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- HS II (lecture room II)
Institute for Advanced Studies
Stumpergasse 56, A – 1060 Wien
<http://economics.ihs.ac.at/seminars>

JOINT VIENNA MACROECONOMICS SEMINAR

Charles ENGEL,
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“Currency Misalignments and Optimal Monetary Policy: A Reexamination”

Abstract

This paper examines optimal monetary policy in an open-economy two-country world with sticky prices under pricing to market. We show that currency misalignments are inefficient and lower world welfare. We find that optimal policy must target consumer price inflation, the output gap, and the currency misalignment. The paper derives the loss function of a cooperative monetary policymaker and the optimal targeting rules. The model is a modified version of Clarida, Gali, and Gertler's (JME, 2002). The key change is that we allow pricing to market or local-currency pricing and consider the policy implications of currency misalignments. Besides highlighting the importance of the currency misalignment, our model also gives a rationale for targeting CPI, rather than PPI, inflation.