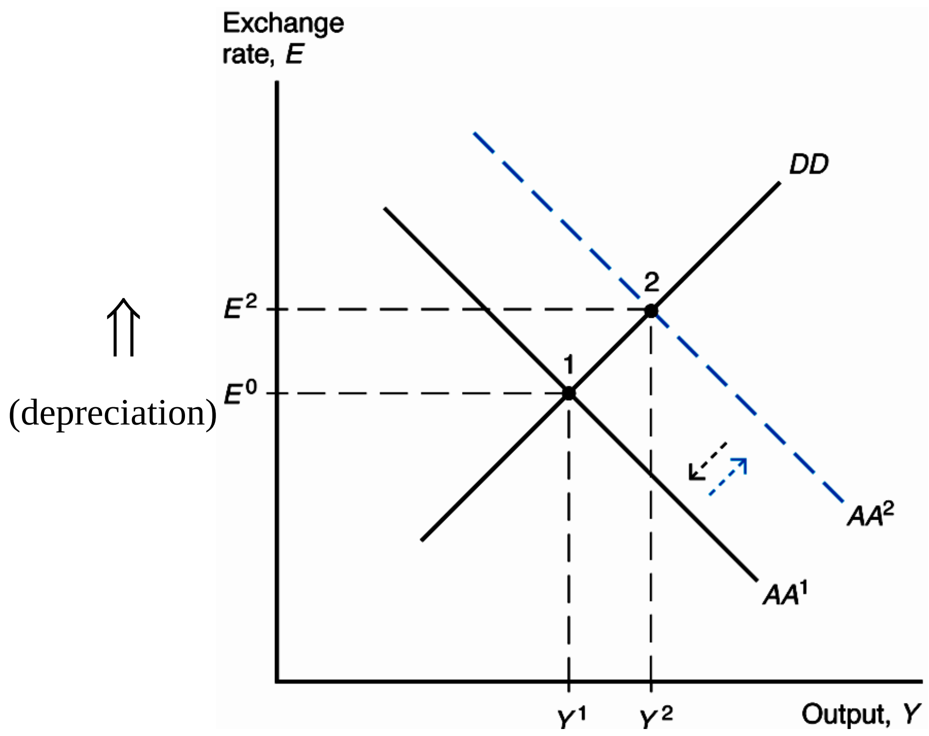
Monetary Policy under Fixed Exchange Rates



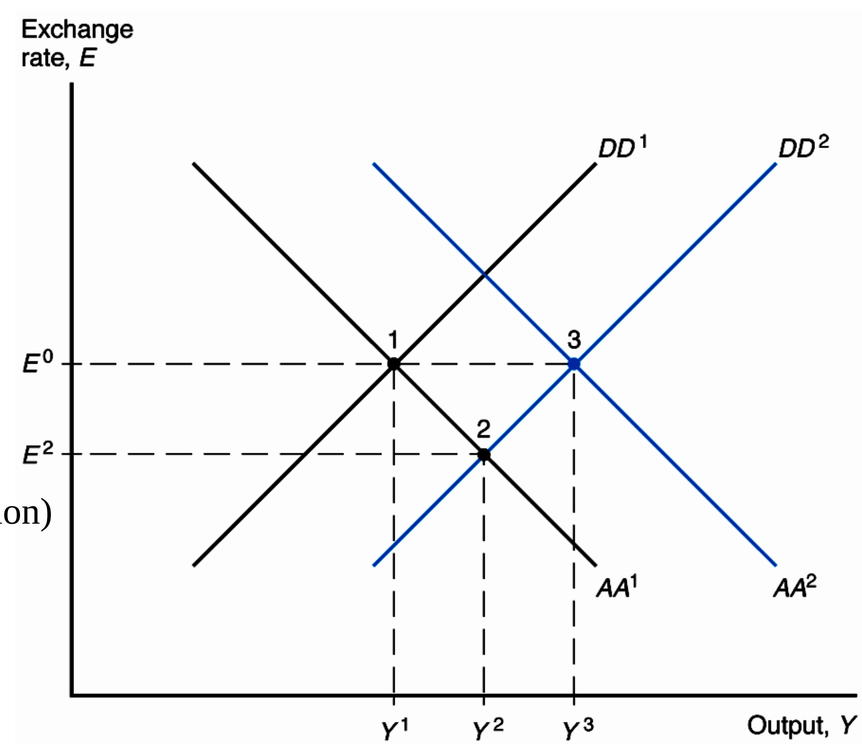
1. CB attempts to stimulate economy (buys domestic assets)
2. $E_0 \Rightarrow E_2$; $AA_1 \Rightarrow AA_2$
3. But CB is pegging! Can't allow depreciation to happen
4. So the CB sells foreign reserves to move $E_2 \Rightarrow E_0$
5. This brings exchange rate back to E_0, and forces AA_2 back to AA_1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

Monetary policy <u>ineffective</u> 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

Fiscal policy is <u>more effective</u> under fixed exchange rates



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(appreciation)

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 (eg 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 countries 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

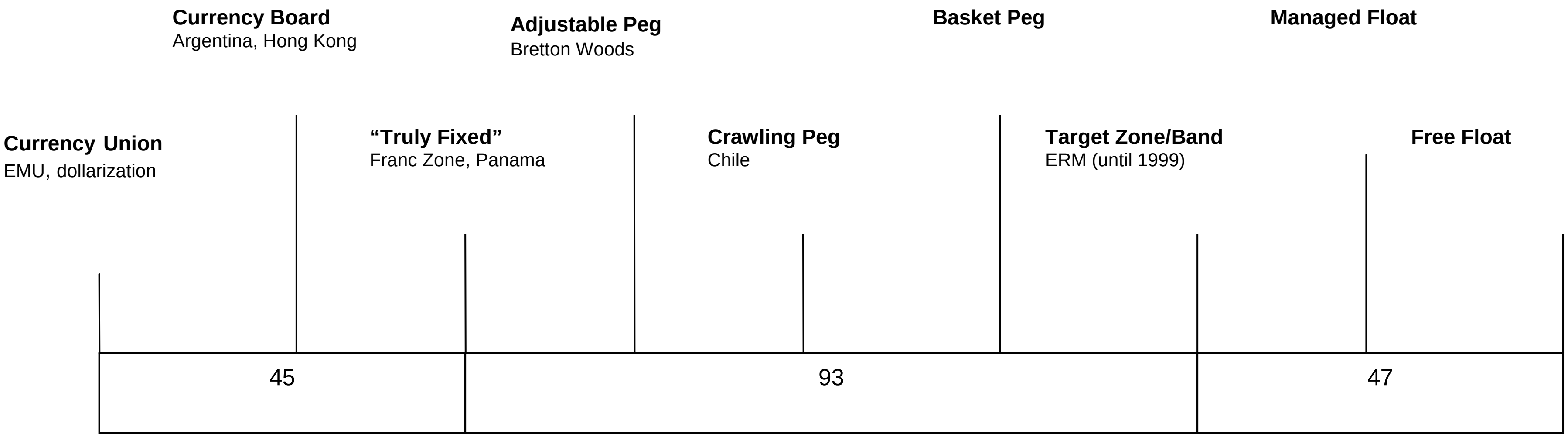
Exchange rate regime		
	Fixed	**Flexible**
Fiscal policy	**Effective**	**Ineffective** (fiscal expansion causes appreciation so Net Exports decrease)
Monetary policy	**Ineffective** (due to CB sterilization $E_0 \Rightarrow E_2 \Rightarrow E_0$)	**Effective**

Summary of Monetary and Fiscal Policy Effects in Open Economies

	Small open economy, perfect capital mobility	
	Fixed exchange rates	**Flexible exchange rates**
Monetary policy	Impotent, no independent effect, consistent with trilemma	Strong, exchange rate impact augments direct effect of policy on domestic spending
Fiscal policy	Strong, fiscal policy gains control over money supply	Impotent, international crowding out augments domestic crowding out

	Large open economy, imperfect capital mobility	
	Fixed exchange rates	**Flexible exchange rates**
Monetary policy	Impotent, same as in small open economy	Strong, with more exchange rate effect than in small open economy
Fiscal policy	Strong, but not as effective as in small open economy	Impotent, as in small open economy

Exchange Rate Regimes 1999



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)

- **<u>AA schedule</u>** 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