# Fixed versus Flexible Exchange Rates
# Chapter 19

1. Fixed versus flexible exchange rates

2. Supply shocks under flexible exchange rates

3. Fixed-price two-country model of international transmission of shocks

# 1 Fixed versus Flexible Exchange Rates

## 1.1 Monetary Policy

### 1.1.1 Flexible exchange rates

- Use monetary policy for stabilization
- No long-run effects because money is neutral
- The more open the economy, the more quickly prices adjust and the smaller the benefits

### 1.1.2 Fixed exchange rates

- Discipline - important for a country which is not very good at monetary policy and has high inflation

- Can fail to discipline fiscal authority, leading to exchange rate crises

## 1.2 Asymmetry in monetary policy

### 1.2.1 Flexible exchange rates

- Each country responsible for own monetary policy

### 1.2.2 Fixed

- US determined world money supply
- Other countries lost monetary policy
- Other countries might or might not like inflation and/or monetary stimulus chosen by US

## 1.3 Fiscal Policy

### 1.3.1 Flexible exchange rates

- Currency appreciates
- Output rises, but less than if exchange rate was fixed

### 1.3.2 Fixed exchange rates

- Keeping exchange rate fixed requires expansionary monetary policy
- Output effects of fiscal policy larger than under flexible exchange rates

## 1.4 Output Volatility

### 1.4.1 Flexible exchange rates

- Shocks to DD

- Shocks to AA

### 1.4.2 Fixed exchange rates

- Shocks to DD

- Shocks to AA

## 1.5 Asymmetry in adjustment:

- Shift in world taste away from domestic goods
- Need $q = \frac{EP^*}{P}$ to rise

### 1.5.1 Flexible exchange rates

- $E$ rises immediately and output remains at full employment
- Works for all flexible exchange rate countries

### 1.5.2 Fixed exchange rates

- Any country other than the US could devalue their currency
- Reduction in demand for domestic goods tended to raise $E$
- Other countries had to sell their currencies and buy dollar reserves to keep the dollar from depreciating
- Fall in US money supply would cause a recession
- Creating a fall in domestic price to restore equilibrium

## 1.6 Beggar-thy-neighbor policies

### 1.6.1 Flexible exchange rates

- Monetary expansion
- Temporary increase in output at expense of higher long-run prices
- Temporary increase in output accompanied by deterioration in terms of trade (lower relative price of domestic goods)

### 1.6.2 Fixed exchange rates

- IMF oversight was designed to prevent competitive devaluations

- Enforced international policy cooperation

## 1.7 Exchange rate volatility

### 1.7.1 Flexible exchange rates

- Exchange rates are asset prices

- Asset prices are volatile

- Volatility creates uncertainty and can reduce incentives to trade, reducing the gains from trade

### 1.7.2 Fixed exchange rates

- Fixed exchange rates are not volatile

- Except when there is an exchange rate crisis

# 2 Oil Price (Supply) Shocks under Flexible Exchange Rates

## 2.1 Aggregate supply and demand

### 2.1.1 Supply

- Short-run
- Long-run

### 2.1.2 Aggregate demand

## 2.2 Increase in price of imported oil

- Price shock for all oil-importing countries

- Interest-rate parity graph
  - World interest rate rises
  - No change in exchange rate among oil importers

- AA-DD graph extended to include interest rates
- Policy dilemma
  - Fiscal policy
  - Monetary policy
- Demand management not very useful for a supply shock

# 3 International Transmission of Policy: Short-run

## 3.1 Model

- Two large countries

- Home goods market equilibrium

$$Y = C\left(Y - T\right) + I + G + CA\left(\frac{EP^*}{P}, Y - T, Y^* - T^*\right)$$

- Foreign goods market equilibrium

$$Y^* = C^*\left(Y^* - T^*\right) + I^* + G^* + CA^*\left(\frac{EP^*}{P}, Y - T, Y^* - T^*\right)$$

- World current accounts sum to zero

$$CA + CA^* = 0$$

## 3.2 Graph of goods market equilibrium in each country

- Home goods market equilibrium (HH)
- Foreign goods market equilibrium (FF)
- Shifts
  - Monetary expansion
  - Fiscal expansion

## 3.3 Policy and its transmission

- Volker's disinflation policy 1981-83

- Reagan's fiscal stimulus