Identifying the Effects of Simultaneous Monetary Policy Shocks. Fear of Floating under Inflation targeting

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Many central banks, particularly in the developing world, aim for exchange rate stability as a macroeconomic goal. However, most are reluctant to relinquish monetary policy autonomy, so they end up operating through both interest rate and foreign exchange interventions. But the use of multiple policy instruments does not necessarily equip monetary authorities with better tools to achieve their targets. On the contrary, their effects can potentially offset each other. Using daily data from the Central Bank of Colombia during the period of 1999-2012, I study the effects of simultaneous policies by first deriving new measures of monetary shocks and then determining their impact on economic activity. The main findings indicate that (i) while interest rate interventions have a significant impact on real and nominal variables, foreign exchange interventions tend to have limited effects; and (ii) empirical anomalies, such as the price puzzle, are eliminated when properly accounting for the systematic responses of policy.

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