

Flexible Exchange Rates

(lecture outline)

- effects of monetary policy
 - monetary policy is amplified
- effects of fiscal policy
 - less effective than under fixed rates regime
- external shock under fixed and flexible rates
 - flexible rates accommodate external shocks better than fixed rates
- money demand shock under fixed and flexible rates
 - fixed rates accommodate money demand shocks better than flexible rates
- monetary policy under flexible rates
 - “*just do it*” approach
 - inflation targeting
 - * prerequisites
 - central bank independence
 - fiscal order
 - no other target than inflation (such as exchange rates or wages)
 - inflation is controllable, $\pi_{t+1} = f\left(\frac{\Delta MB_t}{MB_t}\right) + \varepsilon_t$
 - * experience with inflation targeting
 - π is low
 - $\text{var}(\mathbf{E})_i 0$
 - $\pi^{\text{target}} \neq \pi^{\text{actual}}$
 - * issues for developing countries
 - reliance on seignorage as a source of revenue
 - unstable relationship between inflation, interest rates and money supply
 - Central Bank independence
 - measurement of inflation