[Exchange Rates and Economic Policy]

Fiscal Policy:

Fiscal policy is effective under fixed exchange rates.

An increase in government expenditures, G, leads to an increased demand for money and hence an increased rate of interest (price of money). Capital funds are then attracted from abroad and the government has to prevent a $ appreciation by the central bank buying the foreign currency and assets. This leads to an increase in the bank's reserves; hence money supply increases, then interest rates fall and income increases. (Shift outwards of the IS curve).

Similarly, an decrease in government expenditures, G, leads to an decreased demand for money, a decreased rate of interest, and an outflow of funds, which the government has to absorb to prevent a $ depreciation by the central bank selling foreign currency reserves. This leads to a decrease in money supply and income and increase in interest rates. (Shift inwards of the IS curve).

Fiscal policy is ineffective under floating exchange rates.

An increase in government expenditures, G, leads to an increase in income Y, and interest rates; and hence a $ appreciation. The higher $ produces a lack of competitiveness, so that next exports (X - M) falls, which reduces Y through accounting identity and hence Y remains unchanged. (The IS curve shifts outwards and then immediately shifts back).

Monetary Policy:

Monetary policy is ineffective under fixed exchange rates.

An increase in money supply, M, leads to an increased level of income, and a reduced rate of interest. The lower interest rate implies an outflow of funds and pressure for a $ depreciation. With a fixed exchange rate the government buys $ to prevent the depreciation, which reduces their reserves and hence also reduces money supply. This exactly offsets the previous increase in money supply, leaving the policy ineffective. (LM curve shifts outwards and then immediately back to its previous position).

Similarly, a decreased money supply leads to a decreased level of income and an increased rate of interest. This stimulates an inflow of funds and pressure for a

$ appreciation, which the government sells $ to prevent the appreciation, which increases reserves and then increases money supply. This exactly offsets the previous decrease in money supply, leaving the policy ineffective. (LM curve shifts inwards and then immediately outwards).

Monetary policy is effective under floating exchange rates.

An increase in money supply, M, leads to an increased level of income, and a reduced rate of interest, which encourages an outflow of funds and hence a $ depreciation. (LM curve shifts outwards).