International Monetary Arrangements
Choice of Exchange Rate Regime

• Three Approaches

1. “Sources of Shocks” (Poole)

2. “Credibility/Dynamic Inconsistency” (Barro-Gordon)

3. “Optimum Currency Area” (Mundell)
“Sources of Shock”

• Mundell-Fleming model implies certain shocks are “automatically offset” during certain regimes:
  – Ex: (im) potency of (monetary) fiscal policy affecting output during fixed exchange rates
  – Generalization: this applies to all shifts to (LM) IS curve, e.g., shocks to (money) investment demand

• Key Idea: Authorities choose exchange regime to smooth shocks of relevance, avoid output volatility
  – Mostly financial shocks: fix exchange rate
  – Float with mostly real shocks

• But theory works terribly in practice
“Credibility”

• Which institution is more reliable – monetary or fiscal authority?
  – Ex: Monetary policy highly potent effect on output in flexible regime; constrained and impotent in fix

• Key Idea: choose exchange rate regime to allocate discretion/power to more trustworthy authority.
  – With untrustworthy central bank, fix exchange rate
  – Float if trust central bank more than government
“Optimum Currency Areas”

• Mundell: When are two regions more likely to gain from common currency?
  – If they share deep trade links (single currency reduces transaction costs of trade)
  – If they have similar business cycles (so don’t need different monetary policies)
But if Two Regions have Asymmetric Business Cycles ...

- Need to be able to *Adjust* to “Asymmetric Shocks” (good for one region, bad for another)
  - Otherwise boom in one region causes inflation
  - Recession in other causes unemployment
Possible Methods to Adjust (to Asymmetric Business Cycles)

- *Sharing risks* via public sector (system of taxes and transfers)
  - Or via private sector (international cross-holdings of assets)

- *Factor mobility* (unemployed workers move to places of high demand)
Mundell’s “Optimum Currency Area”

1. Suppose business cycles are asymmetric, and
2. Suppose that there is little risk-sharing, and factors are immobile, then
3. Gain from using differential monetary policy to smooth different shocks
   • Use different monies to adjust to different business cycles
     – Evidence within countries (e.g., American regions)
     – Evidence across countries (e.g., EMU)
Some Exotic Exchange Rate Regimes

• *Dollarization* (e.g., Panama): use another country’s money

• *Currency Union* (e.g., EMU): share a common money

• *Currency Board* (e.g., Hong Kong): eliminate central bank credit-- all the central bank’s assets are international reserves

• *Crawling Peg*: exchange rate is fixed but moves over time (usually gradually and within bands)
Key Takeaways

• Countries endogenously choose exchange rate regime

• Currency unions with different regions must be able to adjust