  $\theta < \theta^*$ ,  $D(\theta) = 0$  for all  $\theta > \theta^*$ , and  $\theta' = \theta^*$ .

*Proof.* Given an arbitrary equilibrium policy  $r(\theta)$ , we consider the continuation game that follows  $r = \underline{r}$  and construct the iterated deletion mapping  $\mathcal{T} : [\underline{\theta}, \theta'] \rightarrow [\underline{\theta}, \theta']$  as follows. Take any  $\tilde{\theta} \in [\underline{\theta}, \theta']$  and let

$$G(x; \tilde{\theta}) \equiv \frac{1 - \Psi\left(\frac{x - \tilde{\theta}}{\varepsilon}\right)}{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right) + p(x) + \Psi\left(\frac{x - \theta''}{\varepsilon}\right)}.$$

$G(x; \tilde{\theta})$  thus represents the probability of  $\theta < \tilde{\theta}$ , conditional on  $x$  and  $\underline{r}$ . Note that  $\lim_{x \rightarrow -\infty} p(x) = \lim_{x \rightarrow +\infty} p(x) = 0$  and therefore  $\lim_{x \rightarrow -\infty} G(x; \tilde{\theta}) = 1$  and  $\lim_{x \rightarrow +\infty} G(x; \tilde{\theta}) = 0$ . It follows that, for every  $\tilde{\theta}$ , there is at least one solution to the equation  $G(x; \tilde{\theta}) = \underline{r}/\pi$ . Then let  $\tilde{x} = \tilde{x}(\tilde{\theta})$  be the lowest solution to this equation, i.e.  $\tilde{x}(\tilde{\theta}) \equiv \min\{x \mid G(x; \tilde{\theta}) = \underline{r}/\pi\}$ , and define  $\tilde{\tilde{\theta}} = \tilde{\tilde{\theta}}(\tilde{\theta})$  as the unique solution to  $\tilde{\tilde{\theta}} = \Psi\left(\frac{\tilde{x} - \tilde{\theta}}{\varepsilon}\right)$ . Note that  $G(x; \tilde{\theta}) > \underline{r}/\pi$  for every  $x < \tilde{x}$  and  $\Psi\left(\frac{\tilde{x} - \tilde{\theta}}{\varepsilon}\right) > \theta$  for every  $\theta < \tilde{\tilde{\theta}}$ . That is, if all  $\theta < \tilde{\tilde{\theta}}$  are expected to devalue, all  $x < \tilde{x}$  necessarily find it optimal to attack, which in turn implies that any  $\theta < \tilde{\tilde{\theta}}$  necessarily devalues, unless  $\theta$  is playing  $r^*$  rather than  $\underline{r}$ , which happens in equilibrium only if  $\theta \geq \theta'$ . The iterated deletion operator  $\mathcal{T}$  is thus defined by

$$\mathcal{T}(\tilde{\theta}) \equiv \min\left\{\theta', \tilde{\tilde{\theta}}\right\}.$$

Observe that  $G$  is strictly increasing in  $\tilde{\theta}$ , implying that  $\tilde{x}$  and therefore  $\tilde{\tilde{\theta}}$  are also strictly increasing in  $\tilde{\theta}$ .<sup>20</sup> We conclude that the mapping  $\mathcal{T}$  is weakly increasing for all  $\tilde{\theta} \in [\underline{\theta}, \theta']$ . Obviously,  $\mathcal{T}$  is also bounded above by  $\theta'$ . Finally, note that  $\theta^* \leq \theta' \leq \theta^{**} < \infty$  and  $\theta^* \leq \theta_{MS}$ , but so far we have ruled out neither  $\theta' \leq \theta_{MS}$ , nor  $\theta' > \theta_{MS}$ .

Next, we compare  $\mathcal{T}$  with the iterated deletion operator of the Morris-Shin game without signaling (or, equivalently, of the continuation game at  $\underline{r}$  when the pooling equilibrium is played). This operator,  $\mathcal{F} : [\underline{\theta}, \bar{\theta}] \rightarrow [\underline{\theta}, \bar{\theta}]$ , is defined by  $\mathcal{F}(\hat{\theta}) = \hat{\hat{\theta}}$ , where  $\hat{x} = \hat{x}(\hat{\theta})$  and  $\hat{\hat{\theta}} = \hat{\hat{\theta}}(\hat{\theta})$  are the unique solutions to  $1 - \Psi\left(\frac{\hat{x} - \hat{\theta}}{\varepsilon}\right) = \underline{r}/\pi$  and  $\hat{\hat{\theta}} = \Psi\left(\frac{\hat{x} - \hat{\theta}}{\varepsilon}\right)$ .  $\mathcal{F}$  has a unique fixed point at

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<sup>20</sup>In general,  $\tilde{x}$  and therefore  $\tilde{\tilde{\theta}}$  need not be continuous in  $\tilde{\theta}$ . Continuity is ensured when  $\Psi$  satisfies the MLRP, in which case  $G$  is strictly decreasing in  $x$ , implying that  $G(x, \tilde{\theta}) = \underline{r}/\pi$  has a unique solution and this solution is continuously increasing in  $\tilde{\theta}$ . All we need, however, is monotonicity of the lowest solution, which is true for any  $\Psi$ .

$\hat{\theta} = \hat{\bar{\theta}} = \theta_{MS}$ , and satisfies  $\hat{\theta} < \mathcal{F}(\hat{\theta}) < \theta_{MS}$  whenever  $\hat{\theta} \in [\underline{\theta}, \theta_{MS})$  and  $\hat{\theta} > \mathcal{F}(\hat{\theta}) > \theta_{MS}$  whenever  $\hat{\theta} \in (\theta_{MS}, \bar{\theta}]$ . Moreover, since  $G(x; \theta) > 1 - \Psi\left(\frac{x-\theta}{\varepsilon}\right)$  for all  $x$  and  $\theta$ , we have  $\tilde{x}(\theta) > \hat{x}(\theta)$  and therefore  $\tilde{\theta}(\theta) > \hat{\theta}(\theta)$ . We conclude that, for any  $\theta \in [\underline{\theta}, \theta']$ , either  $\tilde{\theta}(\theta) \geq \theta'$ , in which case  $\mathcal{T}(\theta) = \theta'$ , or  $\tilde{\theta}(\theta) < \theta'$ , in which case  $\mathcal{T}(\theta) > \mathcal{F}(\theta)$ .

Finally, we consider the sequence  $\{\theta^k\}_{k=1}^{\infty}$ , where  $\theta^1 = \underline{\theta}$  and  $\theta^{k+1} = \mathcal{T}(\theta^k)$  for all  $k \geq 1$ . This sequence represents iterated deletion of dominated strategies starting from  $\underline{\theta}$ . Since this sequence is monotone and bounded above by  $\theta'$ , it necessarily converges to some limit  $\theta^{\infty} \leq \theta'$ . This limit must be a fixed point of  $\mathcal{T}$ , that is,  $\theta^{\infty} = \mathcal{T}(\theta^{\infty})$ . We first prove that either  $\theta^{\infty} = \theta'$ , or  $\theta^{\infty} > \theta_{MS}$ . Suppose  $\theta^{\infty} < \theta'$ . This can be true only if  $\tilde{\theta}(\theta^{\infty}) < \theta'$ . If it were the case that  $\theta^{\infty} \leq \theta_{MS}$ , we would then have  $\mathcal{T}(\theta^{\infty}) > \mathcal{F}(\theta^{\infty}) \geq \theta^{\infty}$ , which contradicts the assumption that  $\theta^{\infty}$  is a fixed point for  $\mathcal{T}(\cdot)$ . Therefore,  $\theta^{\infty} = \theta'$  whenever  $\theta' \leq \theta_{MS}$ , whereas  $\theta^{\infty} > \theta_{MS}$  whenever  $\theta' > \theta_{MS}$ . We next prove that  $\theta^{\infty} = \theta' = \theta^*$ . Suppose that  $\theta' > \theta^*$ . If  $\theta' \leq \theta_{MS}$ , then  $\theta^{\infty} = \theta' > \theta^*$  and all  $\theta \in (\theta^*, \theta')$  would devalue in equilibrium. If instead  $\theta' > \theta_{MS}$ , then  $\theta^{\infty} > \theta_{MS} \geq \theta^*$  and again all  $\theta \in (\theta^*, \theta^{\infty})$  would devalue in equilibrium. But either case is impossible as any  $\theta > \theta^*$  can ensure no devaluation and a positive payoff by setting  $r^*$ . Therefore, it is necessarily the case that  $\theta' = \theta^*$ . This also implies that  $\theta' \leq \theta_{MS}$  and therefore  $\theta^{\infty} = \theta' = \theta^*$ , which completes the proof of this lemma.  $\square$

We next show that, if the posterior beliefs given  $\underline{r}$  are monotonic in  $x$ , then speculators follow a threshold strategy and therefore the size of an attack is decreasing in the fundamentals  $\theta$ . This in turns implies that the bank sets  $r^*$  for all  $\theta \in [\theta^*, \theta^{**}]$ .

**Lemma 4.** If in equilibrium  $\mu(\theta \leq \theta^* | x, \underline{r})$  is monotonic in  $x$ , then necessarily  $\alpha(\theta, \underline{r})$  is strictly decreasing in  $\theta$ , in which case  $\theta'' = \theta^{**}$ , and  $r(\theta) = r^*$  for all  $\theta \in [\theta^*, \theta^{**}]$ .

Proof. Following Lemma 3, the probability of devaluation conditional on  $x$  and  $\underline{r}$  is given by

$$\mu(D = 1 | x, \underline{r}) = \mu(\theta \leq \theta^* | x, \underline{r}) = G(x; \theta^*) \equiv \frac{1 - \Psi\left(\frac{x-\theta^*}{\varepsilon}\right)}{1 - \Psi\left(\frac{x-\theta^*}{\varepsilon}\right) + p(x) + \Psi\left(\frac{x-\theta''}{\varepsilon}\right)},$$

with  $\lim_{x \rightarrow -\infty} G(x; \theta^*) = 1$  and  $\lim_{x \rightarrow +\infty} G(x; \theta^*) = 0$ . When  $G(x, \theta^*)$  is monotonic in  $x$ , there is a unique  $x'$  such that  $G(x'; \theta^*) = \underline{r}/\pi$  and thus speculators follow a threshold strategy with  $a(x, \underline{r}) = 1$  if  $x < x'$  and  $a(x, \underline{r}) = 0$  if  $x > x'$ . It follows that  $\alpha(\theta, \underline{r})$  is strictly decreasing in  $\theta$  and, since  $\theta''$  solves  $\alpha(\theta'', \underline{r}) = C(r^*)$ , all  $\theta \in [\theta^*, \theta'']$  necessarily set  $r^*$ . But then,  $p(x) = 0$  for any  $x$ , and  $x' = \hat{x}(\theta^*, \theta'')$ , implying that  $\alpha(\theta, \underline{r}) = \Psi\left(\frac{\hat{x}(\theta^*, \theta'') - \theta}{\varepsilon}\right)$ . Thus,  $\theta''$  solves  $\Psi\left(\frac{\hat{x}(\theta^*, \theta'') - \theta''}{\varepsilon}\right) = C(r^*)$ ,

and from Proposition (3),  $\widehat{x}(\theta^*, \theta^{**}) - \theta^{**} = \widehat{x}(\theta^*, \theta'') - \theta''$ . From the monotonicity of  $\widehat{x}(\theta^*, \theta) - \theta$  established in Lemma 2, it follows that  $\theta'' = \theta^{**}$ .  $\square$

The above result presumed monotonicity of the posterior  $\mu(\theta \leq \theta^* | x, \underline{r})$  in  $x$ . Since all  $\theta \leq \theta^*$  set  $\underline{r}$ , this is likely to be the case for a wide range of noise structures. In the next lemma, we prove this is necessarily the case at least when the noise  $\xi$  follows a distribution which satisfies the MLRP.

**Lemma 5.** If  $\Psi$  satisfies the MLRP, then  $\mu(\theta \leq \theta^* | x, \underline{r})$  is monotonic in  $x$ .

Proof. Let  $I(\theta)$  be the probability that  $\theta$  sets  $\underline{r}$ . Using  $p(x) + \Psi\left(\frac{x-\theta''}{\varepsilon}\right) = \int_{\theta^*}^{\infty} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta$ , we have that

$$\frac{G(x; \theta^*)}{1 - G(x; \theta^*)} = \frac{1 - \Psi\left(\frac{x-\theta^*}{\varepsilon}\right)}{\int_{\theta^*}^{\infty} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta},$$

and therefore

$$\frac{d\left(\frac{G(x; \theta^*)}{1 - G(x; \theta^*)}\right)}{dx} = \frac{-\frac{1}{\varepsilon} \psi\left(\frac{x-\theta^*}{\varepsilon}\right)}{\int_{\theta^*}^{\infty} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta} - \frac{\left[1 - \Psi\left(\frac{x-\theta^*}{\varepsilon}\right)\right] \frac{d}{dx} \left(\int_{\theta^*}^{\infty} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta\right)}{\left[\int_{\theta^*}^{\infty} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta\right]^2}.$$

It follows that  $dG(x; \theta^*)/dx \leq 0$  if and only if

$$\frac{\int_{-\infty}^{\theta^*} \frac{1}{\varepsilon^2} \psi'\left(\frac{x-\theta}{\varepsilon}\right) d\theta}{\int_{-\infty}^{\theta^*} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) d\theta} - \frac{\int_{\theta^*}^{\infty} \frac{1}{\varepsilon^2} \psi'\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta}{\int_{\theta^*}^{\infty} \frac{1}{\varepsilon} \psi\left(\frac{x-\theta}{\varepsilon}\right) I(\theta) d\theta} \leq 0.$$

Using the fact that  $I(\theta) = 1$  for all  $\theta \leq \theta^*$ , the above is equivalent to

$$\mathbb{E}_{\theta} \left[ \frac{\frac{1}{\varepsilon} \psi'\left(\frac{x-\theta}{\varepsilon}\right)}{\psi\left(\frac{x-\theta}{\varepsilon}\right)} \middle| \theta \leq \theta^*, x, \underline{r} \right] - \mathbb{E}_{\theta} \left[ \frac{\frac{1}{\varepsilon} \psi'\left(\frac{x-\theta}{\varepsilon}\right)}{\psi\left(\frac{x-\theta}{\varepsilon}\right)} \middle| \theta > \theta^*, x, \underline{r} \right] \leq 0,$$

which holds true if  $\psi'/\psi$  is monotone decreasing.  $\square$

Combining Lemmas 1, 2, and 3, we conclude that any robust equilibrium belongs necessarily to either (a) or (b) in Theorem 1. If, in addition,  $\Psi$  satisfies the MLRP, Lemmas 4 and 5 imply that any equilibrium in (b) is a two-threshold equilibrium, which completes the proof of the theorem.  $\blacksquare$

**Proof of Proposition 5.** Take any random variable  $r^*$  with compact support  $\mathcal{R}^* \subseteq (\underline{r}, \widetilde{r})$  and distribution  $\Phi$ . We want to show that for  $\varepsilon$  sufficiently small, there exist thresholds  $x^*, \theta^* \in (\underline{\theta}, \theta_{MS})$ , and  $\theta^{**} \in (\theta^*, \overline{\theta})$ , a system of beliefs  $\mu$ , and a robust equilibrium such that: (i) The bank follows a non-monotonic policy with  $r(\theta) = \underline{r}$  for  $\theta \notin [\theta^*, \theta^{**}]$ , and  $r(\theta) \in \mathcal{R}^*$  with  $r(\theta)$  non-decreasing in  $\theta$  for  $\theta \in [\theta^*, \theta^{**}]$ . (ii) Whenever  $r < \underline{r}^*$ , speculators attack if and only if  $x < x^*$ ; whenever

$r \in [\underline{r}^*, r^*)$ , they attack if and only if  $x < \bar{x}$ ; and whenever  $r \geq r^*$ , they attack if and only if  $x < \underline{x}$ . (iii) Devaluation occurs with probability  $D(\theta) = 1$  for  $\theta < \theta^*$ , with probability  $D(\theta) < 1$  and non-increasing in  $\theta$  for  $\theta \in [\theta^*, \theta^{**}]$ , and with probability  $D(\theta) = 0$  for  $\theta > \theta^{**}$ .

The proof is in five steps: Steps 1 and 2 characterize the thresholds  $\theta^*$ ,  $\theta^{**}$ , and  $x^*$ ; Step 3 examines the behavior of the bank; Step 4 examines the beliefs and the strategy of the speculators; Step 5 establishes robustness in the sense of Definition 2.

**Step 1.** Let  $\underline{r}^* \equiv \min \mathcal{R}^* > \underline{r}$  and  $\bar{r}^* \equiv \max \mathcal{R}^* < \tilde{r}$ . Define

$$\widehat{U}(\theta) \equiv \begin{cases} \max_{r \in [\underline{r}^*, \bar{r}^*]} \{-C(r)\} & \text{if } \theta < \underline{\theta}, \\ \max_{r \in [\underline{r}^*, \bar{r}^*]} \{\theta \Phi(r) - C(r)\} & \text{if } \theta \in [\underline{\theta}, \bar{\theta}], \\ \max_{r \in [\underline{r}^*, \bar{r}^*]} \{\theta - (1 - \Phi(r)) \Psi\left(\frac{\bar{x} - \theta}{\varepsilon}\right) - C(r)\} & \text{if } \theta > \bar{\theta}, \end{cases}$$

and  $\widehat{r}(\theta)$  as the corresponding arg max. Note that maximizing over  $[\underline{r}^*, \bar{r}^*]$  is equivalent to maximizing over  $\mathcal{R}^*$  as necessarily  $\widehat{r}(\theta) \in \mathcal{R}^*$ . Note also that  $\widehat{U}(\theta)$  is non-decreasing for all  $\theta$ , and strictly increasing whenever  $\widehat{U}(\theta) > -C(\underline{r}^*)$ . Moreover,  $\widehat{U}(\underline{\theta}) = -C(\underline{r}^*) < 0$  and  $\widehat{U}(\theta_{MS}) \geq \theta_{MS} - C(\bar{r}^*) > \theta_{MS} - C(\tilde{r}) = 0$ . Therefore, there exists a unique  $\theta^* \in (\underline{\theta}, \theta_{MS})$  such that  $\widehat{U}(\theta^*) = 0$ ,  $\widehat{U}(\theta) < 0$  for all  $\theta < \theta^*$ , and  $\widehat{U}(\theta) > 0$  for all  $\theta > \theta^*$ .

**Step 2.** For any  $\theta \geq \theta^*$ , define the functions  $\widehat{x}(\theta; \theta^*)$  and  $v(\theta; \theta^*)$  as follows

$$\frac{1 - \Psi\left(\frac{\widehat{x} - \theta^*}{\varepsilon}\right)}{1 - \Psi\left(\frac{\widehat{x} - \theta^*}{\varepsilon}\right) + \Psi\left(\frac{\widehat{x} - \theta}{\varepsilon}\right)} = \frac{r}{\pi} \quad \text{and} \quad v(\theta; \theta^*) = \theta - \Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta}{\varepsilon}\right).$$

Note that  $d\widehat{x}(\theta; \theta^*)/d\theta \in (0, 1)$  and therefore  $dv(\theta; \theta^*)/d\theta > 1$ . Note also that for any  $\theta > \theta^*$ ,  $\Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta}{\varepsilon}\right) \rightarrow 0$  as  $\varepsilon \rightarrow 0$ . To see this, suppose instead that  $\lim_{\varepsilon \rightarrow 0} \Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta}{\varepsilon}\right) = \omega$  for some  $\omega > 0$ . This can be true only if  $\lim_{\varepsilon \rightarrow 0} \widehat{x}(\theta; \theta^*) \geq \theta$ , in which case  $\theta > \theta^*$  implies  $\lim_{\varepsilon \rightarrow 0} \widehat{x}(\theta; \theta^*) > \theta^*$  and therefore  $\lim_{\varepsilon \rightarrow 0} \Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta^*}{\varepsilon}\right) = 1$ . But then

$$\lim_{\varepsilon \rightarrow 0} \left\{ \frac{1 - \Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta^*}{\varepsilon}\right)}{1 - \Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta^*}{\varepsilon}\right) + \Psi\left(\frac{\widehat{x}(\theta; \theta^*) - \theta}{\varepsilon}\right)} \right\} = \frac{0}{0 + \omega} = 0 < \frac{r}{\pi},$$

which is a contradiction. Consider now the function  $g(\theta) = v(\theta; \theta^*) - \widehat{U}(\theta)$ . From the envelope theorem,  $\partial \widehat{U}(\theta)/\partial \theta$  is bounded above by 1 for any  $\theta \leq \bar{\theta}$  and hence  $g(\theta)$  is strictly increasing in  $\theta$  over this range. Moreover, by definition of  $\widehat{x}(\theta; \theta^*)$ , we have that  $\Psi\left(\frac{\widehat{x}(\theta^*; \theta^*) - \theta^*}{\varepsilon}\right) = \frac{\pi - r}{\pi} = \theta_{MS}$  and therefore  $v(\theta^*; \theta^*) = \theta^* - \theta_{MS}$ . Since  $\theta^* < \theta_{MS}$  and  $\widehat{U}(\theta^*) = 0$ , we conclude that  $g(\theta^*) < 0$ . Next,

note that for any  $\theta \leq \bar{\theta}$ ,  $\theta^*$  and  $\hat{r}(\cdot)$  are independent of  $\varepsilon$ , whereas  $\Psi\left(\frac{\hat{x}(\theta; \theta^*) - \theta}{\varepsilon}\right) \rightarrow 0$  as  $\varepsilon \rightarrow 0$  for every  $\theta > \theta^*$ . (See the argument above). Since  $\bar{\theta} > \theta^*$  and  $C(\hat{r}(\bar{\theta})) > 0$ , it follows that there exists  $\bar{\varepsilon} > 0$  such that  $\Psi\left(\frac{\hat{x}(\bar{\theta}; \theta^*) - \bar{\theta}}{\varepsilon}\right) < C(\hat{r}(\bar{\theta}))$  whenever  $\varepsilon < \bar{\varepsilon}$ . But then  $v(\bar{\theta}; \theta^*) > \bar{\theta} - C(\hat{r}(\bar{\theta})) \geq \hat{U}(\bar{\theta})$  and therefore  $g(\bar{\theta}) > 0$ . We conclude that, for  $\varepsilon < \bar{\varepsilon}$ , there exists a unique  $\theta^{**} \in (\theta^*, \bar{\theta})$  such that  $g(\theta^{**}) = 0$ ,  $g(\theta) < 0$  for  $\theta < \theta^{**}$ , and  $g(\theta) > 0$  for  $\theta > \theta^{**}$ . Moreover, note that, as  $\varepsilon \rightarrow 0$ ,  $v(\theta; \theta^*) \rightarrow \theta > \hat{U}(\theta)$  for every  $\theta > \theta^*$ ; it follows that  $\theta^{**} \rightarrow \theta^*$  as  $\varepsilon \rightarrow 0$ . Next, let

$$x^* \equiv \hat{x}(\theta^{**}; \theta^*) \quad \text{and} \quad \tilde{U}(\theta; \theta^*) \equiv \theta - \Psi\left(\frac{x^* - \theta}{\varepsilon}\right).$$

Compare now  $\tilde{U}(\theta; \theta^*)$  with  $v(\theta; \theta^*)$ . That  $\hat{x}(\theta^{**}; \theta^*) = x^*$  implies  $\tilde{U}(\theta^{**}; \theta^*) = v(\theta^{**}; \theta^*)$ , while the fact that  $\hat{x}(\theta; \theta^*)$  is increasing in  $\theta$  implies  $\tilde{U}(\theta; \theta^*) < v(\theta; \theta^*)$  for all  $\theta < \theta^{**}$  and  $\tilde{U}(\theta; \theta^*) > v(\theta; \theta^*)$  for all  $\theta > \theta^{**}$ . Combining this result with the properties of the function  $g(\theta)$ , we conclude that  $\tilde{U}(\theta; \theta^*) < v(\theta; \theta^*) < \hat{U}(\theta)$  for all  $\theta < \theta^{**}$ ,  $\tilde{U}(\theta; \theta^*) = v(\theta; \theta^*) = \hat{U}(\theta)$  at  $\theta = \theta^{**}$ , and  $\tilde{U}(\theta; \theta^*) > v(\theta; \theta^*) > \hat{U}(\theta)$  for all  $\theta > \theta^{**}$ . Finally, let  $\hat{\theta}$  be the unique solution to  $\tilde{U}(\hat{\theta}; \theta^*) = 0$  and note that  $\hat{\theta} \in (\theta^*, \theta^{**})$ , since  $\tilde{U}(\theta^{**}; \theta^*) > 0 > \tilde{U}(\theta^*; \theta^*)$ .

**Step 3.** Consider now the behavior of the bank. Given the strategy of the speculators, the bank prefers  $\underline{r}$  to any  $r < \underline{r}^*$ , and  $\bar{r}^*$  to any  $r > \bar{r}^*$ . Furthermore, by definition,  $\hat{r}(\theta)$  dominates any  $r \in [\underline{r}^*, \bar{r}^*]$ . We thus need to compare only the payoff from playing  $\hat{r}(\theta)$  with that from playing  $\underline{r}$ . Playing  $\hat{r}(\theta)$  yields  $\hat{U}(\theta)$ , while playing  $\underline{r}$  yields  $\underline{U}(\theta) = \max\{0, \tilde{U}(\theta; \theta^*)\}$ . Note that  $\underline{U}(\theta) = 0$  if  $\theta \leq \hat{\theta}$  and  $\underline{U}(\theta) = \tilde{U}(\theta) > 0$  if  $\theta > \hat{\theta} \in (\theta^*, \theta^{**})$ . It follows that  $\hat{U}(\theta) < 0 = \underline{U}(\theta)$  for all  $\theta < \theta^*$ ,  $\hat{U}(\theta) > 0 = \underline{U}(\theta)$  for all  $\theta \in (\theta^*, \hat{\theta}]$ ,  $\hat{U}(\theta) > \tilde{U}(\theta) = \underline{U}(\theta) > 0$  for all  $\theta \in (\hat{\theta}, \theta^{**})$ , and  $\underline{U}(\theta) = \tilde{U}(\theta) > \hat{U}(\theta)$  for all  $\theta > \theta^{**}$ . Therefore, it is indeed optimal for the bank to play  $\hat{r}(\theta)$  whenever  $\theta \in [\theta^*, \theta^{**}]$  and  $\underline{r}$  otherwise. The resulting probability of devaluation is  $D(\theta) = 1$  for  $\theta < \theta^*$ ,  $D(\theta) = \Phi(\hat{r}(\theta)) \in [0, 1)$  for  $\theta \in [\theta^*, \theta^{**}]$ , and  $D(\theta) = 0$  for  $\theta > \theta^{**}$ . Since  $\hat{r}$  is non-decreasing,  $D$  is non-increasing in the range  $[\theta^*, \theta^{**}]$ .

**Step 4.** Consider next the behavior of the speculators. For any  $r < \underline{r}^*$ , devaluation occurs if and only if  $\theta < \hat{\theta}$ . In equilibrium, at  $r = \underline{r}$ , the probability of devaluation is given by

$$\mu(\theta < \hat{\theta} | x, \underline{r}) = \mu(\theta < \theta^* | x, \underline{r}) = \frac{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right)}{1 - \Psi\left(\frac{x - \theta^*}{\varepsilon}\right) + \Psi\left(\frac{x - \theta^{**}}{\varepsilon}\right)}.$$

By construction,  $x^*$  solves  $\pi\mu(\theta < \hat{\theta} | x^*, \underline{r}) = \underline{r}$ , and since  $\mu(\theta < \hat{\theta} | x, \underline{r})$  is decreasing in  $x$ , attacking the currency if and only if  $x < x^*$  is indeed optimal. For any out-of-equilibrium  $r < \underline{r}^*$ , we consider

beliefs  $\mu$  such that  $\mu(\theta < \widehat{\theta}|x, r)$  is non-increasing in  $x$  and  $\pi\mu(\theta < \widehat{\theta}|x, r) = r$  at  $x = x^*$ . For any  $r \geq \underline{r}^*$ , we let  $\mu(\theta \in (\underline{\theta}, \bar{\theta})|x, r) = 1$  for all  $x \in [\underline{x}, \bar{x}]$ ,  $\mu(\theta < \underline{\theta}|x, r) = 1$  for  $x < \underline{x}$ , and  $\mu(\theta > \bar{\theta}|x, r) = 1$  for  $x > \bar{x}$ . In particular, for any  $r \in r(\Theta)$  with  $r \geq \underline{r}^*$ ,  $\mu(\theta \in \theta^{-1}(r)|x, r) = 1$  for all  $x$  such that  $\Theta(x) \cap \theta^{-1}(r) \neq \emptyset$ , where  $\theta^{-1}(r) = \{\theta : r(\theta) = r\}$ . In addition, for any out-of-equilibrium  $r$ , if  $r$  is not dominated in equilibrium by  $r(\theta)$  for some  $\theta \in \Theta(x)$ , then we further restrict  $\mu$  to satisfy  $\mu(\theta|x, r) = 0$  for all  $\theta \in \Theta(x)$  such that  $\theta - C(r) < U(\theta)$ . These beliefs satisfy (4), as well as  $\mu \in \mathcal{M}(r)$ ; and given these beliefs, the strategy of the speculators is sequentially optimal for any  $r$  and  $x$ .

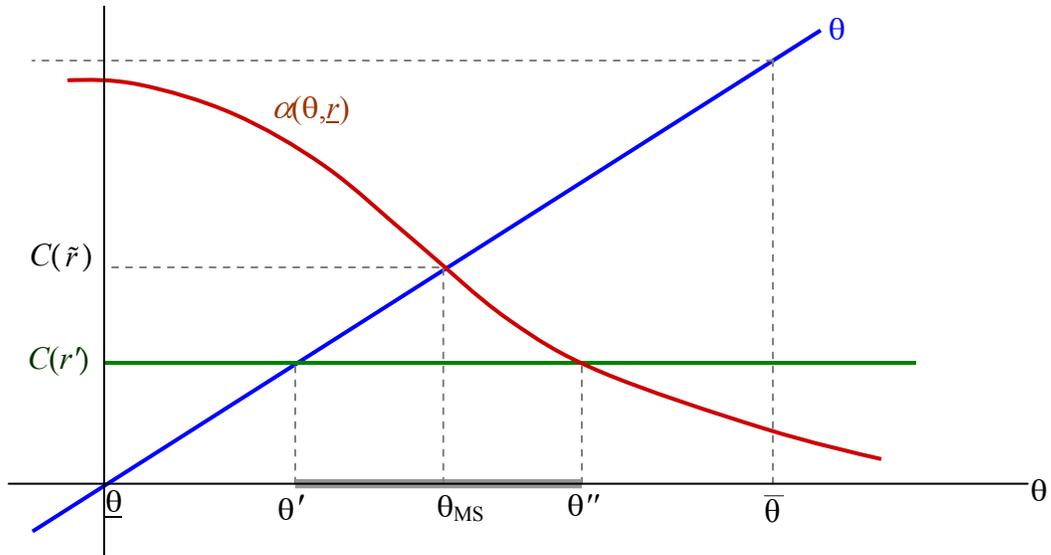
**Step 5.** Finally, consider robustness. Assume  $\Psi$  has bounded support, let  $\varepsilon$  be sufficiently small, and construct the corresponding sunspot equilibrium as above. Let  $\alpha^* \equiv \alpha(\theta^*, \underline{r}) = \Psi\left(\frac{x^* - \theta^*}{\varepsilon}\right)$  and  $\alpha^{**} \equiv \alpha(\theta^{**}, \underline{r}) = \Psi\left(\frac{x^* - \theta^{**}}{\varepsilon}\right)$  and note that  $0 < \alpha^{**} < \alpha^* < 1$ . Similarly, let  $\xi^* \equiv \Psi^{-1}(\alpha^*)$  and  $\xi^{**} \equiv \Psi^{-1}(\alpha^{**})$  and note that  $\xi^{**} < \xi^*$ . Hence, one can always find a  $k > 0$  such that  $0 < \Psi(\xi^{**} - k) < \Psi(\xi^* + k) < 1$ , and a c.d.f.  $F$  with unbounded support such that  $F(\xi) = \Psi(\xi)$  for all  $\xi \in [\xi^{**} - k, \xi^* + k]$ ,  $F(\xi) > \Psi(\xi)$  for all  $\xi < \xi^{**} - k$ , and  $F(\xi) < \Psi(\xi)$  for all  $\xi > \xi^* + k$ . We argue that the same  $r(\theta)$  and  $D(\theta)$  that is sustained when the noise distribution is  $\Psi$ , can also be sustained when the distribution is  $F$ . Indeed, consider the functions  $\widehat{U}, \widehat{r}, \widehat{x}, v, g, \widetilde{U}$ , and  $\underline{U}$  defined above, where  $\Psi$  is replaced with  $F$ . Note that  $\widehat{U}(\theta)$  and  $\widehat{r}(\theta)$  are independent of the noise distribution for all  $\theta \leq \bar{\theta}$ . It follows that the same  $\theta^*$  continues to solve  $\widehat{U}(\theta^*) = 0$ . By construction of  $F$ , the functions  $\widehat{x}(\theta; \theta^*)$ ,  $v(\theta; \theta^*)$ , and  $g(\theta)$  remain the same in a neighborhood of  $\theta^{**}$ . It follows that the same  $\theta^{**}$  and  $x^*$  continue to solve  $g(\theta^{**}) = 0$  and  $x^* = \widehat{x}(\theta^{**}; \theta^*)$ . But then  $\widetilde{U}(\theta; \theta^*)$  and  $\underline{U}(\theta)$  also remain the same in a neighborhood of  $\theta^{**}$ . Since  $\widehat{U}(\theta)$  is also the same for all  $\theta < \bar{\theta}$ , and  $\theta^{**} < \bar{\theta}$ , we infer  $\underline{U}(\theta^{**}) = \widetilde{U}(\theta^{**}; \theta^*) = \widehat{U}(\theta^{**})$ . Like in Step 3 above, the latter ensures that the optimal policy is  $r(\theta) = \widehat{r}(\theta)$  for all  $\theta \in [\theta^*, \theta^{**}]$  and  $r(\theta) = \underline{r}$  otherwise. Since  $\widehat{r}(\theta)$  is also the same for all  $\theta \in [\theta^*, \theta^{**}]$ , this proves that the same policy  $r(\theta)$  can be sustained with either  $\Psi$  or  $F$ . Similarly, all  $\theta < \theta^*$  continue to devalue with certainty and all  $\theta > \theta^{**}$  continue to maintain the peg with certainty, while for  $\theta \in [\theta^*, \theta^{**}]$  the probability of devaluation is  $D(\theta) = \Phi(\widehat{r}(\theta))$ . Therefore, the same devaluation probability  $D(\theta)$  can also be sustained with either  $\Psi$  or  $F$ . A symmetric argument applies if  $\Psi$  is unbounded. With  $\xi^*$  and  $\xi^{**}$  defined as above, take an arbitrary  $k > 0$  and construct  $F$  so that  $F$  has bounded support  $[\xi^{**} - 2k, \xi^* + 2k]$  and satisfies  $F(\xi) = \Psi(\xi)$  for all  $\xi \in [\xi^{**} - k, \xi^* + k]$ ,  $F(\xi) < \Psi(\xi)$  for all  $\xi < \xi^{**} - k$ , and  $F(\xi) > \Psi(\xi)$  for all  $\xi > \xi^* + k$ . It follows that  $F$  sustains the same  $r(\theta)$  and  $D(\theta)$  as  $\Psi$ . We conclude that the sunspot equilibria of Proposition 5 are robust. ■

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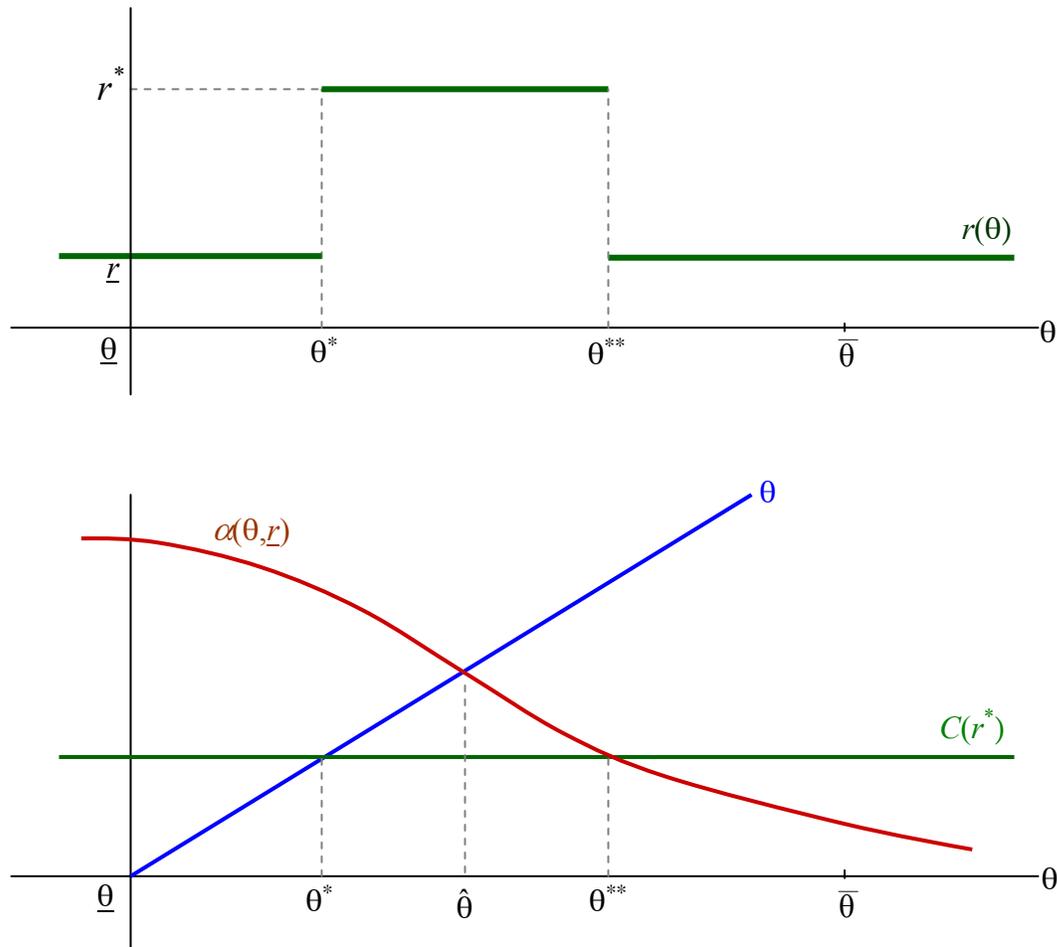
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**Figure 1**

There exists an *inactive policy equilibrium* in which the central bank sets  $\underline{r}$  for all  $\theta$ , the size of the attack is  $\alpha(\theta, \underline{r})$ , and devaluation occurs if and only if  $\theta < \theta_{MS}$ . Any  $r' \in (\underline{r}, \tilde{r}]$  is dominated in equilibrium by  $\underline{r}$  if and only if  $C(r') > \theta$  or  $C(r') > \alpha(\theta, \underline{r})$ , that is, if and only if  $\theta \notin [\theta', \theta'']$ . It follows that, for any  $\theta \in [\theta', \theta'']$ , if the central bank deviates from  $\underline{r}$  to  $r'$ , the market “learns” that  $\theta \in [\theta', \theta'']$ . Speculators then coordinate on the same behavior as when  $r = \underline{r}$ , thus eliminating any incentive for the bank to raise the interest rate.



**Figure 2**

For each  $r^* \in (\underline{r}, \tilde{r}]$ , there is a *two-threshold equilibrium* in which the interest rate is  $r(\theta) = r^*$  if  $\theta \in [\theta^*, \theta^{**}]$  and  $r(\theta) = \underline{r}$  otherwise, and in which devaluation occurs if and only if  $\theta < \theta^*$ . When the central bank raises the interest rate at  $r^*$ , the market “learns” that  $\theta \in [\theta^*, \theta^{**}]$  and coordinates on no attack. When instead the bank sets  $\underline{r}$ , speculators attack if and only if their signal is sufficiently low, in which case the size of the attack is decreasing in  $\theta$ . It follows that it is optimal for the central bank to raise the interest rate at  $r^*$  if and only if  $C(r^*) \leq \hat{\theta}$  and  $C(r^*) \leq \alpha(\theta, \underline{r})$ , that is, if and only if  $\theta \in [\theta^*, \theta^{**}]$ .