

## **Managed Floating: Theory and Practice**

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Abstract:

Although there seems to be a broad consensus among economists that purely floating or completely fixed exchange rates (the so-called corner solutions) are the only viable alternatives of exchange rate management, many countries do not behave according to this paradigm and adopt a strategy within the broad spectrum of exchange rate regimes that is limited by the two corner solutions. These intermediate regimes are characterized by significant foreign exchange market interventions of central banks and a certain degree of exchange rate flexibility with non-preannounced exchange rate targets. While academic research in this area usually concentrates on some specific aspects of intermediate regimes (such as the effectiveness of interventions or institutional aspects), managed floating has rarely been analyzed as a comprehensive monetary policy strategy. In this paper, we present a monetary policy framework in which central banks simultaneously use the exchange rate and the interest rate as operating targets of monetary policy. We explain the mechanics of foreign exchange market interventions and sterilization and we explain why a central bank has an interest of controlling simultaneously the two operating targets. We derive the monetary policy rules for the two operating targets from a simple open economy macro model in which the uncovered interest parity condition and the Monetary Conditions Index play a central role.

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