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**OPTIMAL MONETARY POLICY UNDER
ASSET MARKET SEGMENTATION**

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Optimal Monetary Policy under Asset Market Segmentation¹

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Abstract

This paper studies optimal monetary policy in a small open economy under flexible prices. The paper's key innovation is to analyze this question in the context of environments where only a fraction of agents participate in asset market transactions (i.e., asset markets are segmented). In this environment, we first show that there exist state contingent rules (based either on the rate of money growth or the devaluation rate) that can implement the first-best equilibrium. Such rules, however, would require the monetary authority to respond to contemporaneous shocks and would thus be difficult to implement. We then proceed to analyze optimal monetary policy rules within the class of non-state contingent rules. Our main result is that amongst non-state contingent rules, policies targeting monetary aggregates (which allow for nominal exchange rate flexibility) welfare-dominate rules that target the exchange rate. In particular, we find that a fixed exchange rate is never optimal. Our analysis would thus tend to support monetary policy arrangements that allow for nominal exchange rate flexibility.

KEYWORDS: Optimal monetary policy, asset market segmentation

JEL CLASSIFICATION: F1, F2

1 Introduction

The desirability of alternative monetary policies continues to be one of the most analyzed and hotly debated issues in macroeconomics. If anything, the issue is even of greater relevance for emerging markets, which experience far greater macroeconomic volatility than industrial countries. Should emerging markets fix the exchange rate to a strong currency or should they let it float? Should they be targeting inflation and follow Taylor-type rules or should they have a monetary target? In practice, the range of experiences is not only broad but also varies considerably over time. While in the early 1990s many emerging countries were following some sort of exchange rate peg (the 10-year Argentinean currency board that started in 1991 being the most prominent example), most of them switched to more flexible arrangements after the 1994 Mexican crisis and the 1997-98 Asian crises. If history is any guide, however, countries dislike large fluctuations in exchange rates and eventually seek to limit them by interventions or interest rates changes (Calvo and Reinhart (2002)). Hence, it would not be surprising to see a return to less flexible arrangements in the near future. The cross-country and time variation of monetary policy and exchange rate arrangements in emerging countries is thus remarkable and essentially captures the different views of policymakers and international financial institutions regarding the pros and cons of different regimes.

The conventional wisdom derived from the literature regarding the choice of exchange rate regimes is based on the Mundell-Fleming model (i.e., a small open economy with sticky prices and perfect capital mobility). In such a model, it can be shown (see Calvo (1999) for a simple derivation) that if the policymaker's objective is to minimize output variability, fixed exchange rates are optimal if monetary shocks dominate and flexible exchange rates are optimal if real shocks dominate. As Calvo (1999, p. 4) puts it, this is "a result that every well-trained economist carries on [his/her] tongue". The intuition is simple enough: real shocks require an adjustment in relative prices which, in the presence of sticky prices, can most easily be effected through changes in the nominal exchange rate; in contrast, monetary shocks require an adjustment in real money balances that can be most easily carried out through changes in nominal money balances (which

happens endogenously under fixed exchange rates). In fact, most of the modern literature on the choice of exchange rate regimes has considered variations of the Mundell-Fleming model in modern clothes (rechristened nowadays as “new open economy macroeconomics”): for instance, Engel and Devereux (1998) show how the conventional results are sensitive to whether prices are denominated in the producer’s or consumer’s currency and Cespedes, Chang, and Velasco (2000) incorporate liability dollarization and balance sheets effects and conclude that the standard prescription in favor of flexible exchange rates in response to real shocks is not essentially affected. In a similar vein, while the literature on monetary policy rules for open economies is more recent, it has been carried out mostly in the context of sticky-prices model (see, for instance, Clarida, Gali, and Gertler (2001), Ghironi and Rebucci (2001), and Schmitt-Grohe and Uribe (2000)). In particular, Clarida, Gali, and Gertler (2001) conclude that Taylor-type rules remain optimal in an open economy though openness can affect the quantitative magnitude of the responses involved.

The fact that most of the literature on the choice of exchange rate regimes and monetary policy rules relies on sticky prices models raises a fundamental (though seldom asked) question: are sticky prices (i.e., frictions in good markets) more relevant in emerging markets than frictions in asset markets? Given that even for the United States 59 percent of the population (as of 1989) did not hold interest bearing assets (see Mulligan and Sala-i-Martin (2000)) and that, for all the financial opening of recent decades, financial markets in developing countries remain far less sophisticated than in the United States, it seems clear that financial markets frictions are pervasive in developing countries. In this light, it would seem important to understand the implications of models with financial markets frictions for the optimal choice of exchange rate regimes and policy rules. A convenient way of modelling financial market frictions is to assume that, at any point in time, some agents do not have access to asset markets (due to, say, a fixed cost of entry, lack of information, and so forth). These so-called asset market segmentation models have been used widely in the closed macro (see, among others, Alvarez and Atkeson (1997), Alvarez, Lucas, and Webber (2001) and Chatterjee and Corbae (1992)). In a first paper (Lahiri, Singh, and Vegh (2003)), we have analyzed the implications of asset market segmentation for the choice of exchange rate regimes under both

complete and incomplete markets (for agents that have access to asset markets). We conclude that the policy prescription is exactly the *opposite* of the one that follows from the Mundell-Fleming model: when monetary shocks dominate, flexible exchange rates are optimal, whereas when real shock dominate, fixed rates are optimal.¹ The punchline is that the choice of fixed versus flexible rates should therefore not only depend on the *type of shock* (monetary versus real) but also on the *type of friction* (goods markets versus asset markets).

In this paper, we turn to the more general issue of optimal monetary policy rules (of which a fixed exchange rate or pure floating rate are, of course, particular cases). For analytical simplicity, we restrict our attention to the case in which agents that have access to asset markets (called “traders”) face complete markets. Our first result of interest is that there are state contingent rules (based either on the rate of money growth or the rate of devaluation) that can implement the first-best equilibrium. These rules entail reacting to both output and velocity shocks. Interestingly enough, the optimal reaction to output shocks is procyclical in the sense that either the rate of money growth or the rate of devaluation should be raised in good times and lowered in bad times. Intuitively, this reflects the need to insulate non-traders (i.e., those agents with no access to capital markets) from output fluctuations. In the case of the state-contingent money growth rule, this insulation is achieved by redistributing resources from non-traders to traders in good times and viceversa in bad times. More specifically, by, say, increasing the money supply in good times, traders’ real money balances increase (since they get a disproportionate amount of money while the price level increases in proportion to the money injection), which they can use to buy goods from non-traders. In the case of the state-contingent devaluation rate rule, the insulation is achieved by devaluing in good times. While such a devaluation does not affect traders’ real money balances (since they can always replenish their nominal money balances at the central bank’s window), it

¹Not surprisingly, our results are in the spirit of an older – and less well-known literature – that analyzed the choice of exchange rate regimes in models with no capital mobility; see, in particular, Fischer (1977) and Lipschitz (1978). It is worth noting, however, that these early models failed to capture agent heterogeneity and hence missed the role of redistributive/asymmetric policies, a key channel in our model.

reduces non-traders' real money balances thus forcing them not to over-consume in good times. In sum, the key to achieving the first best is that the monetary authority's actions hit traders and non-traders asymmetrically.

Since state-contingent rules are, by their very nature, not easy to implement in practice (as they would require the monetary authority to respond to *contemporaneous* shocks), we then proceed to ask the question: what are the optimal policy rules within the class of non-state contingent rules? Since in our model shocks are independently and identically distributed, non-state contingent rules take the form of either a constant money growth rate or a constant rate of devaluation. Our main finding is that, among non-state contingent rules, money-based rules generally welfare-dominate exchange rate-based rules. In fact, a fixed exchange rate is *never* optimal in our model, while a constant money supply rule (i.e., zero money growth) would be optimal if the economy were hit only by monetary shocks. Intuitively, this reflects a fundamental feature of our model: asset market segmentation critically affects the key adjustment mechanism that operates under predetermined exchange rates; namely, the exchange of money for bonds (or viceversa) at the central bank's window. Since only a fraction of agents operate in the asset market, this typical mechanism loses effectiveness in our model. In contrast, the typical adjustment mechanism that operates under flexible rates (adjustments in the exchange rate/price level) is not affected by asset market segmentation. We thus conclude that our model would rationalize monetary regimes where the exchange rate is allowed to (at least partly) respond to various shocks.

The paper proceeds as follows. Section 2 presents the model and the equilibrium conditions while Section 3 describes the allocations under alternative exchange rate regimes and compares welfare under the different regimes. Section 4 studies the implications of the different monetary regimes for macroeconomic volatility. Finally, Section 5 concludes. Algebraically tedious proofs are consigned to an appendix.

2 Model

The basic model is an open economy variant of the model outlined in Alvarez, Lucas, and Weber (2001). Consider a small open economy perfectly integrated with world goods markets. There is a unit measure of households who consume an internationally-traded good. The world currency price of the consumption good is fixed at one. The households face a cash-in-advance constraint. As is standard in these models, households are prohibited from consuming their own endowment. We assume that a household consists of a seller-shopper pair. While the seller sells the household's own endowment, the shopper goes out with money to purchase consumption goods from other households.

There are two potential sources of uncertainty in the economy. First, each household receives a random endowment y_t of the consumption good in each period. We assume that y_t is an independently and identically distributed random variable with mean \bar{y} and variance σ_y^2 .² Second, following Alvarez *et al*, we assume that the shopper can access a proportion v_t of the household's current period (t) sales receipts, in addition to the cash carried over from the last period (M_t), to purchase consumption. We assume that v_t is an independently and identically distributed random variable with mean $\bar{v} \in [0, 1]$ and variance σ_v^2 . Only a fraction λ of the population, called traders, has access to (complete) asset markets, where $0 \leq \lambda \leq 1$.³ The rest, $1 - \lambda$, called non-traders, can only hold domestic money as an asset. In the following we shall refer to these v shocks as velocity shocks.⁴

²We could allow for different means and variances for the endowments of traders and non-traders without changing our basic results.

³As will become clear below, the assumption of complete markets for traders greatly simplifies the problem. In Lahiri, Singh, and Vegh (2003), we also solve the case of incomplete markets for some particular policy rules (i.e., constant money supply and constant exchange rate) and show that similar results obtain.

⁴There are alternative ways in which one can think about these velocity shocks. Following Alvarez, Lucas, and Weber (2001) one can 'think of the shopper as visiting the seller's store at some time during the trading day, emptying the cash register, and returning to shop some more'. The uncertainty regarding v can be thought of as the uncertainty regarding the total volume of sales at the time that the shopper accesses the cash register. Alternatively, one can think of this as representing an environment where the shopper can purchase goods either through cash or credit.

In each period t , the economy experiences one of the finitely many events $x_t = \{v_t, y_t\}$. Denote by $x^t = (x_0, x_1, x_2, \dots, x_t)$ the history of events up to and including period t . The probability, as of period 0, of any particular history x^t is $\pi(x^t) = \pi(x^t | x^{t-1}) \pi(x^{t-1})$. The households' intertemporal utility function is

$$W_0 = \sum_{t=0}^{\infty} \sum_{x^t} \beta^t \pi(x^t) u(c(x^t)), \quad (1)$$

where β is the households' time discount factor, and $c(x^t)$ is consumption in period t .

The timing runs as follows. First, both the endowment and velocity shocks are realized at the beginning of every period. Second, the household splits. Sellers of both households stay at home and sell their endowment for local currency. Shoppers of the non-trading households are excluded from the asset market and, hence, go directly to the goods market with their overnight cash to buy consumption goods. Shoppers of trading households first carry the cash held overnight to the asset market where they trade in bonds and receive any money injections for the period. They then proceed to the goods market with whatever money balances are left after their portfolio rebalancing. After acquiring goods in exchange for cash, the non-trading-shopper returns straight home while the trading-shopper can re-enter the asset market to exchange goods for foreign bonds. After all trades for the day are completed and markets close, the shopper and the seller are reunited at home.

2.1 Households' problem

2.1.1 Traders

Traders have access to world capital markets in which they can trade state contingent securities spanning all states. The traders begin any period with assets in the form of money balances and state-contingent bonds carried over from the previous period. Armed with these assets the shopper of the trader household visits the asset market where she rebalances the household's asset position and also receives the lump sum asset market transfers from the government. For any period $t \geq 0$,

However, the mix of cash and credit transactions is uncertain and fluctuates across periods.

the accounting identity for the asset market transactions of a trader household is given by

$$\hat{M}^T(x^t) = M^T(x^{t-1}) + S(x^t) f(x^t) - S(x^t) \sum_{x^{t+1}} q(x^{t+1}|x^t) f(x^{t+1}) + \frac{T(x^t)}{\lambda}, \quad (2)$$

where $\hat{M}^T(x^t)$ denotes the money balances with which the trader leaves the asset market under history x^t (which includes the time t state x_t) while $M^T(x^{t-1})$ denotes the money balances with which the trader entered the asset market.⁵ $S(x^t)$ is the exchange rate (the domestic currency price of foreign currency). $f(x^{t+1})$ denotes units of state-contingent securities, in terms of tradable goods, bought in period t at a per unit price of $q(x^{t+1}|x^t)$. A trader receives payment of $f(x^{t+1})$ in period $t+1$ if and only if the history x^{t+1} occurs. T are aggregate (nominal) lump-sum transfers from the government.^{6,7}

After asset markets close, the shopper proceeds to the goods market with \hat{M}^T in nominal money balances to purchase consumption goods. The cash-in-advance constraint for traders is thus given by

$$S(x^t) c^T(x^t) = \hat{M}^T(x^t) + v_t S(x^t) y_t. \quad (3)$$

Equation (3) shows that for consumption purposes, traders can augment the beginning of period cash balances by withdrawals from current period sales receipts v_t (the velocity shocks). Note that purchasing power parity implies that $S(x^t)$ also denotes the domestic currency price of consumption goods under history x^t . Lastly, period- t sales receipts net of withdrawals become beginning of next

⁵Note that the money balances with which a trader enters the asset market at time t reflects the history of realizations till time $t-1$. Hence, beginning of period money balances at time t are depend on the history x^{t-1} .

⁶We assume that these transfers are made in the asset markets, where only the traders are present. Note that since T denotes aggregate transfers, the corresponding per trader value is T/λ since traders comprise a fraction λ of the population.

⁷The assumption of endogenous lump-sum transfers will ensure that any monetary policy may be consistent with the intertemporal fiscal constraint. This becomes particularly important in this stochastic environment where these endogenous transfers will have to adjust to ensure intertemporal solvency for *any* history of shocks. To make our life easier, these transfers are assumed to go only to traders. If these transfers also went to non-traders, then (12) would be affected.

period's money balances

$$M^T(x^t) = S(x^t) y_t (1 - v_t). \quad (4)$$

Combining equations (2) and (3) yields

$$M^T(x^{t-1}) + \frac{T(x^t)}{\lambda} + v_t S(x^t) y_t = S(x^t) c^T(x^t) - S(x^t) f(x^t) + S(x^t) \sum_{x_{t+1}} q(x^{t+1}|x^t) f(x^{t+1}). \quad (5)$$

We assume that $M_0^T = \bar{M}$. We assume that actuarially fair securities are available in international asset markets. By definition, actuarially fair securities imply that

$$\frac{q(x_i^{t+1}|x^t)}{q(x_j^{t+1}|x^t)} = \frac{\pi(x_i^{t+1}|x^t)}{\pi(x_j^{t+1}|x^t)}, \quad (6)$$

for any pair of securities i and j belonging to the set x . Further, no-arbitrage implies that the price of a riskless security that promises to pay one unit next period should equal the price of a complete set of state-contingent securities (which would lead to the same outcome):

$$\frac{1}{1+r} = \sum_{x_{t+1}} q(x^{t+1}|x^t). \quad (7)$$

Using (6) repeatedly to solve for a particular security relative to all others and substituting into (7), we obtain:

$$q(x^{t+1}|x^t) = \beta \pi(x^{t+1}|x^t), \quad (8)$$

where we have assumed that $\beta = 1/(1+r)$. Note further that the availability of these sequential securities is equivalent to the availability of Arrow-Debreu securities, where all markets open only on date 0. Hence, by the same logic, it must be true for Arrow-Debreu security prices that

$$q(x^t) = \beta^t \pi(x^t). \quad (9)$$

The traders arrive in this economy at time 0 with initial nominal money balances \bar{M} and initial net foreign asset holdings of f_0 . To ensure market completeness, we allow for asset market trade

right before period 0 shocks are realized, so that traders can exchange f_0 for state-contingent claims payable after the realization of shocks in period 0. Formally,

$$f_0 = \sum_{x_0} q(x_0) f(x_0), \quad (10)$$

where $q(x_0) = \beta\pi(x_0)$.

Maximizing (1) subject to (5) yields

$$q(x^{t+1}|x^t) = \beta\pi(x^{t+1}|x^t) \frac{u'(c(x^{t+1}))}{u'(c(x^t))}. \quad (11)$$

Equation (11) is the standard Euler equation for the trader which relates the expected marginal rate of consumption substitution between today and tomorrow to the return on savings discounted to today. Since $\beta = \frac{1}{1+r}$, it is clear from (8) and (11) that traders choose a flat path for consumption.

2.1.2 Non-traders

As stated earlier, the non-traders in this economy do not have access to asset markets. They are born with some initial nominal money balances \bar{M} and then transit between periods by exchanging cash for goods and vice-versa.⁸ The non-trader's cash-in-advance constraint is given by:

$$S(x^t)c^{NT}(x^t) = M^{NT}(x^{t-1}) + v_t S(x^t)y_t, \quad (12)$$

where $M^{NT}(x^{t-1})$ is the beginning of period t nominal money balances (which is dependent on the history x^{t-1}) for non-traders. Their initial period cash-in-advance constraint is

$$S(x^0)c^{NT}(x^0) = \bar{M} + v_0 S(x^0)y_0$$

Like traders, the non-traders can also augment their beginning of period cash balances by withdrawals from current period sales receipts v_t (the velocity shocks). Money balances at the beginning of period $t + 1$ are given by sales receipts net of withdrawals for period t consumption:

$$M^{NT}(x^t) = S(x^t)y_t(1 - v_t), \quad (13)$$

⁸Note that we have assumed that the initial holdings of nominal money balances is invariant across the two types of agents, i.e., $M_0^T = M_0^{NT} = \bar{M}$.

2.2 Government

The government in this economy holds foreign bonds (reserves) which earn the world rate of interest r . The government can sell nominal domestic bonds, issue domestic money, and make lump sum transfers to the traders. Thus, the government's budget constraint is given by

$$S(x^t) \sum_{x^{t+1}} q(x^{t+1}|x^t) h(x^{t+1}) - S(x^t)h(x^t) + T(x^t) = M(x^t) - M(x^{t-1}), \quad (14)$$

where h are foreign bonds held by the government, M is the aggregate money supply, and T is government transfers to the traders. It is crucial to note that changes in money supply impact only the traders since they are the only agents present in the asset market.

2.3 Equilibrium conditions

Equilibrium in the money market requires that

$$M(x^t) = \lambda M^T(x^t) + (1 - \lambda)M^{NT}(x^t). \quad (15)$$

The flow constraint for the economy as a whole (i.e., the current account) follows from combining the constraints for non-traders (equations (12) and (13)), traders (equation (5)), and the government (equation (14)) and money market equilibrium (equation (15)):

$$\lambda c^T(x^t) + (1 - \lambda)c^{NT}(x^t) = y_t + k(x^t) - \sum_{x^{t+1}} q(x^{t+1}|x^t) k(x^{t+1}), \quad (16)$$

where $k \equiv h + \lambda f$ denotes per-capita foreign bonds for the economy as a whole.

To obtain the quantity theory, combine (3), (13) and (15) to get:

$$\frac{M(x^t)}{1 - v_t} = S(x^t)y_t. \quad (17)$$

Notice that the stock of money relevant for the quantity theory is end of period t money balances $M(x^t)$. This reflects the fact that, unlike standard CIA models (in which the goods market is open before the asset market and shoppers cannot withdraw current sales receipts for consumption), in this model (i) asset markets open before goods market open (which allows traders to use period t

money injections for consumption purposes in that period); and (ii) both traders and non-traders can access current sales receipts.

Combining (12) and (13) gives the consumption of non-traders:

$$c^{NT}(x^t) = \frac{S(x^{t-1})}{S(x^t)}(1 - v_{t-1})y_{t-1} + v_t y_t. \quad (18)$$

$$c^{NT}(x^0) = \frac{\bar{M}}{S(x^0)} + v_0 y_0 \quad (19)$$

To obtain the level of constant consumption for traders, we use equation (4) to substitute for M_t^T in equation (5). Then, subtracting $S(x^t)y_t$ from both sides allows us to rewrite (5) as

$$f(x^t) - \sum_{x^{t+1}} q(x^{t+1}|x^t) f(x^{t+1}) + y_t - c^T(x^t) = \frac{M(x^t) - M(x^{t-1})}{S(x^t)} - \frac{T(x^t)}{\lambda},$$

where we have used equation (17) to get

$$M(x^t) - M(x^{t-1}) = S(x^t)y_t - S(x^{t-1})y_{t-1} - (v_t S(x^t)y_t - v_{t-1} S(x^{t-1})y_{t-1}).$$

Using equation (14) in the equation above gives

$$\begin{aligned} & \sum_{x^{t+1}} q(x^{t+1}|x^t) \left(\frac{h(x^{t+1})}{\lambda} + f(x^{t+1}) \right) - f(x^t) - \frac{h(x^t)}{\lambda} \\ &= y_t - c^T(x^t) + \left(\frac{1-\lambda}{\lambda} \right) \left(\frac{M(x^t) - M(x^{t-1})}{S(x^t)} \right), \end{aligned} \quad (20)$$

where h_0 and f_0 are given exogenously. Using (9) and iterating forward on equation (20), it can be checked that under either regime and for any type of shock (i.e., velocity or output shock), consumption of traders is given by:⁹

$$c^T(x^t) = r \frac{k_0}{\lambda} + \bar{y} + r \sum_{x^t} \beta^t \pi(x^t) \left(\frac{1-\lambda}{\lambda} \right) \left(\frac{M(x^t) - M(x^{t-1})}{S(x^t)} \right), \quad t \geq 0, \quad (21)$$

where $k_0 = h_0 + \lambda f_0$. In the following, we shall maintain the assumption that initial net country assets are zero, i.e., $k_0 = 0$.

⁹This is accomplished by multiplying each period's flow constraint by $q(x^t)$ and summing it over all possible realizations. Then, summing it over all periods and imposing transversality conditions gives the intertemporal budget constraint.

3 Alternative Monetary Regimes

Having described the model and the equilibrium conditions above, we now turn to allocations under specific monetary policy regimes. We will look at four regimes: (i) the state contingent money growth rule which implements the first-best; (ii) the state contingent devaluation rate rule which also implements the first-best; (iii) the best non-state contingent money growth rule which maximizes joint welfare of both types of agents; and (iv) the best non-state contingent exchange rate rule which maximizes the joint welfare of both agents. The reason we are interested in studying simple, non-state contingent rules is because they are easier to implement and monitor. The end goal, of course, is to evaluate both the welfare implications under these four regimes as well as the implied macroeconomic volatility under them. Of particular interest is an evaluation of the welfare losses that are implied by following simple non-state contingent rules relative to the first-best state contingent rule.¹⁰

Before proceeding we need to tie down the initial period price level, S_0 . From the quantity theory equation we know that $S_0 = \frac{M_1}{(1-v_0)y_0}$. In order to keep initial period allocations symmetric across regimes we make the neutral assumption that $M_1 = \bar{M}$. Hence,

$$S_0 = \frac{\bar{M}}{(1-v_0)y_0}. \quad (22)$$

Noting that $S_0 = S(x^0)$, it is easy to check from equation (19) that this assumption implies that

$$c_0^{NT} = y_0. \quad (23)$$

In order to make progress analytically, we shall now specialize the utility function to the quadratic form. Thus, we assume from hereon that the periodic utility of the household of either type is given by:

$$u(c) = c - \zeta c^2. \quad (24)$$

¹⁰An extensive literature on the time consistency of monetary policy going back to Aurenheimer (1974) has documented the advantages of rules over discretion in conducting monetary policy due to commitment problems on the part of the monetary authority.

Note that the quadratic utility specification implies that the expected value of periodic utility can be written as

$$E(c - \zeta c^2) = E(c) - \zeta [E(c)]^2 - \zeta Var(c). \quad (25)$$

where $Var(c)$ denotes the variance of consumption.

We shall conduct the welfare analysis by comparing the expectation of lifetime welfare at time $t = 0$ conditional on period 0 realizations (but before the revelation of any information at time 1). Specifically, the expected welfare under any monetary regime is calculated given the initial period shocks x_0 , the initial price level $S_0 = \frac{\bar{M}}{(1-v_0)y_0}$ as well as the associated initial money injection for period 1: $M(x^0) = M_1 = \bar{M}$. In terms of preliminaries, it is useful to define the following:

$$W^{i,j} = E \left\{ \sum \beta^t \left[c_t^{i,j} - \zeta \left(c_t^{i,j} \right)^2 \right] \right\}, \quad i = T, NT, \quad j = \text{monetary regime}, \quad (26)$$

$$W^j = \lambda W^{T,j} + (1 - \lambda) W^{NT,j}, \quad j = \text{monetary regime}. \quad (27)$$

Equation (26) gives the welfare for each agent under a specific monetary policy regime where the relevant consumption for each type of agent is given by the consumption functions relevant for that regime. Equation (27) is the aggregate welfare for the economy under each regime. It is the sum of the regime specific welfares of the two types of households weighted by their population shares.

3.1 First-best state contingent money growth rule

We have shown above that when traders have access to complete markets, they can fully insure against all shocks. Hence, the only role for policy is to smooth the consumption of non-traders who do not have access to asset markets.¹¹ Clearly, the first-best outcome for the non-traders would be a flat consumption path (recall that all the welfare losses for non-traders in this model come from consumption volatility).

¹¹The conclusion that the only role for policy is to smooth the consumption of non-traders is crucially dependent on the assumptions that the endowment process is the same for both types with the same mean, and that initial net country assets are zero. If this were not the case, then an additional goal for policy would be to shift consumption across types in order to equalize them.

Recall from equation (18) that consumption of non-traders is given by

$$c^{NT}(x^t) = \frac{S(x^{t-1})}{S(x^t)}(1 - v_{t-1})y_{t-1} + v_t y_t. \quad (28)$$

Using the quantity theory equation $S(x^t)y_t(1 - v_t) = M(x^t)$ in the above and rearranging gives

$$c^{NT}(x^t) = y_t - \left(\frac{M(x^t) - M(x^{t-1})}{S(x^t)} \right)$$

Substituting out for $S(x^t)$ from the quantity theory relationship then yields

$$c^{NT}(x^t) = y_t \left[1 - \left(\frac{M(x^t) - M(x^{t-1})}{M(x^t)} \right) (1 - v_t) \right] \quad (29)$$

As was assumed earlier, the endowment sequence follows an i.i.d. process with mean \bar{y} and variance σ_y^2 . It is clear that the first-best outcome for non-traders would be achieved if $c_t^{NT} = \bar{y}$ for all t . The key question that we focus on here is whether or not there exists a monetary policy rule which can implement this allocation.

Let $\mu(x^t)$ be the growth rate of money given history x^t .¹² Hence,

$$M(x^t) - M(x^{t-1}) = \mu(x^t)M(x^{t-1}), \quad t \geq 1$$

Substituting this into equation (29) gives

$$c^{NT}(x^t) = y_t \left[1 - \left(\frac{\mu(x^t)}{1 + \mu(x^t)} \right) (1 - v_t) \right]$$

To check if monetary policy can implement the first-best, we substitute $c^{NT}(x^t) = \bar{y}$ in the above to get

$$\frac{\bar{y}}{y_t} = \left[1 - \left(\frac{\mu(x^t)}{1 + \mu(x^t)} \right) (1 - v_t) \right].$$

This expression can be solved for $\mu(x^t)$ as a function of y_t and v_t . Thus,

$$\mu(x^t) = \frac{y_t - \bar{y}}{\bar{y} - v_t y_t}. \quad (30)$$

A few features of this policy rule are noteworthy. First, as long as the monetary authority chooses μ *after* observing the realizations for y and v , this rule is implementable. Second, equation

¹²Recall that $M_1 = \bar{M}$ implies that $\mu(x^0) = 0$ by assumption.

(30) makes clear that when there are no shocks to output, i.e., $y_t = \bar{y}$ for all t , the optimal policy is to choose $\mu_t = 0$ for all t independent of the velocity shock. Hence, under velocity shocks only, a flexible exchange rate regime with a constant money supply implements the first-best allocation.

A third interesting feature of equation (30) is that the optimal monetary policy is procyclical. In particular, it is easy to check that

$$\frac{\partial \mu(x^t)}{\partial y_t} = \frac{\bar{y}(1 - v_t)}{(\bar{y} - v_t y_t)^2} > 0. \quad (31)$$

Note that the latter inequality in (31) follows from the fact that v is strictly bounded above by one. The intuition for this result is that, *ceteris paribus*, an increase in output raises non-traders' consumption through two channels. First, current sales revenue is higher, which implies that there is more cash available for consumption. Second, an increase in output appreciates the currency thereby raising the real value of money balances brought into the period. To counteract these expansionary effects on non-traders' consumption, the optimal monetary policy calls for an expansion in money growth. An expansion in money growth reduces non-traders' consumption by redistributing resources from non-traders to traders. More specifically, since only traders are present in the asset markets, they get a more than proportionate amount of money while the exchange rate (price level) rises in proportion to the money injection. Hence, traders' real money balances increase, which they can use to buy goods from non-traders and exchange for foreign bonds. In bad times, a money withdrawal from the system leaves traders with lower real money balances, which leads them to sell those goods to non-traders. In other words, policymakers are smoothing non-traders' consumption by engineering a transfer of resources from non-traders to traders in good times and viceversa in bad times.

Fourth, the optimal policy response to velocity shocks depends on the level of output relative to its mean level. In particular,

$$\frac{\partial \mu(x^t)}{\partial v_t} = \frac{y_t(y_t - \bar{y})}{(\bar{y} - v_t y_t)^2} \gtrless 0.$$

Thus, when output is above the mean level, an increase in v calls for an increase in money growth while if output is below the mean then the opposite is true. Intuitively, an increase in v_t

has two opposing effects on real balances available for consumption. First, it raises real balances since it implies that a higher proportion of current sales can be used in the current period. Second, a higher v_t depreciates the currency thereby decreasing the real value of money balances brought into the period. When output is equal to the mean level, absent a change in policy, these effects exactly offset each other. On the other hand, when output is above (below) the mean, the current sales effect is stronger (weaker) than the exchange rate effect. Hence, an increase (decrease) in μ provides the appropriate correction through the redistribution channel spelled out above.

3.2 First-best state contingent devaluation rate rule

To derive the first-best state contingent devaluation rate rule, substitute $c_t^{NT} = \bar{y}$ into equation (28) and replace $\frac{S(x^{t-1})}{S(x^t)}$ by $\frac{1}{1+\varepsilon(x^t)}$ to obtain:

$$\varepsilon(x^t) = \frac{(1 - v_{t-1})y_{t-1}}{\bar{y} - v_t y_t} - 1. \quad (32)$$

Again, several features of this rule are noteworthy. First – and as was the case for the money growth rule just discussed – as long as the monetary authority can observe contemporaneous realizations of y and v , this rule is implementable. Second – and unlike the money growth rule just discussed – this rule also depends on past values of output. Intuitively, the reason is that under a peg, non-traders’ consumption depends on last period’s consumption, as follows from (28). Third, if there are no shocks to either output or velocity (i.e., if $y_t = \bar{y}$ and $v_t = \bar{v}$ for all t), then the optimal policy is to keep the exchange rate flat (i.e., $\varepsilon = 0$).

Fourth, this rule is procyclical with respect to output in the sense that, all else equal, a higher realization of today’s output calls for an increase in the rate of devaluation. Intuitively, an increase in today’s output increases today’s non-traders’ consumption because current sales revenue is higher, which implies that there is more cash available for consumption. To keep non-traders’ consumption flat over time, the monetary authority needs to offset this effect. The way to do so is to increase today’s exchange rate (i.e., a nominal devaluation). A nominal devaluation will tend to lower real money balances of both traders and non-traders. Traders, however, can easily undo this by replenishing their nominal money balances at the central bank’s window (as in the standard model).

Non-traders, however, have no way of doing this and hence see their consumption reduced by the fact that they have lower real money balances. In bad times (low realization of output), a revaluation will have the opposite effect. In sum, the monetary authority is able to smooth non-traders' consumption through real balances effect.

Fifth, a high realization of today's velocity shock also calls for an increase in the rate of devaluation. Intuitively, a high value of v implies that both traders and non-traders have a higher level of real cash balances for consumption. Traders, of course, can undo this in the asset markets. Non-traders, however, cannot do this and would be forced to consume too much today. By devaluing, the monetary authority decreases the value of non-traders' real money balances. Conversely, a low value of v would be counteracted by a nominal revaluation.

3.3 Non-state contingent money growth rule

The first non-state contingent rule that we analyze is a time invariant money growth rule. The main exercise is to determine the constant money growth rule which maximizes the joint, share-weighted lifetime welfare of the two types of agents in the economy. Hence, the objective is to choose μ to maximize

$$W^\mu = \lambda W^{T, \mu} + (1 - \lambda) W^{NT, \mu}.$$

In order to compute the optimal constant non-state contingent money growth rule, we first need to determine the consumption allocations for the two agents under this regime (for an arbitrary but constant money growth rate). As before we use μ to denote the rate of money growth. Given a utility specification, μ can be computed by maximizing weighted utilities.

Under the time invariant money growth rule and the quantity theory equation $S_t y_t (1 - v_t) = M_{t+1}$, equations (18) and (21) imply that consumption of nontraders and traders are given by

$$c_t^{NT} = z(1 - v_t) y_t + v_t y_t, \quad t \geq 1 \tag{33}$$

$$c_t^T = r \frac{k_0}{\lambda} + \bar{y} \left[1 + \left(\frac{1 - \lambda}{\lambda} \right) (1 - z) (1 - \bar{v}) \right] \tag{34}$$

where $z \equiv \frac{1}{1 + \mu}$ ($= \frac{M_t}{M_{t+1}}$). From here on, we abstract from distributional issues relating to the

distribution of initial wealth across agents, by assuming that initial net country assets are zero, i.e., $k_0 = 0$. Since $\lambda E [c^T] + (1 - \lambda) E [c_t^{NT}] = \bar{y}$, under our maintained assumption of quadratic preferences, the optimal z is determined by solving the problem:

$$\min_z \left\{ \lambda (E (c^T))^2 + (1 - \lambda) (E (c^{NT}))^2 + (1 - \lambda) Var [c^{NT}] \right\}. \quad (35)$$

In order to derive the optimal money growth rate we need to know the expected consumption levels of the two types as well as the unconditional consumption variance for the nontraders. The expected consumption is trivial to compute and, from (33), it can be shown that the variance of non-trader's consumption is given by:

$$Var [c_t^{NT}] = z^2 \sigma_y^2 + (1 - z)^2 [\sigma_y^2 \sigma_v^2 + \bar{y}^2 \sigma_v^2 + \bar{v}^2 \sigma_y^2] + 2z(1 - z) \bar{v} \sigma_y^2. \quad (36)$$

Substituting in the relevant expressions for c^T , $E(c^{NT})$, and $Var [c^{NT}]$ into (35) and taking the first order condition with respect to z yields

$$z = \frac{\sigma_{vy}^2 - \bar{v} \sigma_y^2 + \frac{(1 - \bar{v})^2}{\lambda} \bar{y}^2}{\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2 + \frac{(1 - \bar{v})^2}{\lambda} \bar{y}^2}, \quad (37)$$

where $\sigma_{vy}^2 \equiv \sigma_y^2 \sigma_v^2 + \bar{y}^2 \sigma_v^2 + \bar{v}^2 \sigma_y^2$. Since $\mu = \frac{1 - z}{z}$, the optimal μ that is implied by (37) is

$$\tilde{\mu} = \frac{(1 - \bar{v}) \sigma_y^2}{\sigma_{vy}^2 + \frac{(1 - \bar{v})^2 \bar{y}^2}{\lambda} - \bar{v} \sigma_y^2}. \quad (38)$$

Equation (38) makes clear that the higher the value of λ , the higher will be $\tilde{\mu}$. This is due to the fact that with a higher share of traders, transferring resources from nontraders in order to minimize their consumption variances does not create large differences in the consumption levels of the two types.

We should note two special cases. First, when the economy is open to only output shocks, i.e.,

$\sigma_v^2 = 0$, the optimal rate of money growth implied by equation (38) is¹³

$$\tilde{\mu}|_{\sigma_v^2=0} = \frac{1 - \bar{v}}{\bar{v}^2 + \frac{(1-\bar{v})^2 \bar{y}^2}{\lambda \sigma_y^2} - \bar{v}}.$$

The optimal $\tilde{\mu}$ is thus an increasing function of the variance of output shocks, σ_y^2 . Intuitively, policymakers find it optimal to provide insurance to non-traders by reducing their consumption variability. The “price” of this insurance (a transfer from non-traders to traders) increases with the variability of output. (Notice that a positive μ implies a transfer from non-traders to traders.)

Second, when there is no output volatility in the economy so that $\sigma_y^2 = 0$, the optimal constant money growth rate given by (38) is

$$\tilde{\mu} = 0,$$

which implies that a policy of fixed money supply is optimal. Interestingly, we have seen above that the state contingent first-best rule calls for $\mu = 0$ when there are no output shocks. Hence, when there is no output volatility in the economy, the non-state contingent optimal money growth rule coincides with the state contingent first-best rule. In general, however, a fixed money rule does not achieve the first best equilibrium.

3.3.1 Welfare loss relative to the first-best

Under our quadratic preference specification, welfare under the state-contingent rule is

$$W^{fb} = \lambda W^{T,fb} + (1 - \lambda) W^{NT,fb} = \bar{y} - \zeta \bar{y}^2 \tag{39}$$

We now compute the welfare loss under the optimal money growth rule relative to the first best.

Define the welfare loss under money growth rate $\tilde{\mu}$, relative to the first-best as¹⁴

$$\Delta W^{\tilde{\mu}} = W^{fb} - W^{\tilde{\mu}}$$

¹³Let $k_0 = 0$. Then, a sufficient condition to ensure that $\mu > 0$ is $\bar{v} < \frac{1}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2}}$. Even for $\lambda = 1$, and a relatively high value of $\frac{\sigma_y^2}{\bar{y}^2} = 0.1$ the above holds if $\bar{v} < 0.99$. (Note that a value of 0.99 implies a velocity of $\frac{1}{1-\bar{v}} = 100$, much higher than empirically observed values.)

¹⁴Superscript $\tilde{\mu}$ denotes variable values under optimal money growth rule.

Observe that the welfare maximizing $\tilde{\mu}$ that is obtained from (35) also minimizes $\Delta W^{\tilde{\mu}}$. In the appendix we show that by substituting in the relevant expressions for $E(c^T)$, $E(c^{NT})$ and $Var[c^{NT}]$ into the welfare loss expression gives

$$\Delta W^{\tilde{\mu}} = \frac{\zeta(1-\lambda)}{1-\beta} \left(\frac{1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2}\right)}{1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2}\right) + \lambda \frac{\sigma_y^2}{\bar{y}^2}} \right) \sigma_y^2 \quad (40)$$

If only one shock is present at a time, then (40) simplifies to

$$\Delta W^{\tilde{\mu}} = \begin{cases} 0; & \text{only velocity shocks } (\sigma_y^2 = 0) \\ \frac{\zeta(1-\lambda)}{1-\beta} \frac{\sigma_y^2}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2}}; & \text{only output shocks } (\sigma_v^2 = 0) \end{cases} \quad (41)$$

Equation (41) shows that when there is no output volatility so that $\sigma_y^2 = 0$, the welfare loss from following the optimal money growth rule is zero. This reflects the fact that under no output shocks the optimal state contingent rule and the optimal non-state contingent money growth rule coincide. They both call for a fixed money rule.

Equation (41) also shows that when there is no volatility in the velocity process, i.e., $\sigma_v^2 = 0$, so that the economy is exposed to only output volatility, the welfare losses from following a non-state contingent money growth rule are increasing in the volatility of output and decreasing in the share of traders λ . Both these comparative static effects are intuitive. The higher is σ_y^2 the greater is the loss from not being able to vary the growth rate of money to better accommodate the state of the economy. On the other hand, the greater is the share of traders in the economy (a higher λ), the closer the economy is to full insurance since the traders can completely insure against all risk. Hence, the smaller are the welfare losses relative to the first-best under the fixed money growth rule.

A special case of the constant money growth rule is the fixed money supply rule, i.e., $\mu = 0$. Hence, money supply is set to \bar{M} for all t . In this case the welfare loss relative to the first-best is:

$$\Delta W^{\bar{M}} = \frac{\zeta(1-\lambda)}{1-\beta} \sigma_y^2$$

Thus,

$$\frac{\Delta W^{\bar{M}}}{\Delta W^{\tilde{\mu}}} = 1 + \lambda \frac{\sigma_y^2}{\bar{y}^2} \geq 1.$$

This expression shows that only in the special case of no output volatility ($\sigma_y^2 = 0$), do we have $\Delta W^{\bar{M}} = \Delta W^{\bar{\mu}} = 0$. In general, a fixed money policy generates welfare losses which are at least as great as those under an optimally chosen constant money growth rule.

3.4 Optimal rate of devaluation

We now turn to our second non-state contingent rule which is a fixed rate of devaluation. This rule is of interest for two reasons. First, a number of developing countries use the exchange rate as a nominal anchor and thereby prefer some sort of exchange rate rule. Second, an exchange rate rule corresponds closely to an inflation targeting policy in this one good world of our model. Needless to say inflation targeting is a policy which is both widely used and discussed in policy circles.

Define $z \equiv \frac{1}{1+\varepsilon} \left(= \frac{S_{t-1}}{S_t} \right)$. As before the optimal z or, equivalently, the rate of devaluation ε is determined by solving (35). Under a constant devaluation rate, equations (18), (23) and (21) imply that consumption of nontraders and traders are given by

$$\begin{aligned} c_t^{NT} &= z(1 - v_{t-1})y_{t-1} + v_t y_t, \quad t \geq 1, \\ c_t^T &= \bar{y} \left[1 + \left(\frac{1-\lambda}{\lambda} \right) (1-z)(1-\bar{v}) \right]. \end{aligned}$$

Hence,

$$Var [c_t^{NT}] = z^2 \sigma_y^2 + (1+z^2) \sigma_{vy}^2 - 2z^2 \bar{v} \sigma_y^2. \quad (42)$$

Given that $\lambda E(c^T) + (1-\lambda) E(c^{NT}) = \bar{y}$, it is still the case that the optimal z (and hence, the optimal rate of devaluation ε) can be derived from the solution to

$$\arg \min_z \left\{ \lambda (E(c^T))^2 + (1-\lambda) (E(c^{NT}))^2 + (1-\lambda) Var [c_t^{NT}] \right\}.$$

The implied optimal rate of devaluation $\hat{\varepsilon}$ is given by

$$\frac{1-\hat{z}}{\hat{z}} = \hat{\varepsilon} = \lambda \left[\frac{\sigma_v^2}{(1-\bar{v})^2} \left(1 + \frac{\sigma_y^2}{\bar{y}^2} \right) + \frac{\sigma_y^2}{\bar{y}^2} \right] \quad (43)$$

Hence, the optimal rate of devaluation is increasing in the variance of both shocks.

There are two special cases which are worth emphasizing. First, when the economy faces no output uncertainty so that the only uncertainty is regarding the velocity realization, i.e., $\sigma_y^2 = 0$, the optimal rate of devaluation implied by equation (43) is

$$\tilde{\varepsilon} = \frac{\lambda \sigma_v^2}{(1 - \bar{v})^2}.$$

Second, when the only uncertainty is about the output realization, i.e., $\sigma_v^2 = 0$, the optimal devaluation rate is

$$\tilde{\varepsilon} = \frac{\lambda \sigma_y^2}{\bar{y}^2}.$$

It is worth pointing out that equation (43) clearly shows that, in general, it is never optimal to set $\varepsilon = 0$, i.e., fixed exchange rates are never optimal. Only in the uninteresting case of no shocks at all in the economy ($\sigma_v^2 = \sigma_y^2 = 0$) is it optimal to peg the exchange rate.¹⁵

3.4.1 Welfare loss relative to the first-best

We next turn to the welfare loss relative to the first best that is implied by following the devaluation rule. The welfare loss expression is $\Delta W^{\tilde{\varepsilon}} = W^{fb} - W^{\tilde{\varepsilon}}$. Substituting the relevant expressions for trader and nontraders consumption, the nontraders variance, and the optimal devaluation rate policy (43) into $\Delta W^{\tilde{\varepsilon}}$ gives

$$\Delta W^{\tilde{\varepsilon}} = \frac{\zeta(1-\lambda)}{1-\beta} \left(\frac{\bar{v}^2 \left(1 + \frac{\sigma_v^2}{\bar{v}^2} \left(1 + \frac{\bar{y}^2}{\sigma_y^2} \right) \right) + \left(1 + \frac{\sigma_v^2}{(1-\bar{v})^2} \left(1 + \frac{\bar{y}^2}{\sigma_y^2} \right) \right)}{(1-\bar{v})^2 \left(1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2} \right) + \lambda \frac{\sigma_y^2}{\bar{y}^2} \right)} \right) \sigma_y^2 \quad (44)$$

If only one shock is present at a time, then (44) simplifies to

$$\Delta W^{\tilde{\varepsilon}} = \begin{cases} \frac{\zeta(1-\lambda)}{1-\beta} \bar{y}^2 \left(1 + \frac{1}{1 + \lambda \frac{\sigma_v^2}{(1-\bar{v})^2}} \right) \sigma_v^2; & \text{only velocity shocks } (\sigma_y^2 = 0) \\ \frac{\zeta(1-\lambda)}{1-\beta} \bar{v}^2 \left(1 + \frac{(1-\bar{v})^2}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2}} \right) \sigma_y^2; & \text{only output shocks } (\sigma_v^2 = 0) \end{cases} \quad (45)$$

¹⁵It would appear from these expressions that a fixed exchange rate is optimal when there are no traders in the economy, i.e., when $\lambda = 0$. However, this conclusion is not valid since the model is discontinuous at $\lambda = 0$. In particular, when there are no traders at all, there is no way for the monetary authority to introduce money into the economy since all money injections, by assumption, are in the asset market. Hence, maintaining a fixed exchange rate by appropriate changes in money supply is not feasible.

A special case of the fixed devaluation rate policy is the policy of a fixed exchange rate, i.e., $\varepsilon = 0$. In this case the welfare loss relative to the first-best is given by

$$\Delta W^{\bar{S}} = \frac{\zeta(1-\lambda)}{1-\beta} \left((1-\bar{v})^2 + \bar{v}^2 + 2\sigma_v^2 \left(1 + \frac{\bar{y}^2}{\sigma_y^2} \right) \right) \sigma_y^2 \quad (46)$$

If only one shock is present at a time, then (46) simplifies to

$$\Delta W^{\bar{S}} = \begin{cases} \frac{\zeta(1-\lambda)}{1-\beta} 2\sigma_v^2 \bar{y}^2; & \text{only velocity shocks } (\sigma_y^2 = 0) \\ \frac{\zeta(1-\lambda)}{1-\beta} \left((1-\bar{v})^2 + \bar{v}^2 \right) \sigma_y^2; & \text{only output shocks } (\sigma_v^2 = 0) \end{cases} \quad (47)$$

3.5 Welfare comparison

It is clear that $\mu = 0$ will always be dominated by an *optimal* μ since the optimal μ is not constrained to be non-zero. Similarly the fixed exchange rate, i.e., $\varepsilon = 0$ will be always be dominated by $\tilde{\varepsilon}$. The question regarding which of these two non-state contingent rules is better from a welfare standpoint still remains to be answered. To address this question it is useful to derive an expression for $\frac{\Delta W^{\tilde{\varepsilon}}}{\Delta W^{\tilde{\mu}}}$. Note that $\frac{\Delta W^{\tilde{\varepsilon}}}{\Delta W^{\tilde{\mu}}} < 1$ implies that a fixed devaluation rate rule will dominate a fixed money growth rule. The opposite holds when $\frac{\Delta W^{\tilde{\varepsilon}}}{\Delta W^{\tilde{\mu}}} > 1$. Using equations (40) and (44) it can be shown that

$$\frac{\Delta W^{\tilde{\varepsilon}}}{\Delta W^{\tilde{\mu}}} \leq 1 \text{ iff} \quad (48)$$

$$\left(\begin{array}{c} \bar{v}^2 \left(1 + \frac{\sigma_v^2}{\bar{v}^2} \left(1 + \frac{\bar{y}^2}{\sigma_y^2} \right) \right) + \\ (1-\bar{v})^2 \frac{\left(1 + \frac{\sigma_v^2}{(1-\bar{v})^2} \left(1 + \frac{\bar{y}^2}{\sigma_y^2} \right) \right)}{1 + \lambda \left(\frac{\sigma_v^2}{(1-\bar{v})^2} \left(1 + \frac{\bar{y}^2}{\sigma_y^2} \right) + \frac{\sigma_y^2}{\bar{y}^2} \right)} \end{array} \right) \leq \frac{1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2} \right)}{1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2} \right) + \lambda \frac{\sigma_y^2}{\bar{y}^2}}$$

While both sides of equation (48) are increasing (decreasing) in velocity (output) shocks, the LHS increases faster than the RHS when σ_v^2 rises. Hence, $\tilde{\mu}$ will dominate $\tilde{\varepsilon}$ when velocity shocks are relatively dominant. On the other hand, the LHS decreases faster than the RHS when σ_y^2 increases. Hence, the desirability of a optimal ε policy will increase with higher output variance. In the limiting case, when only output shocks are present,

$$\frac{\Delta W^{\tilde{\varepsilon}}}{\Delta W^{\tilde{\mu}}} \leq 1 \text{ if and only if } \bar{v}^2 + \frac{(1-\bar{v})^2}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2}} \leq \frac{1}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2}}$$

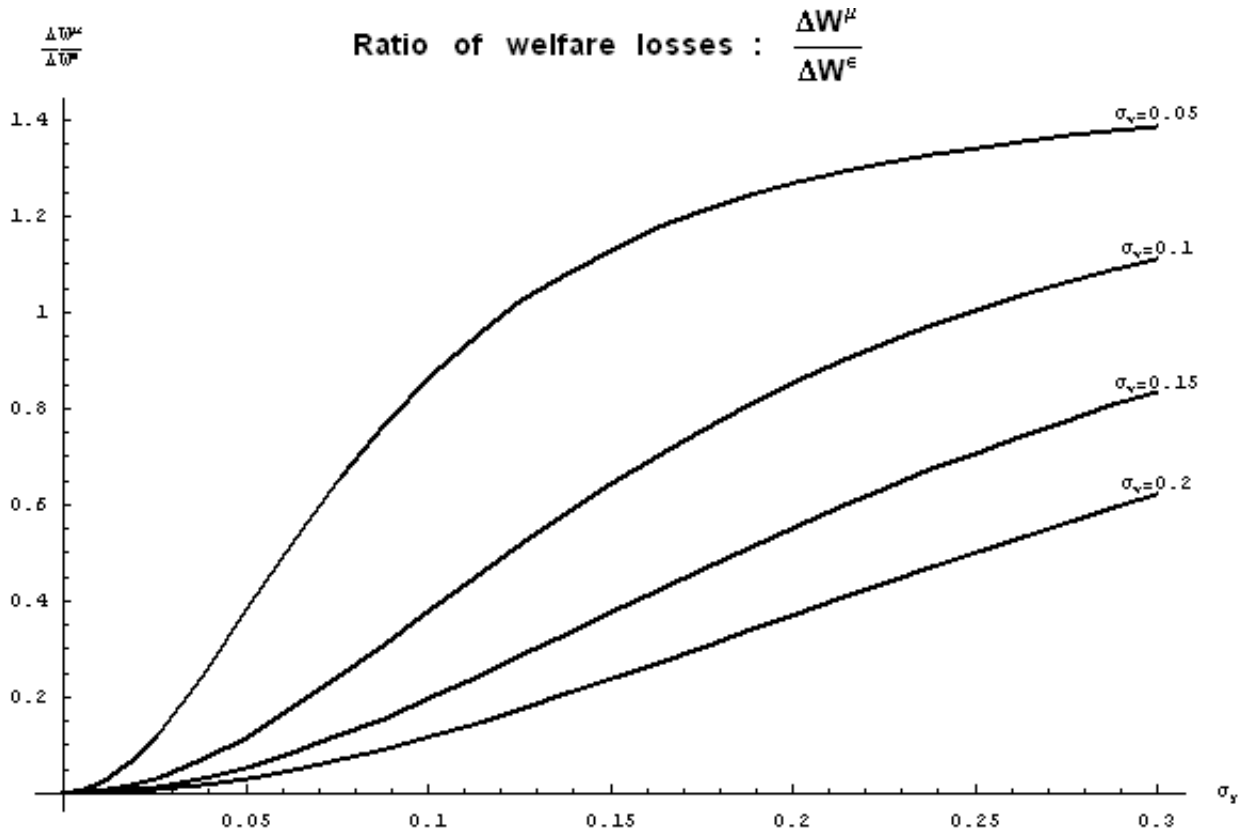


Figure 1: Welfare comparison

Hence, an $\tilde{\varepsilon}$ policy would welfare dominate an $\tilde{\mu}$ policy if and only if

$$\bar{v} \in \left(0, \frac{1}{1 + \frac{\lambda}{2} \frac{\sigma_y^2}{\bar{y}^2}} \right). \quad (49)$$

Figure 1 shows precisely this trade-off through a simulation of the model. It depicts the ratio of the welfare loss (relative to the first best) under optimal μ to the welfare loss under optimal ε . Hence, a value lower than one means that optimal μ delivers higher welfare than optimal ε . The parameters assumed for the simulation are: $\bar{y} = 1$, $\bar{v} = 0.2$, $\lambda = 0.5$, $\beta = 0.97$, $\zeta = 0.15$.¹⁶ For a given σ_v , $\frac{\Delta W^{\tilde{\mu}}}{\Delta W^{\tilde{\varepsilon}}}$ rises with σ_y . Hence, the relative attraction of the fixed devaluation rate

¹⁶We should note that the attempt here is not replicate a specific economy but rather, to determine the qualitative nature of the relationship between the volatility of shocks and the optimal monetary policy regime. We defer till later a discussion about the implications of the model for specific economies.

policy rises with the volatility of output. The figure also shows that for a given σ_y , $\frac{\Delta W^{\bar{\mu}}}{\Delta W^{\bar{\varepsilon}}}$ falls (the schedule shifts down) as σ_v rises. Hence, the money growth rule becomes more attractive as the relative volatility of velocity increases. To summarize, the model predicts that exchange rate targeting rules begin to welfare dominate money growth rules when output shocks become relatively more important while the opposite is true when velocity shocks are relatively dominant.

Since Figure 1 indicates that the welfare comparison depends on both output and velocity volatility, it is useful to focus on some actual numbers for illustration purposes. The following table shows output and velocity volatilities (in percentages) for Argentina, Brazil, and, as a benchmark, the United States.¹⁷ We see that, even in highly volatile countries such as Argentina and Brazil, output volatility is less than 5 percent. It is thus clear from Figure 1 that, given the figures presented in the table, all three countries would be better off with a money growth rule (that allows for exchange rate flexibility) than with a devaluation rule.

Country	Output Volatility	Velocity Volatility
United States	2.05	2.8
Argentina	4.2	11.3
Brazil	3.95	20.6
Note: Figures are expressed as percentages		

4 Macroeconomic Volatility

Another issue of interest is the volatility of different macroeconomic variables that is implied by these alternative monetary regimes. This is of interest both from a policy perspective as well as from the perspective of providing us with some testable implications of the structure. There are three key endogenous macroeconomic variables in the model: consumption, money and the

¹⁷The data for velocity are taken from the IFS. The velocities and their variances have been computed by using nominal GDP and M1. For Argentina and Brazil the data are from 1993Q1- 2003Q2 and for the United States 1970Q1-2003Q2. The figures for output volatility were taken from Talvi and Vegh (2000).

exchange rate (or equivalently, the price level). We look at each of these in turn.

4.1 Consumption variances

It can be verified from equations (36) and (42) that the variances of consumption for nontraders under both $\tilde{\mu}$ as well as $\tilde{\varepsilon}$ are increasing in the variances of output and velocity shocks. However, while consumption variability under $\tilde{\varepsilon}$ grows without bounds, under $\tilde{\mu}$ it stays within bounds. On the other hand, the ratio of the consumption variance under $\tilde{\varepsilon}$ to that under $\tilde{\mu}$ decreases with the variance of output. The consumption variance for nontraders under $\tilde{\varepsilon}$ is lower than under $\tilde{\mu}$ if and only if

$$\bar{v} \in \left(0, \frac{1}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2} + \frac{\lambda^2}{2} \left(\frac{\sigma_y^2}{\bar{y}^2} \right)^2} \right). \quad (50)$$

Although this condition resembles equation (49) which was the relevant condition for comparing welfares, the range under (50) is narrower than in (49). As a result, even though the consumption variance may be higher under $\tilde{\varepsilon}$ in the range $\bar{v} \in \left(\frac{1}{1 + \lambda \frac{\sigma_y^2}{\bar{y}^2} + \frac{\lambda^2}{2} \left(\frac{\sigma_y^2}{\bar{y}^2} \right)^2}, \frac{1}{1 + \frac{\lambda}{2} \frac{\sigma_y^2}{\bar{y}^2}} \right)$, $\tilde{\varepsilon}$ is still preferred to $\tilde{\mu}$. This is because $\tilde{\mu}$ induces a smaller variance at the cost of a larger transfer of consumption to the traders.

4.2 Exchange rate volatilities

A second variable of interest is the volatility of the exchange rate. To get a sense of the implications of different monetary regimes for this volatility, we compare the unconditional variances for the rate of currency depreciation under (1) state-contingent money growth rule, and (2) a fixed money growth rule.

4.2.1 State-contingent rule

Recall that the optimal state contingent money growth rule is given by $\mu_t = \frac{y_t - \bar{y}}{\bar{y} - v_t y_t}$. Substituting this rule into the quantity theory relationship and rearranging the result gives

$$S_t = \frac{M_t}{\bar{y} - v_t y_t}$$

Since $\varepsilon_t = \frac{S_t - S_{t-1}}{S_{t-1}}$, one can use the exchange rate equation derived above to get

$$1 + \varepsilon_t = \frac{S_t}{S_{t-1}} = \frac{(1 - v_{t-1}) y_{t-1}}{\bar{y} - v_t y_t}$$

Taking a second order expansion of this expression around \bar{v} and \bar{y} and then taking expectations yields

$$E \{ \varepsilon_t \} \cong \frac{\sigma_{vy}^2}{\bar{y}^2 (1 - \bar{v})^2} \quad (51)$$

Similarly, a second order approximation for the variance gives

$$Var \{ \varepsilon_t \} \cong \frac{1}{\bar{y}^2 (1 - \bar{v})^2} \left(\sigma_{vy}^2 + (\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2) \left(\frac{\sigma_{vy}^2}{\bar{y}^2 (1 - \bar{v})^2} + \left(1 + \frac{\sigma_{vy}^2}{\bar{y}^2 (1 - \bar{v})^2} \right)^2 \right) \right) \quad (52)$$

4.2.2 Fixed money growth rule

Under a fixed money growth rate μ , the quantity theory relationship implies that the exchange rate is

$$S_t = \frac{(1 + \mu) M_t}{(1 - v_t) y_t}$$

Hence, the rate of depreciation is given by

$$1 + \varepsilon_t = \frac{S_t}{S_{t-1}} = (1 + \mu) \frac{(1 - v_{t-1}) y_{t-1}}{(1 - v_t) y_t}$$

Taking a second order approximation of this equation around \bar{v} and \bar{y} and then taking expectations yields

$$E \{ \varepsilon_t \} \cong \mu + (1 + \mu) \left(\frac{\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2}{\bar{y}^2 (1 - \bar{v})^2} \right)$$

Correspondingly, a second order approximation for the variance gives

$$Var \{ \varepsilon_t \} \cong (1 + \mu)^2 \frac{(\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2)}{\bar{y}^2 (1 - \bar{v})^2} \left(1 + (\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2) \left(\frac{1}{\bar{y}^2 (1 - \bar{v})^2} + \left(1 + \frac{\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2}{\bar{y}^2 (1 - \bar{v})^2} \right)^2 \right) \right) \quad (53)$$

4.2.3 Comparison

Under an optimal fixed money growth rate, $\tilde{\mu} > 0$. Hence, from (52) and (53), a sufficient condition for the variance of the depreciation rate under the optimal fixed money growth rule to be larger

than that under state-contingent rule is $\bar{v} < 0.5$. If this condition holds, then

$$Var_{t-1} \{\varepsilon_t\}_{\bar{\mu}} > Var_{t-1} \{\varepsilon_t\}_{sc} > Var_{t-1} \{\varepsilon_t\}_{\bar{\varepsilon}} = 0$$

4.3 Monetary volatility under various rules

A third variable of interest is the volatility of money. Obviously, the cases to look for are: (1) state-contingent rules and (2) fixed exchange rate regime i.e., $\varepsilon \geq 0$. As before, we compare the volatilities of the implied money growth rates.

4.3.1 State-contingent rule

Since the optimal state contingent rule is $\mu_t = \frac{y_t - \bar{y}}{\bar{y} - v_t y_t}$, to a second order approximation we have

$$E \{\mu_t\} = \frac{\bar{v}}{(1 - \bar{v})^2} \frac{\sigma_y^2}{\bar{y}^2}.$$

Likewise, a second order approximation for the variance yields

$$Var \{\mu_t\} = \frac{1}{(1 - \bar{v})^2} \frac{\sigma_y^2}{\bar{y}^2}. \quad (54)$$

4.3.2 Optimal devaluation rule

Under a fixed rate of devaluation, ε , the implied money growth rate is

$$1 + \mu_t = (1 + \varepsilon) \frac{(1 - v_t) y_t}{(1 - v_{t-1}) y_{t-1}}.$$

Then, taking a second order approximation gives

$$E \{\mu_t\} = \varepsilon + (1 + \varepsilon) \left(\frac{\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2}{\bar{y}^2 (1 - \bar{v})^2} \right),$$

while a second order approximation for the variance yields

$$Var \{\mu_t\} \cong (1 + \varepsilon)^2 \frac{(\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2)}{\bar{y}^2 (1 - \bar{v})^2} \left(\frac{1 + (\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2) *}{\left(\frac{1}{\bar{y}^2 (1 - \bar{v})^2} + \left(1 + \frac{\sigma_{vy}^2 + (1 - 2\bar{v}) \sigma_y^2}{\bar{y}^2 (1 - \bar{v})^2} \right)^2 \right)} \right). \quad (55)$$

4.3.3 Comparison

From (54) and (55), it is clear that when only velocity shocks are present ($\sigma_y^2 = 0$), the state-contingent rule is $\mu = 0$ for all times, and hence monetary volatility under an optimal devaluation rule is the higher. However, when only output shocks are present

$$Var\{\mu_t\}_{sc} \geq Var\{\mu_t\}_{\bar{\varepsilon}} \quad \text{iff} \\ \left(1 + \lambda \frac{\sigma_y^2}{\bar{y}^2}\right) \left(1 + \frac{\sigma_y^2}{\bar{y}^2}\right) \left(1 + \sigma_y^2 (1 - \bar{v})^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2}\right)\right) (1 - \bar{v})^2 \leq 1$$

Clearly, for $\bar{v} = 0$, $Var\{\mu_t\}_{sc} < Var\{\mu_t\}_{\bar{\varepsilon}}$. On the other hand, when $\bar{v} = 1$, $Var\{\mu_t\}_{sc} > Var\{\mu_t\}_{\bar{\varepsilon}}$. Since the LHS is decreasing in \bar{v} , there exists \hat{v} , such that for all $\bar{v} > \hat{v}$, the volatility under state-contingent rule is higher than under optimal devaluation rule. Note that the smaller are σ_y^2 , $\frac{\sigma_y^2}{\bar{y}^2}$, or λ , the smaller will be \hat{v} .

5 Conclusion

This paper has examined optimal monetary policy in the context of a small open economy under asset market segmentation. We have also assumed that traders have access to complete markets. In this context, we have shown that there exist state contingent rules based on either the rate of money growth and the rate of devaluation that can replicate the first best equilibrium. These state contingent rules allow the monetary authority to stabilize non-traders' consumption. While these state contingent rules constitute the natural analytical benchmark, they would be difficult to implement in practice since they require responding to contemporaneous shocks. We therefore examine non-state contingent rules based on either the money supply or the exchange rate and conclude that money supply rules – which allow for exchange rate flexibility – generally dominate exchange rate rules in welfare terms. This would support arrangements that allow for some exchange rate flexibility rather than arrangements based on exchange rate pegs.

An obvious extension of our model would be to investigate the case in which traders face incomplete asset markets. While this will undoubtedly complicate the solution of the model, we believe that our basic results should go through. In addition, we have ignored the issue of

endogeneity of market segmentation. In particular, one would expect that agents endogenously choose to be traders or non-traders with the choice depending on the cost of participating in asset markets as well as the prevailing exchange rate and/or monetary regime. However, we see no reason to believe that this would change our key results. As should be clear from the intuition provided in the paper, what matters for our results is that, at every point in time, some agents have access to assets market while others do not. What particular agents have access to asset markets and whether this group changes over time should not alter the essential arguments. A formal check of this conjecture is left for future work.

6 Appendix

6.1 Welfare loss relative to the first-best under $\tilde{\mu}$

The expected consumption and variances of traders and nontraders are obtained from (33), (34), and (36) as

$$\begin{aligned} c^T &= \left(1 + \left(\frac{1-\lambda}{\lambda}\right) (1-\bar{v}) \frac{\mu}{1+\mu}\right) \bar{y}; \\ E [c_i^{NT}] &= \frac{1+\mu\bar{v}}{1+\mu} \bar{y}; \\ Var [c_i^{NT}] &= \left(\frac{1}{1+\mu}\right)^2 (\sigma_y^2 (1+2\bar{v}\mu) + \mu^2 \sigma_{vy}^2). \end{aligned} \quad (56)$$

Using (56) and (39), we obtain the welfare loss, under $\tilde{\mu}$ as

$$\begin{aligned} \Delta W^{\tilde{\mu}} &= W^{fb} - W^{\tilde{\mu}} \\ &= \frac{\zeta}{1-\beta} (1-\lambda) \left(\frac{1}{1+\tilde{\mu}}\right)^2 \bar{y}^2 \left(\frac{(1-\bar{v})^2}{\lambda} \tilde{\mu}^2 + \frac{\sigma_y^2}{\bar{y}^2} (1+2\bar{v}\tilde{\mu}) + \tilde{\mu}^2 \frac{\sigma_{vy}^2}{\bar{y}^2}\right) \end{aligned}$$

Using (38) in the above expression, and after some algebra we obtain

$$\Delta W^{\tilde{\mu}} = \frac{\zeta}{1-\beta} (1-\lambda) \frac{1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2}\right)}{1 + \frac{\lambda}{(1-\bar{v})^2} \sigma_v^2 \left(1 + \frac{\sigma_y^2}{\bar{y}^2}\right) + \lambda \frac{\sigma_y^2}{\bar{y}^2}} \sigma_y^2$$

which is equation (40) in the main text.

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