Leonardo Auernheimer, joint with Susan George
Crises and Bad Dreams Under a Strict Monetary Rule
Crises and Bad Dreams under a Strict Monetary Rule

Leonardo Auernheimer  
Texas A&M University

and

Susan M. George  
International Monetary Fund

ABSTRACT

Using a simple model, this paper analyzes the response of a strict monetary rule to adverse expectations (bad dreams) and compares it to the response of a nominal exchange rate anchor. We conclude that both systems exhibit a similar "lack of robustness". More specifically, under a monetary rule, an anticipated increase in the money stock, though initially expansionary, becomes contractionary when the adverse expectations are not validated. Further, we explore the effects of those expectations on the government's fiscal position, and find a similar lack of robustness between the two rules. Given these similarities, we hypothesize that much of the criticism of an exchange rate anchor does not consider another strict rule as the alternative, but rather discretion—in which case the debate should be focused on rules versus discretion.

JEL Classification Number: F41