Monetary Rules and Policy Targets under Managed Exchange Rates and Capital Controls: The Case of China

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Summary

This paper examines the performance of monetary policy rules when the economy finds itself in dark corners, when the real sector experiences a sequence of negative shocks from world demand and while the central bank faces prolonged low world interest rates on its foreign-exchange reserve holdings. We examine variations of policy rules and targets, one with strong restrictions on capital flows and a fixed exchange rate, and the other with less restricted capital flows and a more flexible managed exchange rate. Our results show that a more flexible managed exchange-rate system, based on welfare-based Ramsey rules, acts as an effective shock absorber when the economy is in a "dark corner", thus reducing the fall in real GDP and consumption. However, this benefit comes at a cost with a much larger fall in employment and loss in foreign exchange reserves than in the more restricted fixed-rate environment. By contrast, if the Ramsey rule for monetary policy is based a on current-account or external-balance targets, employment and reserve losses are reduced. Our results

suggest that external balance, rather than welfare, should be the proper target for monetary policy as the financial system moves toward a more flexible exchange rate and a less restricted capital account, at least when the economy falls into dark corner periods. These results, based on Ramsey rules, extend to the use of optimal simple rules for the interest rate and the exchange rate, with the former following a Taylor-rule specification, and the latter adjusting to current account and employment targets. However, in dark corner periods, optimal simple rules exact much higher costs, in terms of lost consumption, relative to Ramsey rules, for stabilising the current account and employment.