On the relevance of exchange rate regimes for stabilization policy

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Abstract

This paper assesses the relevance of the exchange rate regime for stabilization policy. Using both fiscal and monetary policy, we conclude that the exchange rate regime is irrelevant. This is the case independently of the severity of price rigidities, independently of asymmetries across countries in shocks and transmission mechanisms. The only relevant conditions are on the mobility of labor and financial assets. The results can be summarized with the claim that every currency area is an optimal currency area. However, with labor mobility or tradable state-contingent assets, additional policy instruments would be required to establish the irrelevance result.

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1. Introduction

This paper revisits the issues in the optimal currency area literature initiated by Mundell [24]. What are the costs of a fixed exchange rate regime, or a monetary union, when there is a role for stabilization policy? We address this question allowing for heterogeneity in the shocks and the
response to them, restrictions on the mobility of factors and incompleteness of asset markets, as is standard in the optimal currency area literature.

When different shocks hit different countries or when there are differences across countries in the effects of shocks, monetary policy, that has a stabilization role because of some form of nominal rigidity, may have to react differently in the different countries. Because of this heterogeneity it is common to infer that there are costs of a common monetary policy, either through a fixed exchange rate regime or a monetary union. In the literature, these costs are taken to be higher the stronger are the asymmetries, the more severe are the nominal rigidities, the more pronounced is the incompleteness of international asset markets, the less mobile is labor, and, finally, the less able is fiscal policy in effectively stabilizing the national economies (Corsetti [12]).

We take the standard approach in the literature on optimal fiscal and monetary policy after Lucas and Stokey [23], followed by many others. There, fiscal and monetary policy are decided jointly by a Ramsey government that must raise distortionary taxes to pay for exogenous government expenditures, so that the Pareto first best solution is not achievable. In our second best environment, we show that the loss of the country specific monetary tool is of no cost. This is true irrespective of the asymmetry in shocks or response to these and the severity of the nominal rigidities. The elements that are crucial in assessing the costs of a single monetary policy are the three last ones in the list by Corsetti above, but labor mobility, and the completeness of international financial markets, work in opposite ways to the conventional wisdom. Fiscal and monetary policy are able to eliminate the costs of a monetary union only if labor is not mobile across countries and private state-contingent debt is not traded internationally. Unless further instruments are considered.

We consider a standard two country model. Each country specializes in the production of a composite tradable good, which aggregates a continuum of goods produced using labor only. Labor is not mobile across countries. Money is used for transactions according to a cash-in-advance constraint on the purchases of the two composite goods by the households of each country. The government of each country must finance exogenous expenditures on the good produced at home with distortionary taxes and seigniorage. The tax instruments are labor income and consumption taxes. There is state-contingent private debt inside each country in zero net supply and noncontingent nominal public debt in each currency that can be traded internationally.

We start by analyzing a benchmark economy where prices are flexible (Sections 2 and 3). We show that any equilibrium allocation in the flexible price, flexible exchange rates, economy can be implemented with fiscal and monetary policies that induce stable producer prices and constant exchange rates. This result has implications for economies under fixed exchange rates with nominal rigidities (Section 4). For those policies, that under flexible prices keep prices constant, if firms were restricted in the setting of prices such as in Calvo [7], those restrictions would be irrelevant and the same allocations could still be implemented. It follows that under sticky prices and fixed exchange rates it is always possible to achieve the same allocations as under flexible prices and exchange rates.

Under sticky prices there are equilibrium allocations other than the ones achieved under flexible prices. We show that the common set of allocations to flexible and sticky prices dominates in welfare terms those other equilibrium allocations. The reason for this result is the one in Diamond and Mirrlees [16], that even in a second best environment it is not optimal to distort production.

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1 See also Corsetti [13].

2 Lump-sum taxes are excluded for distribution reasons. If there were both distortionary and lump-sum taxes, the irrelevance results would still be obtained. It would be possible, in that case, to attain the first best allocations.
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