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Lecture Date: Wednesday, March 3, 2004

FIXED EXCHANGE RATES

STABILIZATION NPOLICIES UNDER A FIXED EXCHANGE RATE:

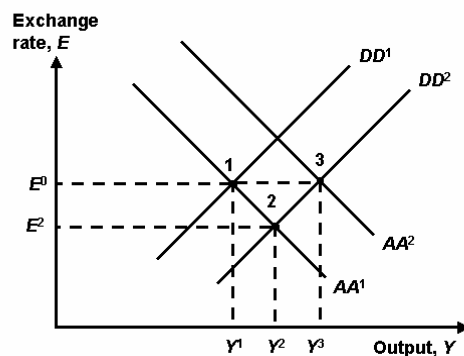
Fiscal Policy:

How does the central bank intervention hold the exchange rate fixed after the fiscal expansion?

The rise in output due to expansionary fiscal policy raises money demand. To prevent an increase in the home interest rate and an appreciation of the currency, the central bank must buy foreign assets with money (i.e., increasing the money supply).

The effects of expansionary fiscal policy when the economy's initial equilibrium is at point 1 are illustrated in Figure 17-3.

Figure 17-3: Fiscal Expansion Under a Fixed Exchange Rate



Changes in the Exchange Rate:

Devaluation: occurs when the central bank raises the domestic currency price of foreign currency, E . It causes a rise in output, in official reserves and an expansion of the money supply. Devaluations are chosen by governments to fight domestic unemployment, improve the current account or affect the central bank's foreign reserves.

Revaluation: occurs when the central bank lowers E .