ABSTRACT

The consequences of tight monetary policy are analyzed in an optimizing currency substitution model of a small open economy that operates under an open capital account and a flexible exchange rate. There is a reasonably good fit between the dynamics generated by the model and the stylized facts in the Kenya 1993 and Nigeria 1989-1991 tight-money episodes. The paper’s results shed light on three issues: (i) Why has tight money provoked stupendous increases in inflation and the real interest rate in some episodes? (ii) Is tight money a foolish, unsustainable policy that always worsens the fiscal deficit and raises the inflation rate in the long run? (iii) When the real interest rate rises sharply, how long does it stay high and how much to the capital stock, employment and real output decline?

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