Expenditure Switching vs. Real Exchange Rate Stabilization: Competing Objectives for Exchange Rate Policy

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Summary

This paper develops a view of exchange rate policy as a trade-off between the desire to smooth fluctuations in real exchange rates so as to reduce distortions in consumption allocations, and the need to allow flexibility in the nominal exchange rate so as to facilitate terms of trade adjustment. The first objective arises because of the presence of slow consumer good price adjustment in response to nominal exchange rate shocks, due to local currency pricing. The second objective arises due to the pass-through of nominal exchange rate changes into prices of imported intermediate goods. We show that optimal nominal exchange rate volatility will reflect these competing objectives. The key determinants of how much the exchange rate should respond to shocks will depend on the extent and source of price stickiness, as well as the elasticity of substitution between home and foreign goods. Quantitatively, we find the optimal exchange rate volatility should be significantly less than would be inferred based solely on terms of trade considerations. Moreover, we find that the relationship between price stickiness and optimal exchange rate volatility may be non-monotonic.