

[Exchange Rate Misalignment and External Imbalances: What is the Optimal Monetary Policy Response?](#)

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How should monetary policy respond to capital inflows that appreciate the currency, widen the current account deficit and cause domestic overheating? Using the workhorse open-macro monetary model, we derive a quadratic approximation of the utility-based global loss function in incomplete market economies, solve for the optimal targeting rules under cooperation and characterize the constrained-optimal allocation. The answer is sharp: the optimal monetary stance is contractionary if the exchange rate pass-through (ERPT) on import prices is incomplete, expansionary if ERPT is complete—implying that misalignment and exchange rate volatility are higher in economies where incomplete pass through contains the effects of exchange rates on price competitiveness.

[Technical Appendix](#)