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Input substitution, export pricing, and exchange rate policy[☆]



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ABSTRACT

This paper develops a small open economy model with sticky prices to show why a flexible exchange rate policy is not desirable in East Asian emerging market economies. We argue that weak input substitution between local labor and import intermediates in traded good production and extensive use of foreign currency in export pricing in these economies can help to explain this puzzle. In the presence of these two trade features, the adjustment role of the exchange rate is inhibited, so even a flexible exchange rate cannot stabilize the real economy in face of external shocks. Instead, due to the high exchange rate pass-through, exchange rate changes will lead to instability in domestic inflation. As a result, a flexible exchange rate regime becomes less desirable. In a very limited parameter space, a fixed exchange rate can be superior to monetary policy rules with high exchange rate flexibility, such as non-traded good price targeting. In most cases, however, non-traded good price targeting still delivers higher welfare.

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1. Introduction

The purpose of this paper is to explain why exchange rates in East Asian economies are usually not as flexible as those in developed countries, i.e., why these economies usually adopt fixed or less flexible exchange rate policies. We argue that this phenomenon can be attributed to two features in trade structures of these economies: weak input substitution between local labor and import intermediates in traded goods production and extensive use of foreign currency in export pricing.

The debate on fixed versus flexible exchange rates has been at the heart of international monetary economics for many years. [Friedman \(1953\)](#) and later [Mundell \(1961\)](#) made the case for flexible exchange rates as an efficient adjustment mechanism, cushioning the economy against external shocks when domestic price levels could not change quickly enough. The implication is that for a small economy buffered by external disturbances from the rest of the world, it is better to allow the exchange rate to adjust.

Recently, a large number of papers have examined business cycle stabilization and welfare properties of simple monetary rules in dynamic, sticky-price, general equilibrium small open economy models.¹ An especially pertinent example is [Schmitt-Grohe and Uribe \(2001\)](#), who examined a small open economy model and compare welfare properties of a number of monetary policy rules allowing for exchange rate movement with a fixed nominal exchange rate rule. They found that the stabilization properties of each of monetary rules with exchange rate flexibility are superior to a fixed exchange rate rule. Recently, in a prominent paper, [Engel \(2011\)](#) shows explicitly in a two-country model that when firms price to market, the optimal monetary policy involves a trade-off among inflation, output gap, and currency misalignment objective. So policy makers will put some weight on exchange rate stability, and CPI inflation is the relevant inflation target for policy makers.

In reality, however, many East Asian economies, such as Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand, pegged their currencies to the US dollar, either explicitly or implicitly. Before the 1997 financial crisis, exchange rate regimes in these economies ranged from a currency board hard peg in Hong Kong to a sliding or crawling peg in Indonesia. After 1997, some of these economies have gradually switched to CPI inflation targeting. However, the volatilities of East Asian currencies are still usually much lower than those of major currencies.²

Thus, it remains a challenge for economists to explain exchange rate regime choices or the inflexibility of exchange rates in these economies. [Calvo and Reinhart \(2002\)](#) argue that this is because of the “fear of floating”, which is due to financial fragility or the presence of foreign currency debt or currency mismatch in these economies. [Céspedes et al. \(2004\)](#) and [Calvo \(2000\)](#) show that, with high foreign currency debt ratios in emerging market economies, a balance sheet effect may lead to a real contraction when the exchange rate devalues. This will force central banks to stabilize their exchange rates. In emerging market economies, the desirability of a flexible exchange rate is subject to financial conditions.

Nevertheless, recent literature finds that, for a small open economy, a fixed exchange rate is still dominated by a flexible exchange rate in terms of welfare, even when financial friction or potentially large balance-sheet effects are taken into consideration. For example, [Gertler et al. \(2007\)](#) show that fixed exchange rates exacerbate financial crises by tying the hands of the monetary authorities, so that the welfare loss following a financial crisis is significantly larger under fixed exchange rates relative to flexible exchange rates. [Chang and Velasco \(2006\)](#) find that “fear of floating” may emerge endogenously when there is a currency mismatch between assets and liabilities, but floating exchange rate regimes always Pareto dominates fixed exchange rate regimes. [Devereux et al. \(2006\)](#) show that financial frictions magnify the volatility of economies but they do not affect the ranking of alternative policy rules. So policy makers would always choose a flexible exchange rate regime.³

¹ See for example, [Devereux et al. \(2006\)](#) and [Gali and Monacelli \(2005\)](#) for details.

² See [Park et al. \(2001\)](#) for details.

³ [Choi and Cook \(2004\)](#) find that a fixed exchange rate stabilizes banks' balance sheets and leads to greater business cycle stability than does an inflation-targeting interest rate rule. This comparison is not based on welfare metric, however.

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