Topics for Today

1.) Monetary & Fiscal Policy with Fixed Exchange Rates

2.) Devaluations

3.) Expected Devaluations and Capital Flight

4.) "Liquidity Traps" and Ex. Rate Policy

Monetary Policy

Suppose the ex. rate is (credibly) fixed at E^0

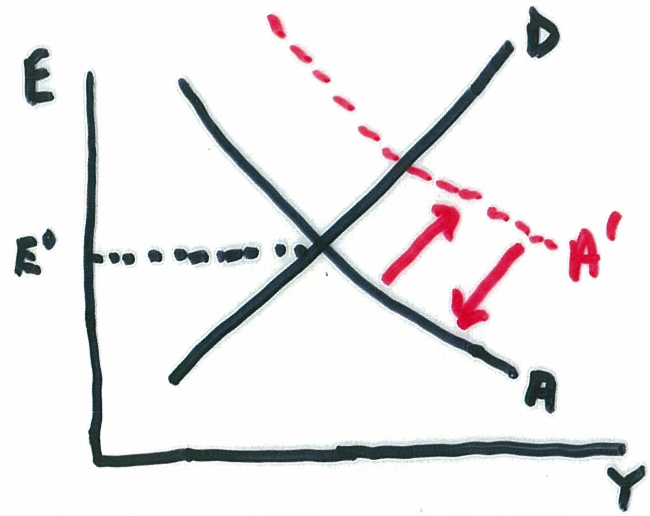
Next, suppose the Central Bank attempts to stimulate the economy by increasing the money supply

CB purchases domestic assets $\Longrightarrow$ Pressure for $R\downarrow$, $Y\uparrow$

$\Longrightarrow$ Pressure for $E\uparrow$

$\Longrightarrow$ CB must sell fx reserves to support domestic currency

$\Longrightarrow$ Money Supply falls back down



Conclusion: With fixed ex. rate, monetary policy is unable to influence the money supply, interest rate, or output. It only affects the currency composition of the Central Bank's Balance Sheet.