Monetary Policy under Fixed Exchange Rates

1. CB attempts to stimulate economy (buys domestic assets)
2. $E_0 \Rightarrow E_2; \ AA_1 \Rightarrow AA_2$
3. But CB is pegging! Can’t allow depreciation to happen
4. So the CB sells foreign reserves to move $E_2 \Rightarrow E_0$
5. This brings exchange rate back to $E_0$, and forces $AA_2$ back to $AA_1$
6. Monetary policy is ineffective under fixed exchange rates
Monetary policy **ineffective** under fixed exchange rates

- With a fixed exchange rate, you give up on an independent monetary policy. You cannot use monetary policy to target domestic inflation or to try to smooth out the domestic business cycle.

- The only hope for independent monetary policy is capital controls to prevent traders buying or selling domestic currency.

- But capital controls reduce trade and foreign direct investment, and present opportunities for corruption.
Fiscal Policy under Fixed Exchange Rates

1. Fiscal stimulus (increase spending; lower taxes) increases aggregate demand (shifts DD to right)

2. But this causes initial appreciation (fall in $E$); equil is at 2.

3. To protect the peg, CB must buy foreign assets with home currency. This increases the domestic money supply, which moves economy to final equil 3 (higher output)

4. Fiscal policy is potent because it causes both the DD and the AA schedules to shift
Disadvantages of Fixed Exchange Rates

• With a fixed exchange rate you give up on an independent monetary policy
• So you cannot use monetary policy to target domestic inflation or to try to smooth out the domestic business cycle
• The only hope for independent monetary policy is exchange controls to prevent traders buying or selling domestic currency
• But exchange controls reduce trade and foreign direct investment, and present opportunities for corruption
Advantages of Fixed Exchange Rates

• Too much exchange rate volatility might be bad for trade
  – Firms might prefer to focus on domestic markets rather than risk losses from international sales due to adverse exchange rate movements

• Countries with histories of bad monetary policy (e.g., inflations) might peg their currency to countries with a better track record
  – By doing this you effectively adopt the other country’s monetary policy

• An extreme form of fixing the exchange rate is to fully adopt another country’s currency (dollarization)
  – Dollarization is more credible than a fixed exchange rate
  – If you adopt the dollar you immediately have US monetary policy
  – But you lose seigniorage revenue
# Macro Policy Effectiveness

<table>
<thead>
<tr>
<th>Exchange rate regime</th>
<th>Fixed</th>
<th>Flexible</th>
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</thead>
<tbody>
<tr>
<td>Fiscal policy</td>
<td>Effective</td>
<td>Ineffective</td>
</tr>
<tr>
<td></td>
<td>(fiscal expansion causes appreciation so Net Exports decrease)</td>
<td></td>
</tr>
<tr>
<td>Monetary policy</td>
<td>Ineffective</td>
<td>Effective</td>
</tr>
<tr>
<td></td>
<td>(due to CB sterilization $E_0 \Rightarrow E_2 \Rightarrow E_0$)</td>
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</table>
# Summary of Monetary and Fiscal Policy Effects in Open Economies

<table>
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<tr>
<th>Small open economy, perfect capital mobility</th>
<th>Flexible exchange rates</th>
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<td><strong>Monetary policy</strong></td>
<td><strong>Fiscal policy</strong></td>
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<tr>
<td>Fixed exchange rates</td>
<td>Impotent, no independent effect, consistent with trilemma</td>
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<tr>
<td>Flexible exchange rates</td>
<td>Strong, fiscal policy gains control over money supply</td>
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<td>Impotent, same as in small open economy</td>
</tr>
<tr>
<td>Flexible exchange rates</td>
<td>Strong, but not as effective as in small open economy</td>
</tr>
</tbody>
</table>
Exchange Rate Regimes 1999

- **Currency Board**: Argentina, Hong Kong
- **Adjustable Peg**: Bretton Woods
- **Basket Peg**: EMU, dollarization
- **Managed Float**: “Truly Fixed” Franc Zone, Panama

**Crawling Peg**: Chile
- **Target Zone/Band**: ERM (until 1999)
- **Free Float**: 45 93 47
Notes

**DD schedule** shows all combinations of output and the exchange rate for which the output market is in short-run equilibrium (aggregate demand = aggregate output).

- It slopes upward because a rise in the exchange rate (depreciation) causes output, $Y$, to rise
  - If $P$ and $P^*$ are fixed in the short run, a depreciation of the domestic currency increases $Y$ via the current account (net exports increase). Similarly, an appreciation of the domestic currency causes a fall in output as net exports decrease

- Some of the factors that shift the **DD** Schedule:
  - Government spending and taxes
  - Domestic Investment and Consumption
  - Demand shift between foreign and domestic goods
Notes (cont)

• **AA schedule** relates exchange rates and output levels that keep the money and foreign exchange (asset) markets in equilibrium. It describes how exchange rates fall/rise as output increases/decreases
  – It slopes downward because a rise in output, Y, causes a rise in home interest rates and a domestic appreciation

• Anything that changes the asset market (foreign exchange and money markets) will shift the curve:
  – A change in the money supply
  – A change in foreign interest rates
  – A change in the real money demand