

15.4: Monetary Autonomy and Exchange Rate Systems

Learning Objective

1. Learn how floating and fixed exchange rate systems compare with respect to monetary autonomy.

Monetary autonomy refers to the independence of a country's central bank to affect its own money supply and conditions in its domestic economy. In a floating exchange rate system, a central bank is free to control the money supply. It can raise the money supply when it wishes to lower domestic interest rates to spur investment and economic growth. By doing so it may also be able to reduce a rising unemployment rate. Alternatively, it can lower the money supply, to raise interest rates and to try to choke off excessive growth and a rising inflation rate. With monetary autonomy, monetary policy is an available tool the government can use to control the performance of the domestic economy. This offers a second lever of control, beyond fiscal policy.

In a fixed exchange rate system, monetary policy becomes ineffective because the fixity of the exchange rate acts as a constraint. As shown in Chapter 12, [Section 12.2](#), when the money supply is raised, it will lower domestic interest rates and make foreign assets temporarily more attractive. This will lead domestic investors to raise demand for foreign currency that would result in a depreciation of the domestic currency, if a floating exchange rate were allowed. However, with a fixed exchange rate in place, the extra demand for foreign currency will need to be supplied by the central bank, which will run a balance of payments deficit and buy up its own domestic currency. The purchases of domestic currency in the second stage will perfectly offset the increase in money in the first stage, so that no increase in money supply will take place.

Thus the requirement to keep the exchange rate fixed constrains the central bank from using monetary policy to control the economy. In other words, the central bank loses its autonomy or independence.

In substitution, however, the government does have a new policy lever available in a fixed system that is not available in a floating system, namely exchange rate policy. Using devaluations and revaluations, a country can effectively raise or lower the money supply level and affect domestic outcomes in much the same way as it might with monetary policy. However, regular exchange rate changes in a fixed system can destroy the credibility in the government to maintain a truly "fixed" exchange rate. This in turn could damage the effect fixed exchange rates might have on trade and investment decisions and on the prospects for future inflation.

Nonetheless, some countries do apply a semifixed or semifloating exchange rate system. A crawling peg, in which exchange rates are adjusted regularly, is one example. Another is to fix the exchange rate within a band. In this case, the central bank will have the ability to control the money supply, up or down, within a small range, but will not be free to make large adjustments without breaching the band limits on the exchange rate. These types of systems provide an intermediate degree of autonomy for the central bank.

If we ask which is better, monetary autonomy or a lack of autonomy, the answer is mixed. In some situations, countries need, or prefer, to have monetary autonomy. In other cases, it is downright dangerous for a central bank to have autonomy. The determining factor is whether the central bank can maintain prudent monetary policies. If the central bank can control money supply growth such that it has only moderate inflationary tendencies, then monetary autonomy can work well for a country. However, if the central bank cannot control money supply growth, and if high inflation is a regular occurrence, then monetary autonomy is not a blessing.

One of the reasons Britain has decided not to join the eurozone is because it wants to maintain its monetary autonomy. By joining the eurozone, Britain would give up its central bank's ability to control its domestic money supply since euros would circulate instead of British pounds. The amount of euros in circulation is determined by the European Central Bank (ECB). Although Britain would have some input into money supply determinations, it would clearly have much less influence than it would for its own currency. The decisions of the ECB would also reflect the more general concerns of the entire eurozone rather than simply what might be best for Britain. For example, if there are regional disparities in economic growth (e.g., Germany, France, etc., are growing rapidly, while Britain is growing much more slowly), the ECB may decide to maintain a slower money growth policy to satisfy the larger demands to slow growth and subsequent inflation in the continental countries. The best policy for Britain alone, however, might be a more rapid increase in money supply to help stimulate its growth. If Britain remains outside the eurozone, it remains free to determine the monetary policies it deems best for itself. If it joins the eurozone, it loses its monetary autonomy.

In contrast, Argentina suffered severe hyperinflations during the 1970s and 1980s. Argentina's central bank at the time was not independent of the rest of the national government. To finance large government budget deficits, Argentina resorted to running the monetary printing presses, which led to the severe hyperinflations. In this case, monetary autonomy was a curse, not a blessing.

In an attempt to restrain the growth of the money supply, Argentina imposed a currency board in 1992. A currency board is a method of fixing one's exchange rate with a higher degree of credibility. By legislating mandatory automatic currency interventions, a currency board operates in place of a central bank and effectively eliminates the autonomy that previously existed. Although Argentina's currency board experiment collapsed in 2002, for a decade Argentina experienced the low inflation that had been so elusive during previous decades.

Key Takeaways

- Monetary autonomy refers to the independence of a country's central bank to affect its own money supply and, through that, conditions in its domestic economy.
- In a fixed exchange rate system, a country maintains the same interest rate as the reserve country. As a result, it loses the ability to use monetary policy to control outcomes in its domestic economy.
- In a floating exchange rate system, a country can adjust its money supply and interest rates freely and thus can use monetary policy to control outcomes in its domestic economy.
- If the central bank can control money supply growth such that it has only moderate inflationary tendencies, then monetary autonomy (floating) can work well for a country. However, if the central bank cannot control money supply growth, and if high inflation is a regular occurrence, then monetary autonomy (floating) will not help the country.

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?"
 - The term describing the relationship between the U.S. Federal Reserve Board and the U.S. government that has quite likely contributed to the low U.S. inflation rate in the past two decades.
 - In part to achieve this, the United Kingdom has refused to adopt the euro as its currency.
 - Of *fixed* or *floating*, in this system a country can effectively set its money supply at any level desired.
 - Of *fixed* or *floating*, in this system a country's interest rate will always be the same as the reserve country's.
 - Of *fixed* or *floating*, in this system a country can control inflation by maintaining moderate money supply growth.

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