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James Staveley-O'Carroll, Olena M. Staveley-O'Carroll

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# Exchange Rate Targeting in the Presence of Foreign Debt Obligations

James Staveley-O'Carroll*    Olena M. Staveley-O'Carroll†

Babson College    College of the Holy Cross

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**Abstract**

We study the impact of foreign debt on the optimal degree of trade-off between the three open economy objectives of the central bank—the desire to smooth exchange rate fluctuations to promote consumption risk sharing, the need for exchange rate flexibility to facilitate expenditure-switching in the face of sticky prices, and the incentive to tilt international prices so as to lower the labor effort of domestic households (terms-of-trade externality)—in a two-country productivity-shock-driven DSGE model with incomplete asset markets and deviations from purchasing power parity. We find that high levels of net foreign debt call for a policy with a significant degree of exchange rate management, which can constrain the extent of otherwise inefficient cross-border wealth transfers that arise due to debt valuation and risk premium effects. In particular, the central bank can improve consumer welfare by up to 0.1 percent of steady state consumption by responding to exchange rate fluctuations when domestic debt-to-GDP ratio reaches 100 percent. We also find that the ranking of optimal policy rules depends on the elasticity of import-export substitution. When home and foreign goods are complements, the responsiveness of the real exchange to shocks is muted, in turn mitigating the excessive cross-country wealth transfer associated with the debt valuation effect. In this case, CPI targeting outperforms the nominal peg at high levels of debt by improving international risk sharing.

Key words: international risk sharing, foreign debt, optimal monetary policy, exchange rate targeting.

JEL classification: E52, F32, F41

* Economics Division, Westgate Hall, Babson College, 231 Forest Street, Babson Park, MA 02457. Email: jstaveleyocarroll1@babson.edu

† Corresponding author. Department of Economics and Accounting, Box 45A, College of the Holy Cross, One College Street, Worcester, MA 01610. Email: omykhayl@holycross.edu



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