

DIW Berlin

Deutsches Institut
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Monetary and Exchange Rate Policies in Cambodia, Laos and
Vietnam: The Scope for Regional Cooperation

Fiscal Implications for Monetary and Exchange Rate Policies

Regional Workshop, Luang Prabang, 14-15 Dec. 2006

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DIW Berlin – Macro Analysis and Forecasting

Outline

- Introduction
- The Basic Mundell-Fleming Framework
- Fiscal Policy and (Inter-) National Financial Institutions
- Modifications of the Basic MF-Framework
- Monetization of Public Deficits
- Fiscal Rules for Monetary and Exchange Rate Cooperation: Lessons from Historical Evidence
- Conclusions

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General Scope of the Paper

- **General theoretical framework**
 - suitable to discuss fiscal policy effects (demand shocks in general)
 - allows for general conclusions
 - ⇒ potential to be specified in terms of individual country cases
 - ⇒ way of thinking

- **Exposition of principle model mechanics**
 - ⇒ help general audience to follow main conclusions

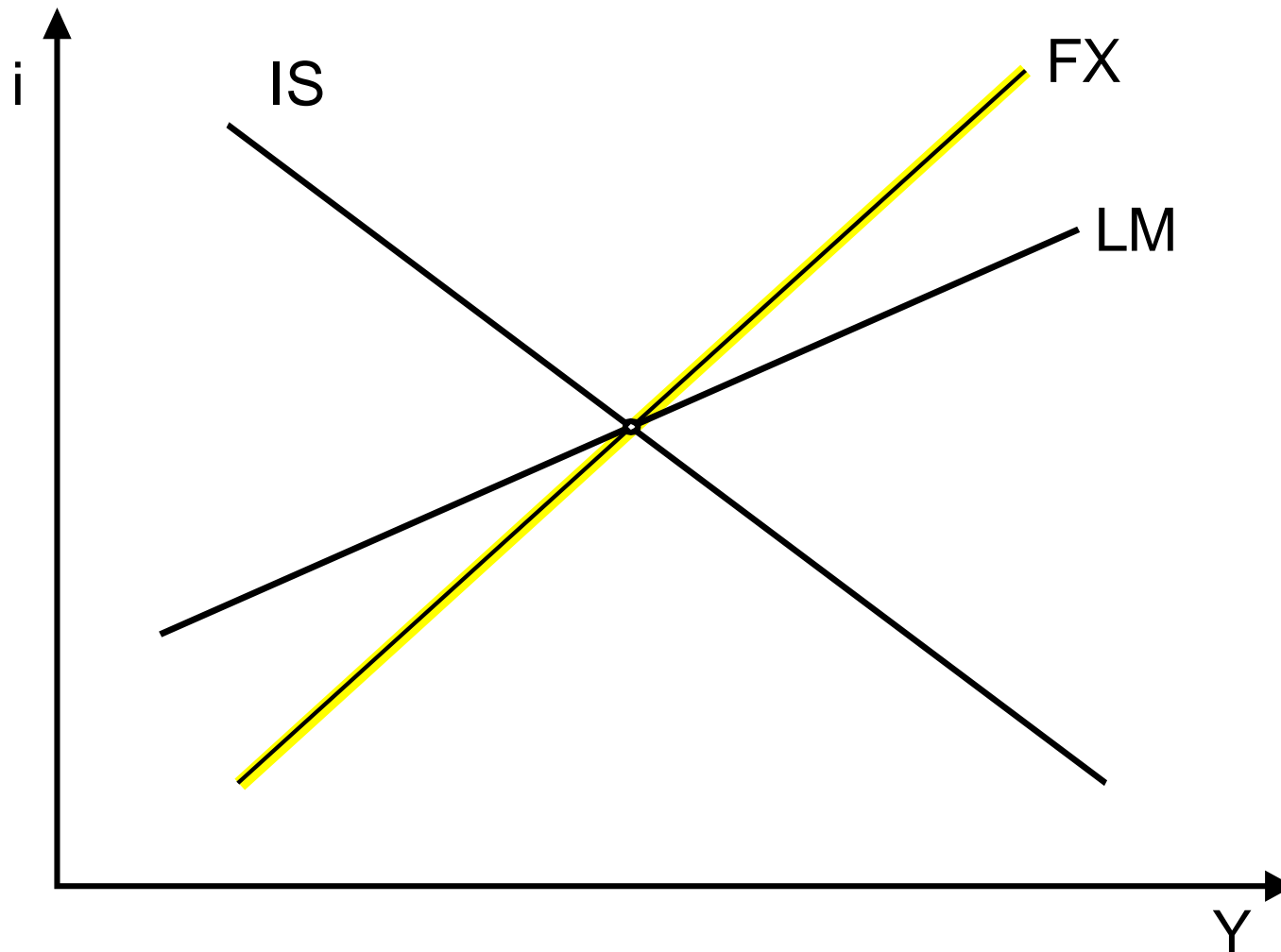
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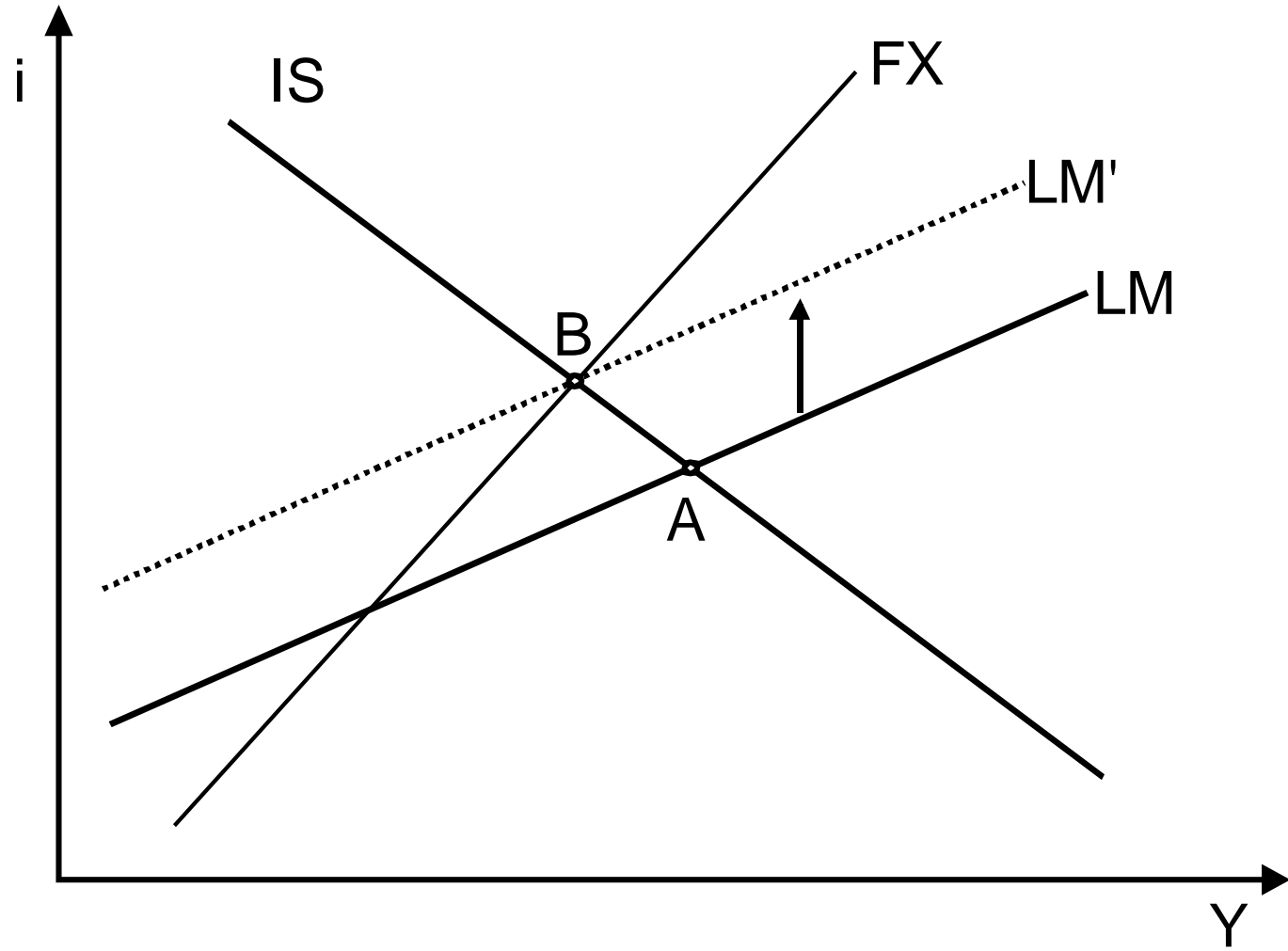
Key Assumptions

- **Markets:**
 - Goods and services (IS)
 - Money (LM)
 - Foreign exchange (FX)
- **Productions follows demand**
- **Demand drivers**
 - Income
 - Interest
 - (Real) Exchange rate
- **Net capital inflows respond to interest rate differentials**

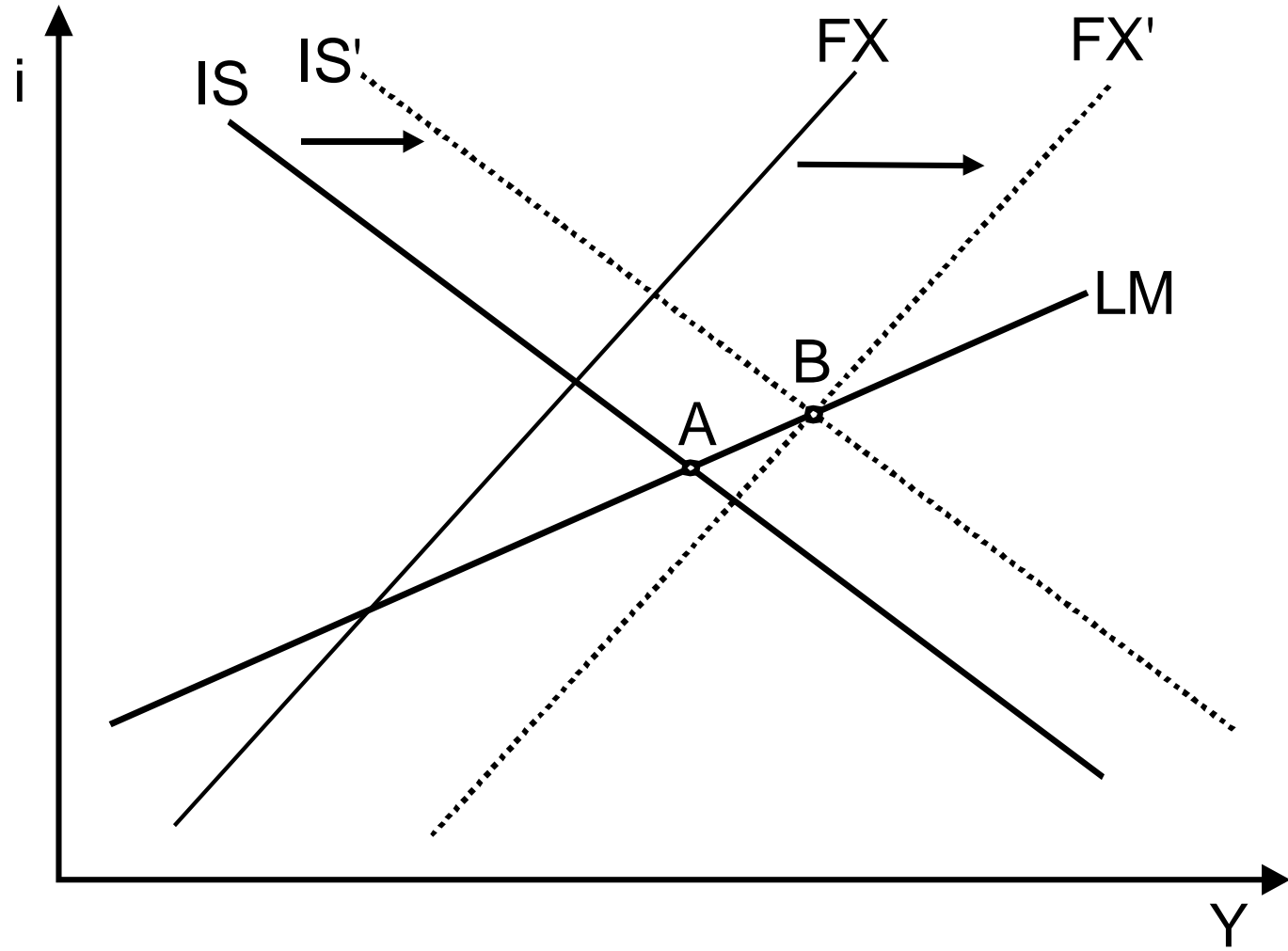
Simultaneous Equilibrium



Fixed Exchange Rates: Disequilibrium and Adjustment Processes



Flexible Exchange Rates: Disequilibrium and Adjustment Processes



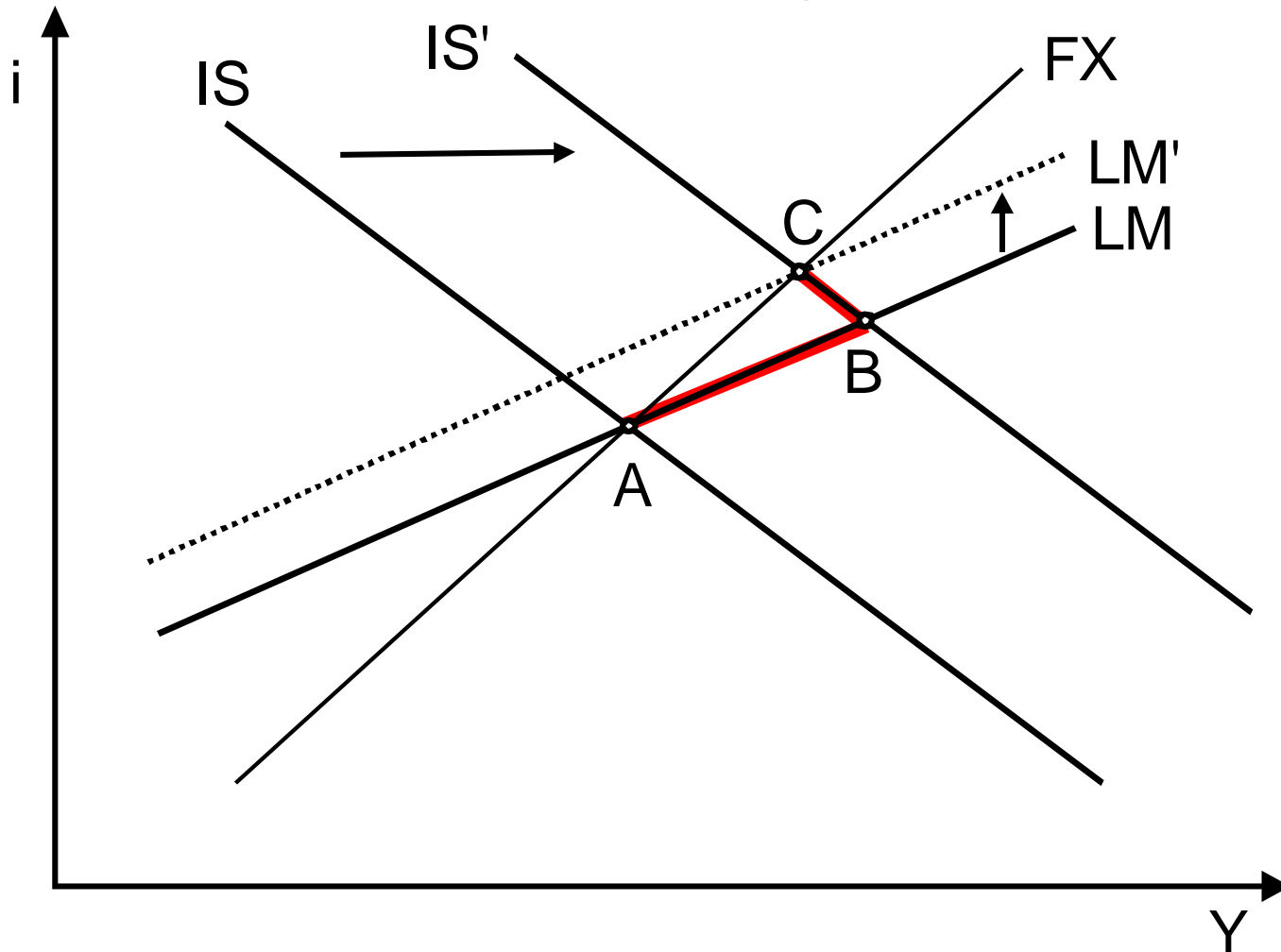
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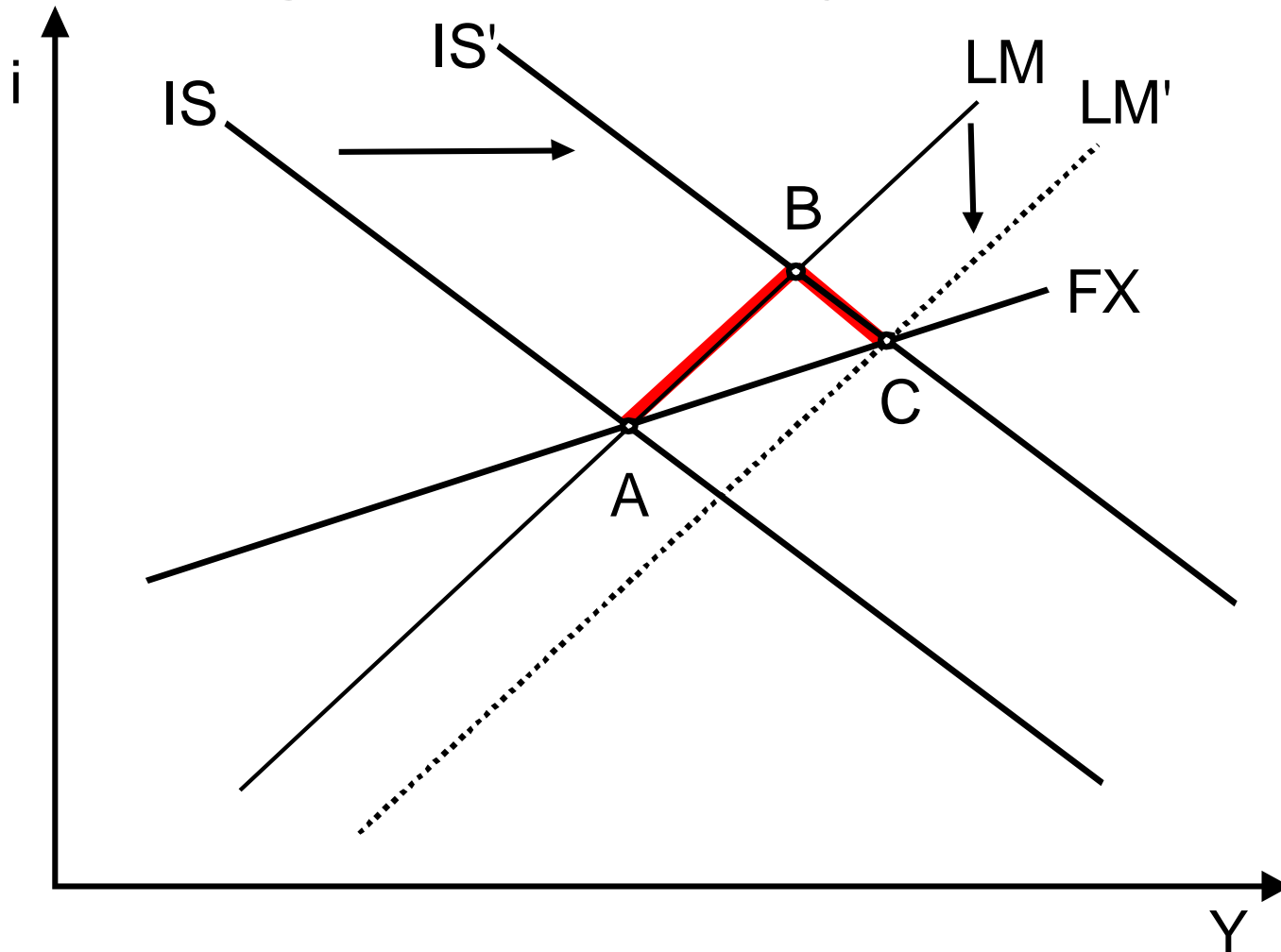
Cross-Border Capital Flows

- Interest elasticity of net capital inflows (NCI)
 - depth of domestic financial markets
 - integration with world markets
- Impact
 - income effects of fiscal policy
 - monetary disturbances (foreign reserves, exchange rate)
- Geometrical interpretation
 - low interest elasticity \Rightarrow steep (extreme case: vertical) FX (case 1: FX steeper than LM)
 - high interest elasticity \Rightarrow flat (extreme case: horizontal) FX (case 2: FX flatter than LM)

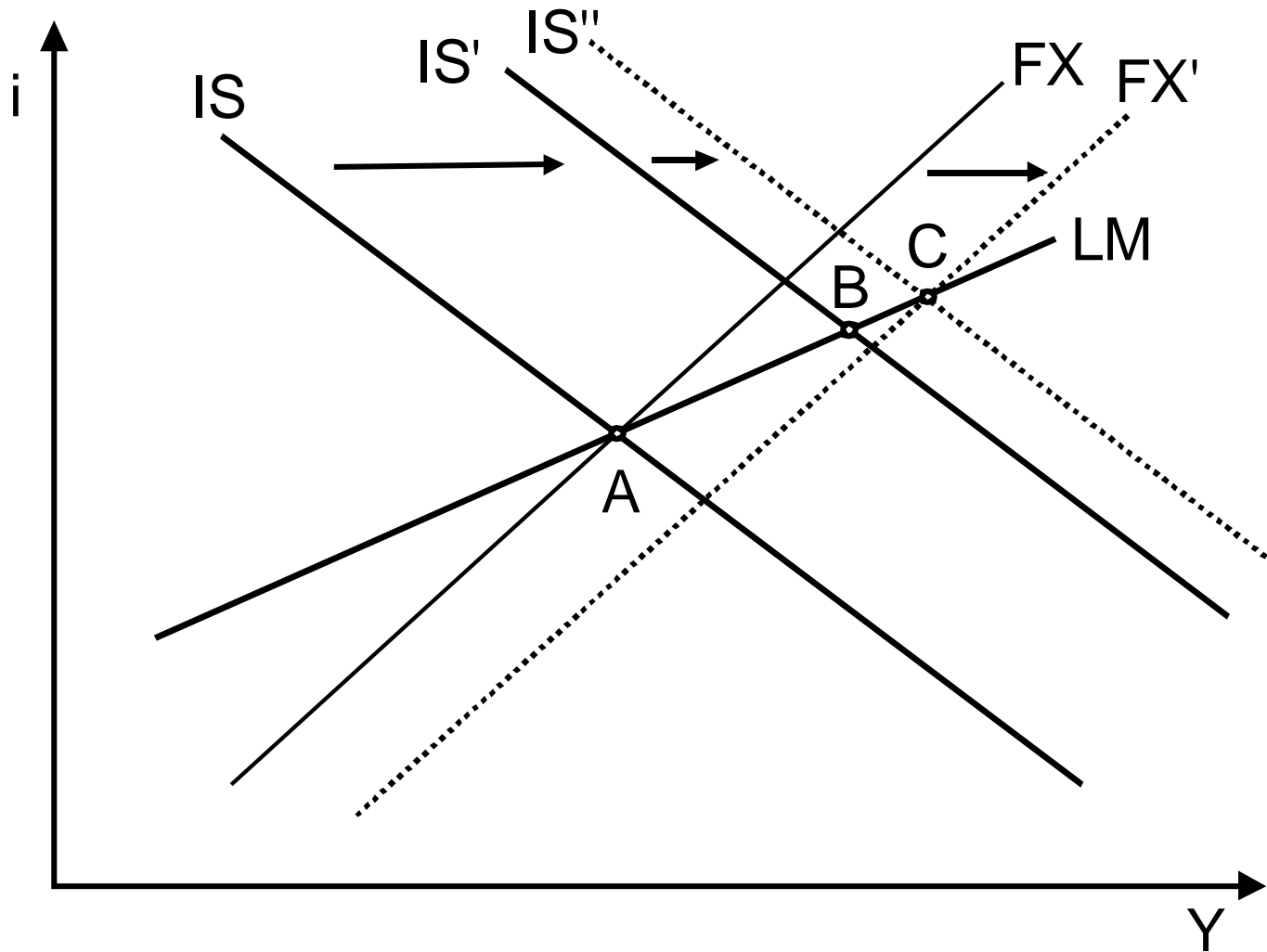
Fiscal Policy Impact Under *Fixed* Exchange Rates Case 1: Low Interest Elasticity of NCI



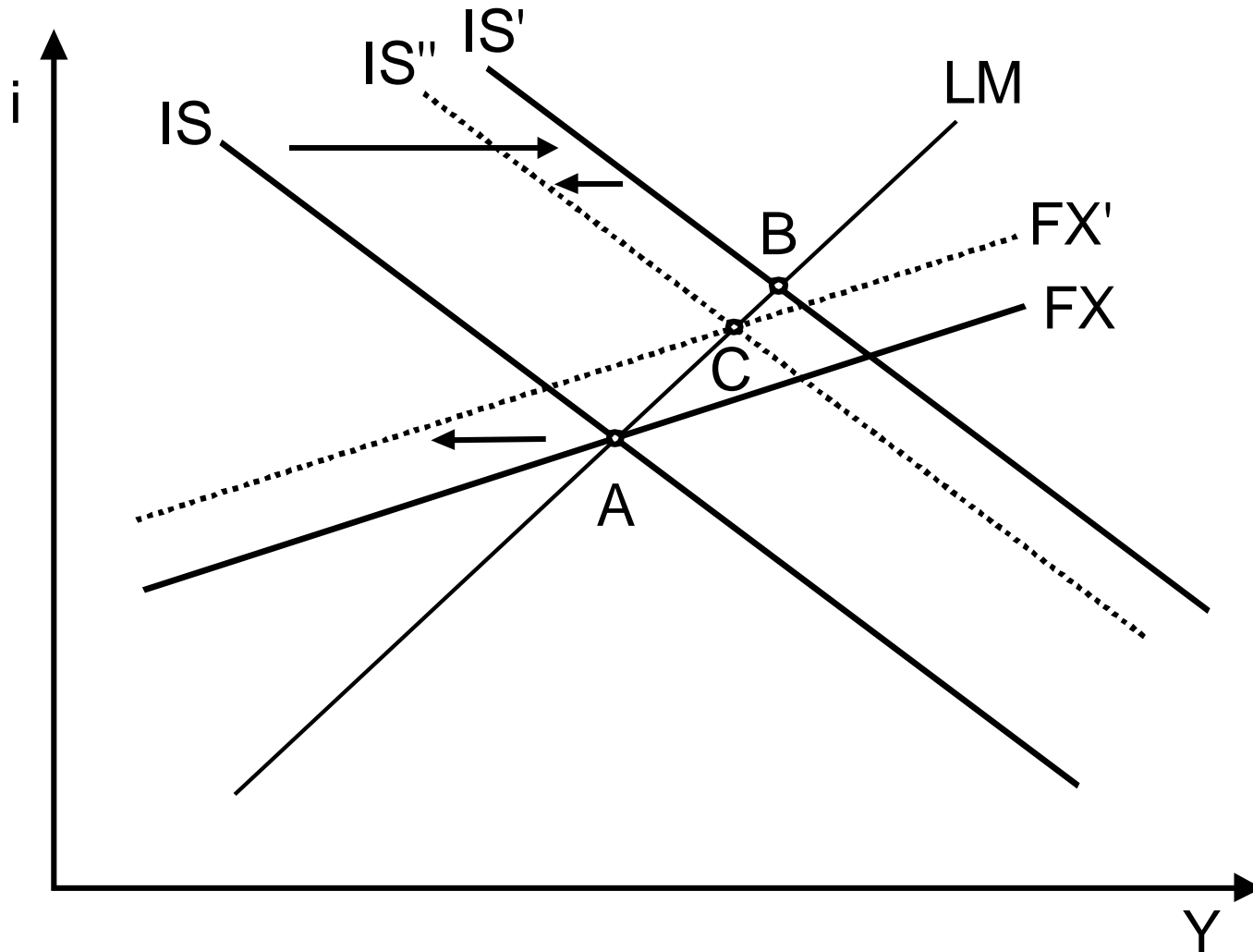
Fiscal Policy Impact Under *Fixed* Exchange Rates Case 2: High Interest Elasticity of NCI



Fiscal Policy Impact Under *Flexible* Exchange Rates Case 1: Low Interest Elasticity of NCI



Fiscal Policy Impact Under *Flexible* Exchange Rates Case 2: High Interest Elasticity of NCI



Intermediate Conclusion

- Fiscal impact on domestic production depends on
 - exchange rate regime
 - interest elasticity of NCI
- Fiscal impact on monetary/currency sphere
 - depends on interest elasticity of NCI
 - is not minimized by extreme elasticities of NCI
 - ⇒ neither perfect mobility of capital flows
(full liberalization of financial markets)
 - ⇒ nor total immobility of capital flows
(protectionist separation of financial markets)

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Modifications

- **Inverse trade response to exchange rate fluctuations**
 - ⇒ demand shocks become a source of foreign exchange market instability in case of low interest elasticity of NCI
- **Income-dependent capital flows**
 - ⇒ scenarios of high interest elasticity of NCI become more likely
 - ⇒ possibly destabilizing effect under fixed exchange rates
- **Flexible money wages and prices**
 - here: exchange-rate induced price level fluctuations only
 - markup-pricing and rigid real wages
 - ⇒ real exchange rate remains unchanged
 - ⇒ results for fixed exchange rates apply

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Monetization of Public Deficits

- Pooling two macroeconomic instruments (deficit spending and money supply) reduces the number of other independently achievable political targets
- Continuous use of monetary policy for fiscal financing destabilizes the economy and can potentially lead to serious financial crises

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Fiscal Rules and Coordination

- Theoretical evidence: Fiscal policies matter!

- Empirical evidence
 - Crash of Bretton Woods
 - EMS crisis 1992/93

- Fiscal rules for monetary unions?
 - Eurozone: Stability and Growth Pact
 - „No bail out“ \Rightarrow no spill-overs external to market processes

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Conclusions

- Foreign exchange system matters for impact of fiscal policy
- Interest elasticity of NCI and therefore financial institution building plays an important role for fiscal effectiveness
 - impact on domestic production \Rightarrow extreme values
 - monetary/currency side effects \Rightarrow medium values
- J-curve trade effects potentially more disturbing the lower the interest elasticity of NCI
- fiscal policy potentially destabilizing under fixed exchange rates if income-dependent cross-border investments are important

Conclusions (cont.)

- Flexible prices and rigid real wages make fixed and flexible exchange rate regimes more similar
- Large-scale use of monetization leads to harmful monetary and exchange rate disruptions
- Monetary/currency side-effects of fiscal policy less important in monetary unions; higher fiscal responsibility of anchor country in fixed exchange rate system