Abstract:

This paper re-examines the merits of including an exchange rate response in Taylor-type interest rate rules for small open economies. Taylor (2001) and Taylor and Williams (2011) express what has been the conventional view: inclusion of the real exchange rate will either add little or might negatively affect the rule's performance. We argue that developments in the theory of optimal monetary policy for open economies taken together with increased instability in world financial markets warrant a re-examination of the issue. Examining three flexible inflation targeting strategies, we find that a small weight on real exchange rate stability in the loss function is sufficient to improve the performance of Taylor-type rules relative to optimal policy. Gains are substantial for domestic and REX inflation targets because a small weight on real exchange rate fluctuations inhibits the aggressive use of the policy instrument under optimal policy. As real exchange rate stability is a built-in feature of a CPI inflation objective, the gains under a CPI inflation target are considerably lower. A central bank that values real exchange rate stability and follows a Taylor-type rule should respond to the real exchange rate. Doing so reduces relative losses irrespective of the specification of the inflation objective. Only a complete disregard for exchange rate stability bears out the view that there is no substantive role for the real exchange rate in Taylor-type rules.