

Floating, Official Dollarization, and Macroeconomic Volatility: An Analysis for the Chilean Economy*

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(Comments are welcome. Please, do not quote.)

Abstract

This paper contrasts the volatility of the main macroeconomic variables of a small open economy in two environments: an official dollarization (OD) scheme and a flexible exchange regime (FER) with inflation targeting (IT). A simple DSGE model calibrated for the Chilean economy is used as a laboratory to study the implications of these regimes on the variances of key variables. Welfare implications are also analyzed for a central bank (CB) that is concerned about output and inflation volatility. The results show that OD implies: (1) higher real volatility due to the absence of countercyclical monetary policy in an economy with price rigidities; (2) lower inflation volatility because of a less volatile foreign interest rate; and (3) from a CB's welfare perspective, OD is dominated by a FER when the CB weighs significantly the deviations of inflation and output from the steady state. Also, OD implies higher fiscal deficit volatility as a consequence of higher tax revenue volatility, and a higher reaction to terms-of-trade shocks.

Keywords: Dollarization, exchange rate regime, real volatility, dynamic equilibrium models, calibration.

JEL classification: E42, E32, E50.

* The views expressed herein are those of the author and do not necessarily represent those of the Central Bank of Chile or its Board.

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