Expectations and Exchange Rate Policy

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Summary

Much of analysis of open economy macroeconomics in the past 30 years has been built on the foundation that exchange rates are asset prices and that some goods prices adjust more slowly than asset prices. If this is true, it means that exchange rates wear two hats: They are asset prices that determine the relative price of two monies, but they also are important in determining the relative prices of goods in international markets in the short run. For example, if export prices are sticky in the exporting currency, then nominal exchange rate movements directly change the terms of trade. While of course the literature has recognized this dual role for exchange rate movements, it has not recognized the implication for exchange-rate or monetary policy.

In this paper we argue that these two alternative roles for the nominal exchange rate may conflict with one another. If news about future asset returns causes movements in current exchange rates, then when nominal prices are slow to adjust, this may cause changes in current relative goods prices that have no efficiency rationale. In this sense, anticipations of future shocks to fundamentals can cause current exchange rate misalignments. Friedman's (1953) case for unfettered flexible exchange rates is overturned when exchange rates are asset prices. We outline a series of models in which an optimal policy eliminates the effects of news on exchange rates.