International Risk-Sharing and the Exchange Rate: Re-evaluating the Case for Flexible Exchange Rates

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Summary

A popular argument for the benefits of flexible exchange rates is that a small economy buffeted by external shocks can use the exchange rate as a 'shock-absorber', cushioning the economy against the full effect of the shocks.

This paper develops a theoretical analysis of the case for the adjustment benefits of flexible exchange rates within a welfare-based model. The results provide a sharp counter-example to the arguments of Mundell (1961), within a very simple model that is set up along conventional lines. The new feature of the analysis is to emphasize the role of international financial markets in affecting the desirability of exchange rate adjustment. Our results show that the case for flexible exchange rates depends critically upon the structure of international financial markets. With full international risk-sharing the exchange rate regime is irrelevant. Without full risk-sharing, a flexible exchange rate acts perfectly as a 'shock-absorber' in line with conventional theory, while a fixed exchange rate causes output to fluctuate in response to demand shocks. Despite this, we find that when evaluating exchange rate regimes in expected utility terms, flexible exchange rates may be welfare-dominated by fixed exchange rates, for a wide range of parameter values. The key explanation is that the absence of international financial markets leads to a combination of excessive exchange rate volatility, and an inefficiently small response of GDP to shifts in world demand. It may be preferable for a country to prevent exchange rate adjustment, while at the same time allowing GDP to respond efficiently.

When we examine the optimal (utility-maximizing) monetary policy in an environment without risk-sharing, we find that the policy maker would always wish to reduce the volatility of the exchange rate relative to that of a flexible exchange rate regime. In some cases, we find that a fully fixed exchange rate is the optimal policy.