Uncertainty Shocks and Monetary Policy Rules in a Small Open Economy

Sargam Gupta
Indian Statistical Institute

Abstract

This paper explores the role of exchange rates (both nominal and real) and monetary policy in amplifying/ stabilizing the real effects of global uncertainty shocks in a small open economy. Post global financial crisis (GFC) of 2008-2009, there has been a surge in the macroeconomics literature on aggregate uncertainty. The recent literature has recognized that global uncertainty shocks reduces private consumption and investment severely in emerging market economies (EMEs). Using data we reproduce stylized facts showing significant movements in exchange rates when EMEs are hit with a global uncertainty shock. We find that interest rate rules under flexible inflation targeting (FIT) regime are ineffective in stabilizing the exchange rates as well as the domestic economy. With interest rate rules there arises trade-off in inflation and output stabilization. Using a small open economy NK-DSGE model, we show that exchange rate rules (ERRs) reduce welfare losses significantly compared to the interest rate rules when an EME is hit with an uncertainty shock. ERRs also reduce variability of exchange rates, inflation and output remarkably. This occurs because exchange rate rules generate a lower risk premium than interest rate rules.

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