Exchange Rate Misalignment, Capital Flows, and Optimal Monetary Policy Trade-off

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What determines the optimal monetary trade-off between internal objectives (inflation and output gap) and external objectives (competitiveness and trade imbalances) when inefficient capital flows cause exchange rate misalignment and distort current account positions? We characterize this trade-off analytically, using the workhorse model of modern monetary theory in open economies under incomplete markets–where inefficient capital flows and exchange rate misalignments can arise independently of nominal distortions. We derive a quadratic approximation of the utility-based global policy loss function under fairly general assumptions on preferences and openness, and solve for the optimal targeting rules under cooperation. We show that, in economies with a low degree of exchange rate pass-through, the optimal response to inefficient capital inflows associated with real appreciation is contractionary, above and beyond the natural rate: the optimal policy curbs excessive demand at the cost of exacerbating currency overvaluation. In contrast, a high degree of pass-through, and/or low trade elasticities, warrants expansionary policies that lean against exchange rate appreciation and competitive losses, at the cost of inefficient inflation.