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Summary of
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External Shocks and Inflation in Developing Countries
Under a Real Exchange Rate Rule

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This paper examines the response of a small open developing economy to external shocks when the authorities target the real exchange rate. It shows that, under these circumstances, real external shocks alter the economy's long-run inflation rate, unlike when a fixed exchange rate or preannounced crawling peg is in place. Under real exchange rate targeting, the "expenditure-switching" function of changes in the real exchange rate is replaced by an "expenditure-reducing" function of changes in the inflation rate and, hence, in the inflation tax. In addition, the paper argues that choosing an appropriate level at which to target the real exchange rate--that is, one that avoids destabilizing the price level in the face of shocks--is no easy matter because it requires detailed knowledge of a range of parameters and structural relationships, which the authorities are unlikely to possess.

The paper then asks whether or not monetary policy can mitigate the destabilizing effects of shocks under real exchange rate targeting. It finds that money cannot replace the exchange rate as a nominal anchor for the domestic price level, irrespective of the degree of capital mobility. This conclusion is shown to apply over all time horizons, except possibly over the very short run.