

14.1: Overview of Policy with Fixed Exchange Rates

Learning Objective

1. Preview the comparative statics results from the AA-DD model with fixed exchange rates.

This chapter uses the AA-DD model to describe the effects of fiscal, monetary, and exchange rate policy under a system of fixed exchange rates. Fiscal and monetary policies are the primary tools governments use to guide the macroeconomy. With fixed exchange rates, a third policy option becomes available—that is, exchange rate policy. Thus we also examine the effects of changes in the fixed exchange rate. These exchange rate changes are called **devaluations** (sometimes competitive devaluations) and **revaluations**.

In introductory macroeconomics courses, students learn how government policy levers can be used to influence the level of the gross national product (GNP), inflation rate, unemployment rate, and interest rates. In this chapter, that analysis is expanded to an open economy (i.e., one open to trade) and to the effects on exchange rates and current account balances.

Results

Using the AA-DD model, several important relationships between key economic variables are shown:

- A monetary policy (change in M^S) has no effect on GNP or the exchange rate in a fixed exchange system. As such, the trade balance, unemployment, and interest rates all remain the same as well. Monetary policy becomes ineffective as a policy tool in a fixed exchange rate system.
- Expansionary fiscal policy ($\uparrow G$, $\uparrow TR$, or $\downarrow T$) causes an increase in GNP while maintaining the fixed exchange rate and constant interest rates. The trade balance and unemployment are both reduced.
- Contractionary fiscal policy ($\downarrow G$, $\downarrow TR$, or $\uparrow T$) reduces GNP while maintaining the fixed exchange rate and constant interest rates. The trade balance and unemployment both rise.
- A competitive devaluation lowers the currency value and causes an increase in GNP. Unemployment falls, interest rates remain the same, and the trade balance rises.
- A currency revaluation raises the currency value and causes a decrease in GNP. Unemployment rises, interest rates remain the same, and the trade balance falls.
- Monetary expansion by the reserve currency country forces the domestic country to run a balance of payments surplus to maintain its fixed exchange rate. The resulting money supply increase causes domestic interest rates to fall to maintain equality with the falling foreign interest rates. Domestic GNP remains fixed, as do unemployment and the trade balance.
- A currency crisis arises when a country runs persistent balance of payments deficits while attempting to maintain its fixed exchange rate and is about to deplete its foreign exchange reserves. A crisis can force a country to devalue its currency or move to a floating exchange rate. To postpone the crisis, countries can sometimes borrow money from organizations like the International Monetary Fund (IMF).
- Anticipation of a **balance of payments crisis** can induce investors to sell domestic assets in favor of foreign assets. This is called **capital flight**. Capital flight will worsen a balance of payments problem and can induce a crisis to occur.

Connections

The AA-DD model was developed to describe the interrelationships of macroeconomic variables within an open economy. Since some of these macroeconomic variables are controlled by the government, we can use the model to understand the likely effects of government policy changes. The main levers the government controls are monetary policy (changes in the money supply), fiscal policy (changes in the government budget), and exchange rate policy (setting the fixed exchange rate value). In this chapter, the AA-DD model is applied to understand government policy effects in the context of a fixed exchange rate system. In Chapter 10, we considered these same government policies in the context of a floating exchange rate system. In Chapter 13, we'll compare fixed and floating exchange rate systems and discuss the pros and cons of each system.

It is important to recognize that these results are what “would” happen under the full set of assumptions that describe the AA-DD model. These effects may or may not happen in reality. Nevertheless, the model surely captures some of the simple cause-and-effect relationships and therefore helps us to understand the broader implications of policy changes. Thus even if in reality many more elements (not described in the model) may act to influence the key endogenous variables, the AA-DD model at least gives a more complete picture of some of the expected tendencies.

Key Takeaways

- The main objective of the AA-DD model is to assess the effects of monetary, fiscal, and exchange rate policy changes.
- It is important to recognize that these results are what “would” happen under the full set of assumptions that describes the AA-DD model; they may or may not accurately describe actual outcomes in actual economies.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - Of *appreciation, depreciation, or no change*, the effect of expansionary monetary policy on the domestic currency value under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of contractionary monetary policy on GNP under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of expansionary monetary policy on the current account deficit under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of contractionary monetary policy on the current account surplus under fixed exchange rates in the AA-DD model.
 - Of *appreciation, depreciation, or no change*, the effect of expansionary fiscal policy on the domestic currency value under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of contractionary fiscal policy on GNP under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of expansionary fiscal policy on the current account deficit under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of a devaluation on GNP under fixed exchange rates in the AA-DD model.
 - Of *increase, decrease, or no change*, the effect of a revaluation on the current account deficit under fixed exchange rates in the AA-DD model.
 - The term used to describe a rapid purchase of foreign investments often spurred by the expectation of an imminent currency devaluation.
 - The term used to describe the situation when a central bank runs persistent balance of payments deficits and is about to run out of foreign exchange reserves.

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