

# **Simple Rules of the Monetary Policy and Incomplete Exchange Rate Pass-Through**

**Walid Y Alali\***

*University of Oxford – Economic Department, Manor Road Building, OX1 3UQ  
Oxford, United Kingdom*

October 2012

## **Abstract**

The performance of various monetary rules is investigated in an open economy with incomplete exchange rate pass-through. Implementing monetary policy through an exchange-rate augmented policy rule does not improve social welfare compared to using an optimized Taylor rule, irrespective of the degree of pass-through. However, an indirect exchange rate response, through a policy reaction to Consumer Price Index (CPI) inflation rather than to domestic inflation, welfare-enhancing in all pass-through cases. This result is moreover independent of whether society values domestic or CPI inflation stabilization. The only case where a direct real exchange rate response is slightly welfare improving occurs when the other reaction coefficients, on inflation and output, are sub-optimal.

**Keywords:** Exchange rate pass-through, monetary policy, simple policy rules, small open economy, Taylor rule

**JEL-Classification:** E52, E58, F41