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Monetary policy in open economies

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Abstract

The recent literature on monetary policy in open economies has produced a strong presumption in favor of activistic policy and flexible exchange rates. We argue that this result may owe much to the combination of two commonly made assumptions: That nominal goods prices are rigid. And that the monetary authorities have a lot of information about the economy. When the source of nominal rigidity is found in wages and monetary policy is conducted according to less information demanding rules (such as a standard interest rate rule) policies that stabilize the money supply or the nominal exchange rate may perform better.

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0. Introduction

The properties of alternative international monetary arrangements have been studied extensively in the literature, first within the Mundell–Fleming and lately within the New Keynesian (NK) model. The former model has identified two key

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factors that make the fixing of the exchange rate costly: (a) Dissimilarities in economic structure, in particular regarding the degree of asymmetry in the shocks, and (b) a high degree of nominal rigidities. Asymmetric shocks generate a need for terms of trade adjustments. If the necessary adjustments cannot occur directly through wage and price changes, they may be accomplished indirectly via exchange rate changes (see Friedman's (1953) case for flexible exchange rates).

The NK model uses diverse "formats" and has produced rather diverse findings. Nevertheless, its main conclusion echoes that of the traditional Mundell–Fleming model (at least under producer currency pricing) and for the same reasons. Namely, abstracting from non-fundamental fluctuations and speculative attacks, flexible exchange rate systems tend to fare better than regimes that severely restrict exchange rate fluctuations (Benigno and Benigno, 2003; Kollmann, 2002; Obstfeld and Rogoff, 2001; Pappa, 2004; Stockman and Ohanian, 1993). Moreover, independent national monetary policy performs quite well, that is, there exist small gains from international policy coordination. While objections to the general validity of these results have been raised[1] they have not undermined their wide acceptance.

There are good reasons to believe that the alleged superiority of monetary policies that feature activism, absence of international coordination and a flexible exchange rate may not be as general as it appears. First, it is typically assumed that the monetary authorities have *complete information* about the structure of the economy and the shocks. Combining this with the assumption that monetary policy is conducted optimally, that is, that it aims at maximizing the utility of the representative agent, often allows these models to generate activist policy equilibria that replicate the efficient, flexible price (or wage) equilibrium. Consequently, when monetary policy is omniscient and omnipotent, it is not sensible to constrain it by making it target the exchange rate. This is especially true when beggar-thy-neighbor effects associated with independent policies are not strong (for instance, when domestic and foreign goods are poor substitutes, see Pappa (2004)).

Second, the ability to manipulate the nominal exchange rate is more useful when there is no production interdependence across countries. If there is also trade in intermediate (capital) goods then an exchange rate depreciation may have adverse, direct effects on the cost of domestic production which go against those on relative demands and which make the exchange rate instrument less useful.[2] Again it is typical in this literature to assume that trade involves only consumption goods.[3]

[1]Two main exceptions have been identified. The use of LCP with buyer's currency improves the relative performance of fixed regimes (Devereux and Engel, 2003; Duarte, 2003). And the presence of an incentive to exploit the country's market power strengthens the case for international policy coordination (even in the form of a fixed regime; Canzoneri et al., 2005; Pappa, 2004).

[2]In graphical terms, a depreciation shifts both the demand and the supply curve for domestic goods upward. See De Grauwe (2001).

[3]There are several works that use traded intermediate goods (for instance, Collard and Dellas, 2002; Chari et al., 2002; Kollmann, 2002) but do not deal explicitly with the issues discussed here. Kollmann is an exception but his evaluation of alternative regimes omits transitional effects, so his welfare comparisons are not complete.