Exchange Rate Policy and Endogenous Price Flexibility

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Summary

The classic argument for flexible exchange rates is that they enhance the ability of the economy to respond to shocks, in the presence of nominal rigidities (e.g. Friedman 1953). While most theoretical analysis of flexible vs. fixed exchange rates take the degree of nominal rigidity to be independent of the exchange rate regime choice itself, informal policy discussion often suggests that a credible exchange rate peg, by eliminating the use of the exchange rate as a mechanism for adjustment, may increase internal price flexibility. This has been especially important in the analysis of the conditions for single (small) countries to follow unilateral `hard peg' policies, fixing the exchange rate under a currency board or dollarization rule. Since these countries will generally not have access to compensating policy responses from the monetary authorities of the currency to which they are pegging, the need to increase internal price flexibility after a peg becomes more critical. Another area where this discussion is important is that of the impact of a monetary union on flexibility. To the extent that a single currency encourages price flexibility within the different regions of the monetary union, this will reduce the loss from the absence of exchange rate adjustment. To this extent, the economic case for a monetary union may be enhanced by the formation of the monetary union.

This paper explores the relationship between exchange rate policy and price flexibility, in a model where price flexibility is an endogenous choice of profit-maximizing firms. A fixed exchange rate may increase the optimal degree of price flexibility by increasing the volatility of demand facing firms. We find that a unilateral peg, such as a Currency Board, adopted by a single country, will increase internal price flexibility, perhaps by a large amount. On the other hand, when an exchange rate peg is supported by bilateral participation of all monetary authorities (such as a monetary union), price flexibility is likely to be little affected, and may actually be less than under freely floating exchange rates.