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| **Report No.** | HIAS-E-38 |
| **Title** | Trend Inflation and Exchange Rate Dynamics:<br>A New Keynesian Approach |
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| **Abstract** | The paper studies exchange rate implications of trend inflation within a two-country New Keynesian (NK) model under incomplete international financial markets. A NK Phillips curve generalized by trend inflation with a positive long-run mean implies an expectational difference equation of inflation with higher-order leads of expected inflation. The resulting two-country inflation differential is smoother, more persistent, and more insensitive to a real exchange rate. General equilibrium then yields (i) a persistent real exchange rate with an autoregressive root close to one, (ii) a hump-shaped impulse response of a real exchange rate with a half-life longer than four years, (iii) a volatile real exchange rate relative to cross-country inflation differential, (iv) an almost perfect co-movement between real and nominal exchange rates. and (v) a sharp rise in the volatility of a real exchange rate from a managed nominal exchange rate regime to a flexible one within an otherwise standard two-country NK model. Trend inflation, therefore, approaches empirical puzzles of exchange rates dynamics. |
| **Keywords** | Real and Nominal Exchange Rates, Trend Inflation, New Keynesian Models |
| **JEL** | E31, E52, F31, and F41 |