

EE 452 International Monetary Economics
6. Floating Exchange Rates & Internal Balance

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Outline

- ☞ Monetary Policy under Flexible Exchange Regime
- ☞ Fiscal Policy under Flexible Exchange Regime
- ☞ Shocks
 - ☞ Internal Shocks
 - ☞ International Capital-Flow Shocks
 - ☞ International Trade Shocks
- ☞ Internal Imbalance and Policy Response
- ☞ International Macroeconomic Policy Coordination

Objectives

- The effectiveness of monetary policy under flexible exchange rates
- The effectiveness of fiscal policy under flexible exchange rate
- Which exchange rate regime performs better in the face of internal shocks?
- Which exchange rate regime performs better in the face of external shocks?

Floating Exchange Rates & Internal Balance

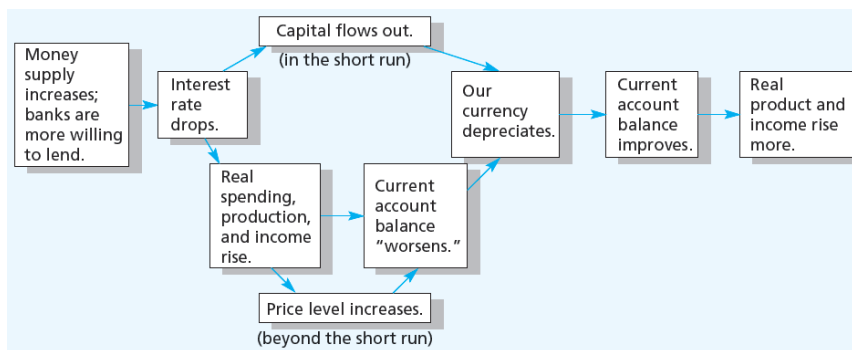
- Changes in exchange rate are the “automatic” mechanism for adjusting to achieve external balance.
- However, even if a floating exchange rate is used to achieve external balance, this still leaves the problem of achieving..._____.
- With a floating rate, the exchange rate brings overall balance of payments into equilibrium by affecting people’s choices about whether to buy goods and services abroad or at home and whether to invest in this country’s financial assets or another country’s financial assets.
 - The impact on demand for goods and services then has a feedback effect on the country’s _____.

Floating Exchange Rates & Internal Balance

- The analysis of how a country with floating exchange rate responds to a policy change or shock can usefully proceed through three steps:
 1.
 2.
 3.

MONETARY POLICY WITH FLOATING EXCHANGE RATES

Effects of Expanding the Money Supply with Floating Exchange Rates



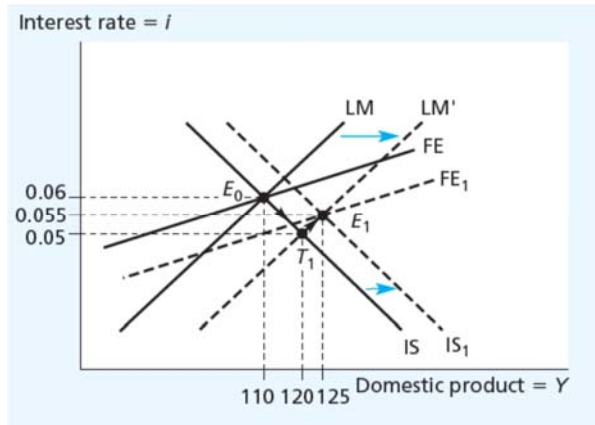
Source: Pugel (2012), p. 615

The Effect of Depreciation on Monetary Expansion

	Change in the Country's Real GDP after Two Years	
	Holding the Exchange Rate Steady	Allowing the Floating Exchange Rate to Depreciate
United States	0.5%	0.8%
Japan	0.7	0.9
Euro area	0.6	0.9

Source: Pugel (2012), p. 616

Expansionary Monetary Policy with Floating Exchange Rates



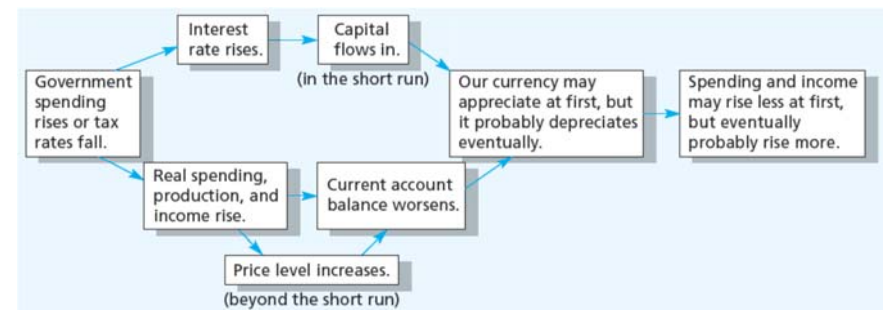
Source: Pugel (2012), p. 616

Monetary policy with Floating Exchange Rates

- With floating or flexible exchange rates, exerts a strong influence over domestic product or income.

FISCAL POLICY WITH FLOATING EXCHANGE RATES

Effects of Expansionary Fiscal Policy with Floating Exchange Rates



Source: Pugel (2012), p. 617

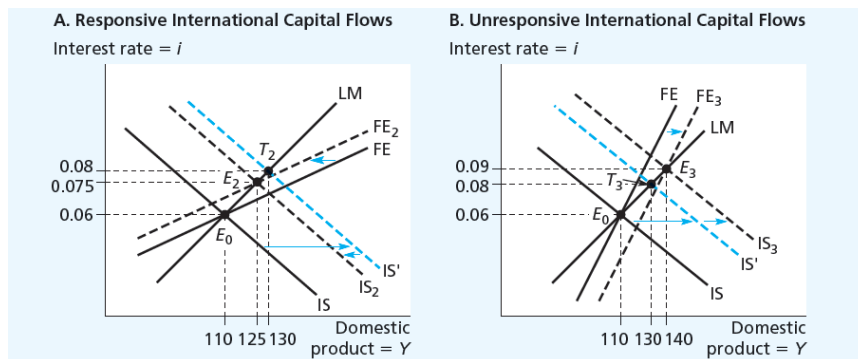
Effects of Expansionary Fiscal Policy with Floating Exchange Rates

- If the country's currency at first....., then the country loses price competitiveness.
- The country's exports decline and its imports increase. ->
 - C/A deficit the expansionary effect of the fiscal change on the country's domestic product.
 - That is, the expansionary effect is reduced by "international crowding out" – theof the country's currency and the resulting..... in the C/A.

Effects of Expansionary Fiscal Policy with Floating Exchange Rates

- If the country's currency, then the country gains price competitiveness.
- The country's exports increase and its imports declines. -> C/A.....
 - C/A surplus the expansionary effect of the fiscal change on the country's domestic product.
 - The enhanced price competitiveness and resulting increase in C/A give a further trade-based stimulus to domestic production.

Expansionary Fiscal Policy with Floating Exchange Rates



Source: Pugel (2012), p. 619

SHOCKS TO THE ECONOMY

Internal Shocks

- Domestic monetary shocks affect the equilibrium relationship between money supply and money demand, causing a shift in thecurve.
 - Example, a change in monetary policy.
 - Domestic monetary shocks have powerful effects on an economy with exchange rate system.
 - If the monetary shock tends to expand the economy, then the exchange rate tends to, further domestic product (causing upward pressure on the price level, too.)
 - If the monetary shock tends to contract the economy, then the country's currency tends to, further domestic product.

Internal Shocks

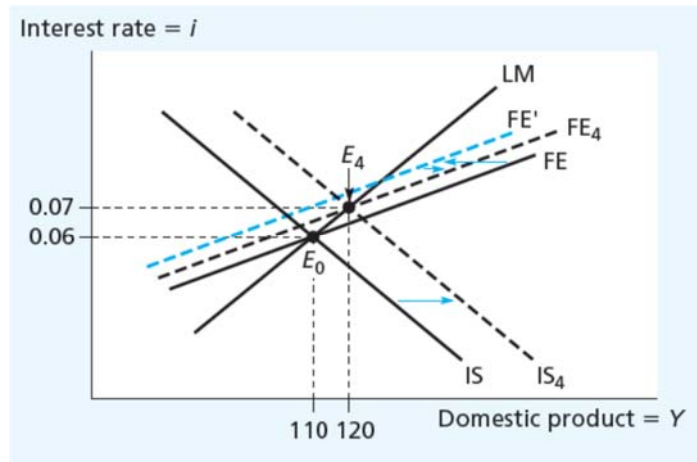
- Domestic spending shocks alter domestic expenditure, causing a shift in the curve.
 - A change in fiscal policy is an example.
 - The effect of fiscal shock depends on which changes more: international capital flows or the country's current account.

INTERNATIONAL CAPITAL-FLOW SHOCKS

International capital-flow shocks

- International capital-flow shocks occur because of changes in investors' perceptions of economic and political conditions in various countries.
 - Example, an adverse shock leading to capital outflow from our country can occur because foreign interest rates increase.

An Adverse International Capital-Flow Shock



Source: Pugel (2012), p. 622

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International capital-flow shocks

- Under floating exchange rates, external capital-flow shocks can have effects on internal balance by altering the exchange rate and the country's international price competitiveness.
- However, it is risky to conclude, on the basis of the simpler IS-LM-FE analysis that an adverse capital-flow shock is simply good for the economy!

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International capital-flow shocks: Precautions

- Reasons for capital outflow.
 - If capital is flowing out because of political or economic problems, then these problems may cause the economy to even though the exchange-rate
- Effects on domestic financial market.
 - If the capital outflow disrupts the domestic financial markets in a way beyond our basic analysis, then the broader domestic economy may be harmed.

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INTERNATIONAL TRADE SHOCKS

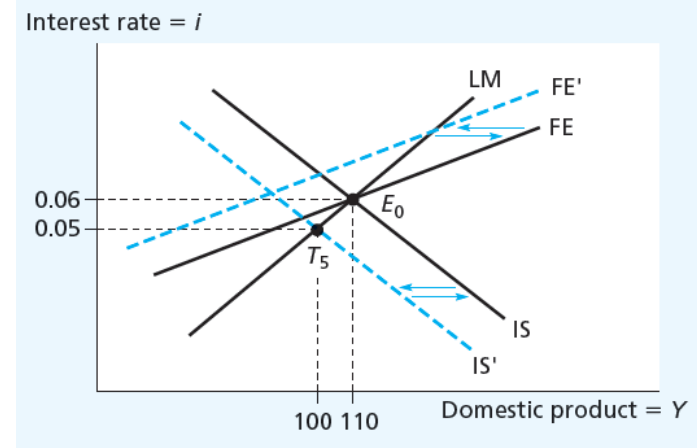
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International Trade Shocks

- International trade shocks cause the value of the country's current account balance to change. Examples:
 - A decline in foreign demand for our exports
 - An increase in our taste for imported goods
 - An increase in price of our important imports such as oil.

An Adverse International Trade Shock



Source: Pugel (2012), p. 624

International Trade Shocks

- With floating exchange rates, the effects of international trade shocks on internal balance are mitigated by the effects of the *resulting change in the exchange rate*.
- An adverse trade shock tends to depreciate the country's currency, and this reverses some of the effects of the shock.

INTERNAL BALANCE AND POLICY RESPONSES

International imbalance and policy responses

- With floating exchange rates, a change in the exchange rate takes care of achieving external balance following a shock.

International imbalance and policy responses

- A floating exchange rate does NOT ensure that the country achieves internal balance, but changes in the floating rate do affect the country's internal balance.
 - Depreciation tends to the economy.
 - Appreciation tends to the country's economy.
- Monetary or fiscal policy can be used to address any internal imbalances.
 - policy is powerful with floating exchange rates, so relatively small change may be enough to reestablish internal balance.
 - policy may be difficult to predict in the case of floating exchange rates.

INTERNATIONAL MACROECONOMIC POLICY COORDINATION

Uncoordinated policies

- The policies adopted by one country have effects on the other countries.
 - as changes in incomes alter demands for imports
 - Changes in international price competitiveness as floating exchange rates change.

One Danger

- Policy change that benefits a country may harm other countries.
- Example: monetary policy causes the other country's currency to appreciate. Other country will lose price competitiveness. – *Beggar-thy-neighbor policy*.

Another Danger

- Each country acting individually may fail to make a policy change whose benefits go mostly to other countries.
- If a number of countries could coordinate so that they all would reap substantial benefits.
- Example: Global stock market crash in Oct 1987
 - Global financial system needed additional liquidity to counteract decline in banking and financial activity.
 - If any one central bank added liquidity, the rest of the global system would benefit, so they may individually be reluctant.
 - Fortunately, several central banks coordinated their actions to inject liquidity and the financial markets stabilized.

International macroeconomic policy coordination

- International macroeconomic policy coordination is the joint determination of several countries' macroeconomic policies to improve joint performance.
 - Example, 1987 Louvre Accord among the G-7 countries.