

# **Monetary Policy in Open Economies under Imperfect Information**

**Harris Dellas**

University of Bern, CEPR, IMOP  
Hong Kong Institute for Monetary Research

April 2003

## **Summary**

International monetary practices have varied both over time and across countries. Some of this variation has been associated with the establishment - and subsequent demise - of global systems of fixed parities (the Gold Standard and the Bretton Woods agreement), or large regional monetary systems (EMS, EMU). But much of the variation is related to individual countries' desire to select an exchange rate arrangement that best suits their particular needs. As economic structures, domestic and international economic conditions and policy objectives differ across countries, it is not surprising that different countries opt for different international monetary arrangements. A good example of this is the monetary practices of Hong Kong and Singapore. Hong Kong has a currency board, while Singapore has a managed float.

In spite of the considerable variation in actual monetary practices, a strong presumption exists in the economic literature that a regime of flexible exchange rates is superior to systems that fix the exchange rate. In this paper we argue that this presumption is partly due to the implausible assumptions typically made about the conduct of monetary policy, in particular, to the assumption that monetary authorities are all knowing and omnipotent. These characteristics support unrestrained monetary policy activism. As the fixed exchange rate regime restricts permissible monetary policies, a fixed regime cannot perform as well as a flexible one.

We show that under conditions of incomplete information about the nature of the shocks that afflict an economy at any point in time, passive monetary policies behave better than activist ones, that a passive, fixed exchange rate regime has good macroeconomic (output and inflation stability) and welfare properties, and finally, that no international policy co-ordination is required in order to produce good outcomes. The latter result, namely that the lack of international co-ordination is not costly in our model, obtains in spite of the fact that the monetary authorities cannot achieve an efficient equilibrium and activist domestic policies are dominated by passive rules.