Currency Substitution as an Automatic Stabilizer

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What is the question?

Farmer(1997) has shown that flexible-prices monetary models display belief-driven cyclical fluctuations under high degrees of relative risk aversion. The result is robust to variantions in the monetary policy and this paper is a simplified version of it. This purpose of this paper is trying to answer and build the intuition of whether the openness in terms of diversified currency holdings by agents will entirely removes cyclical fluctuations of this kind, no matter whether domestic and foreign currencies are substitutions or complements , or even independent.

Why should we care about it?

China has shown strong growth through the years, and the government has loosened the regulations on financial markets and work hard on the inclusion of important indices on both equities and debts. According to “Impossible Trinity”, China is working hard to move from “fixed exchange rate” to “free capital flow”, it is no doubt that capital flows do have a serious impact on the economic system. From the trend I mentioned above, financial liberalization and globalization is more common than before, thus agents have a basket of currencies to choose from and use them to meet all kinds of needs. So it is important to see the agents reactions on inflation by their holdings of currencies and thus the impact on the economic system indirectly.

What is the answer?

The answer is that diversified currency holdings stabilize a simplified version of Farmer’s (1997) indeterminate monetary economy. The result is robust to changing the monetary regime form moving target to flexible inflation targeting, and to whether domestic and foreign currencies are substitutes or complements

How did the author get there?

The analysis started from simplicity to complexity. From different scenarios such as closed economy, small open economy under diversified currency holdings to flexible inflation targeting. See under each assumptions, the change of variables such as time preference, risk aversion or inflation rate will have an impact on currency holdings.