would need to adjust to maintain the parity between domestic and foreign interest rates.

On the other hand, if the country chooses to fix the exchange rate, it would loose control over domestic interest rates. The interest parity need not hold exactly if some premium is required to compensate for the risk associated with unexpected exchange rate movements. However, the determinants of the risk premium are not sufficiently well understood for policy makers to manipulate the premium to gain an extra degree of freedom. Consequently, we will ignore the role of risk premium in interest parity in our discussion of policy constraints. We first consider flexible exchange rates and then examine two varieties of fixed exchange rates.

2.2. Managed Flexible Exchange Rates

Under a pure flexible exchange rate system, the price of a country's currency is determined exclusively by market forces. In practice, however, this system is "managed" in that the central bank intervenes in the exchange market from time to time to influence the path of this price. Flexible exchange rates allow a country monetary independence to set its short-term interest rate at the desired level. However, the independence is significantly limited by the parity relation. Suppose, for example, that the country wants to achieve a domestic interest rate that is one percent below the international level. This objective can be met and be consistent with interest parity condition, provided the exchange rate changes and generates an expectation of one percent appreciation of domestic currency (or equivalently, one percent depreciation of foreign currency). The well-known "overshoot" model developed by Dornbusch suggests that the price of foreign currency in this case would rise sharply above its long-run value to induce expectations that it would depreciate by the required amount.[5]

Even if a country keeps its interest rate tied to the foreign rate, the exchange rate could still fluctuate widely because of shifts in expectations of its future values.

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[5] Rudiger Dornbusch, "Expectations and Exchange Rate Dynamics", **Journal of Political Economy**, 84, 1976, 1161-76.