

Segmented asset markets and optimal exchange rate regimes[☆]

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Received 14 July 2004; received in revised form 12 November 2005; accepted 25 September 2006

Abstract

This paper revisits the issue of the optimal exchange rate regime in a flexible price environment. The key innovation is that we analyze this question in the context of environments where only a fraction of agents participate in asset market transactions (i.e., asset markets are segmented). Under this friction alternative exchange rate regimes have different implications for real allocations in the economy. In the context of this environment we show that flexible exchange rates are optimal under monetary shocks and fixed exchange rates are optimal under real shocks.

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Keywords: Optimal exchange rates; Asset market segmentation

JEL classification: F1; F2

[☆] We would like to thank Andy Atkeson, Mick Devereaux, Huberto Ennis, Andy Neumeier, Mark Spiegel, and seminar participants at Duke, FRB Cleveland, FRB NY, Penn State, UBC, UCLA, UC Santa Cruz, USC, Warwick, CMSG 2003, ITAM-FBBVA Summer Camp 2003, SED 2003, and NBER IFM meeting Fall 2003 for helpful comments and suggestions. We also thank two anonymous referees and the editor whose suggestions have helped us improve the paper substantially. The usual disclaimer applies. Végh would like to thank the UCLA Academic Senate for research support.

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1. Introduction

Fifty years after Milton Friedman's (1953) celebrated case for flexible exchange rates, the debate on the optimal choice of exchange rate regimes rages on as fiercely as ever. Friedman argued that, in the presence of sticky prices, floating rates would provide better insulation from foreign shocks by allowing relative prices to adjust faster. In a world of capital mobility, Mundell's (1968) work implies that the optimal choice of exchange rate regime should depend on the type of shocks hitting an economy: real shocks would call for a floating exchange rate, whereas monetary shocks would call for a fixed exchange rate. Ultimately, however, an explicit cost/benefit comparison of exchange rate regimes requires a utility-maximizing framework, as argued by Helpman (1981) and Helpman and Razin (1979). In such a framework, Devereux and Engel (2003) reexamine this question in a sticky prices model and show how results are sensitive to whether prices are denominated in the producer's or consumer's currency. On the other hand, Cespedes, Chang, and Velasco (2004) incorporate liability dollarization and balance sheets effects and conclude that the standard prescription in favor of flexible exchange rates in response to real shocks is not essentially affected.

An implicit assumption in most, if not all, of the literature is that economic agents have unrestricted and permanent access to asset markets.³ This, of course, implies that in the absence of nominal rigidities, the choice of fixed versus flexible exchange rates is irrelevant. In practice, however, access to asset markets is limited to some fraction of the population (due to, for example, fixed costs of entry). This is likely to be particularly true in developing countries where asset markets are much smaller in size than in industrial countries. Table 1 shows that even for the United States, the degree of segmentation in asset markets is remarkably high. The table reveals that, as of 1989, 59% of U.S. households did not hold any interest bearing assets (defined as money market accounts, certificates of deposit, bonds, mutual funds, and equities). More strikingly, 25% of households did not even have a checking account as late as in 1989. Given these facts for a developed country like the United States, it is easy to anticipate that the degree of asset market segmentation in emerging economies must be considerably higher. Since asset markets are at the heart of the adjustment process to different shocks in an open economy, it would seem natural to analyze how asset market segmentation affects the choice of exchange rate regime.⁴

This paper abstracts from any nominal rigidity and focuses on a standard monetary model of an economy subject to stochastic real and monetary (i.e., velocity) shocks in which the only friction is that an exogenously-given fraction of the population can access asset markets. The analysis makes clear that asset market segmentation introduces a fundamental asymmetry in the choice of fixed versus flexible exchange rates. To see this, consider first the effects of a positive velocity shock in a standard one-good open economy model in the absence of asset market segmentation.

³ There are some exceptions when it comes to the related issue of the costs and benefits of a common currency area (see, for example, Neumeyer (1998) and Ching and Devereux (2003), who analyze this issue in the presence of incomplete asset markets).

⁴ In closed economy macroeconomics, asset market segmentation has received widespread attention ever since the pioneering work of Grossman and Weiss (1983) and Rotemberg (1984) (see also Chatterjee and Corbae (1992) and Alvarez et al. (2001)). The key implication of these models is that open market operations reduce the nominal interest rate and thereby generate the so-called "liquidity effect". In an open economy context, Alvarez and Atkeson (1997) and Alvarez et al. (2002) have argued that asset market segmentation models help in resolving outstanding puzzles in international finance such as volatile and persistent real exchange rate movements as well as excess volatility of nominal exchange rates.

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