

## Economics Seminar, Indian Statistical Institute, New Delhi

SPEAKER: Sanchita Mukherjee, University of California, Santa Cruz

TITLE: The Effects of Capital Market Openness on Exchange Rate Pass-through and Welfare in an Inflation-Targeting Small Open Economy

DAY AND DATE: 3:30 PM, Tuesday, 25th January, 2011

VENUE: Seminar Room 2, ISI Delhi

### ABSTRACT

This paper analyzes the impact of capital market openness on exchange rate pass-through and subsequently on the social loss function in an inflation targeting small open economy under a pure commitment policy. Applying the intuition behind the macroeconomic trilemma, the author examines whether a more open capital market in an inflation-targeting country improves the credibility of the central bank and consequently reduces exchange rate pass-through. First, the effect of capital openness on exchange rate pass-through is empirically examined using a New Keynesian Phillips curve. The empirical investigation reveals that limited capital openness leads to greater pass-through from the exchange rate to domestic inflation, which raises the marginal cost of deviation from the inflation target. This subsequently worsens the inflation output-gap trade-off and increases the social loss of the inflation targeting central bank under pure commitment. However, the calibration results suggest that the inflation output-gap trade-off improves and the social loss decreases even in the presence of larger exchange rate pass-through if the capital controls are effective at insulating the exchange rate from interest rate and risk-premia shocks.