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Author: Juan A. Lafuente Rafaela Perez Jesús Ruiz

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Monetary policy regimes and the forward bias for foreign exchange *

Juan A. Lafuente

University Jaume I, Department of Finance and Accounting,
12071 Castellón (SPAIN), e-mail: lafuen@cofin.uji.es

Rafaela Perez

University Complutense, Department of Economic Analysis I
Campus de Somosaguas, 28223, Madrid (SPAIN)
e-mail: rmperezs@ccee.ucm.es

Jesús Ruiz[†]

University Complutense, Department of Quantitative Economics
Campus de Somosaguas, 28223, Madrid (SPAIN)
e-mail: jruinzand@ccee.ucm.es

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Abstract

This paper provides a theoretical discussion of the forward premium anomaly. We reformulate the well-known Lucas (1982) model by allowing for the existence of monetary policy regimes. The monetary supply is viewed as having two stochastic components: a) a persistent component that reflects the preferences of the central bank regarding the long-run money supply or inflation target, and b) a transitory component that represents short-lived interventions. To generate agents' forecasts, we consider two scenarios: a) consumers can distinguish the permanent and the transitory components of the money supply (complete information), and b) consumers face a signal-extraction problem to disentangle permanent and transitory components of the money supply (incomplete information). We simulate the model from a careful estimate of the parameters involved

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[†]Corresponding author

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