The Case of Flexible Exchange Rates in a Grate Recession

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Summary of the paper

Key Message

...[T]he risk of another great recession strengthens the case for flexible exchange rates.

Praise

- Very nice reading!
- Conveys intuition through simple analytical results, corroborated by more general numerical results
- Sheds more light on the role of exchange rates as shocks absorbers
- Contributes to current debate on fiscal expansions, sovereign risks and exchange rates

Analytical results

- Comparison of three policy environments
- under two dimensions: contractionary foreign demand shock and domestic spending shock

	Demand shock	G. spending multiplier
	Effect on Domestic Output	
Flexible	Mild $(-1, 0)$	< 1
ZLB	Large (< -1)	> 1
Peg	Worse than ZLB	< 1
	Effect on FX	
Flexible	Depreciation	Appreciation
ZLB	Depreciate by less	Depreciation

Extentions: Numerical results

- Quantification of effects: Large depreciation; larger GDP contraction with Peg
- Interesting extension: Sovereign risk and fiscal policy.
  - Risk further depresses domestic demand (increase saving)
  - Noticeable effect of G-spending & risk: Under float and sov. risk FX depreciates (output improves slightly).
  - Yet consumption contracts much more.

Discussion
(Trivia)

General point

- Received wisdom: Floating exchange rates help absorbing shocks if have nominal rigidities
- Yet there are relatively few currencies around.
- Costs and benefits of independent currencies...
- What are the costs?

General point

- Do exchange rates do their job? Are they a fix or a source of problems?
- Exchange-rate disconnect (and all the nice puzzles in international finance)...
  - Extreme scenario: Nominal exchange rates have a life on their own
  - Less extreme scenario: Most of the volatility of FX is not efficient
  - In particular: "efficiency" could depend on source of shocks!
- Is managed float the answer?


THE LIVES
OF
OTHERS

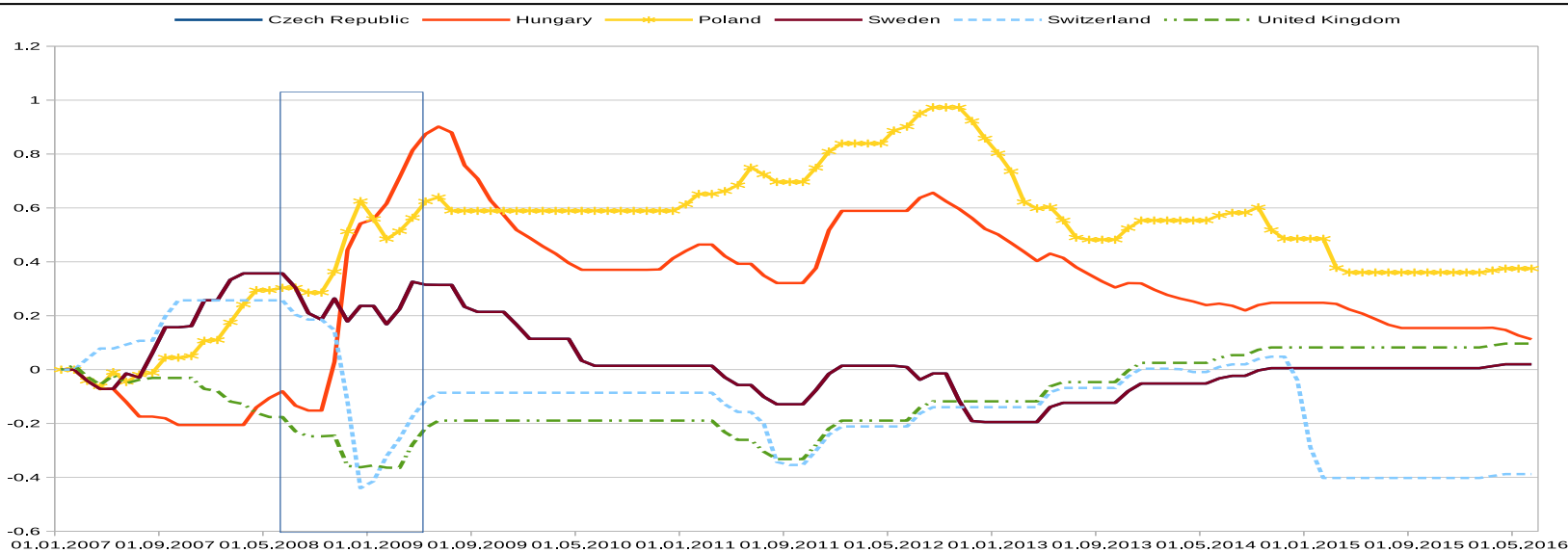
The story seen from the other side

- A globally integrated economy is hit by a contractionary shock
- The ZLB is reached, demand falls sharply
- Policymakers intervene
  - Fiscal expansions, asset purchase programs, forward guidance, negative rates, long term lending, QE, QQE... helicopter money?
- Tides and ebbs of international capital flows
- What does the FX do?

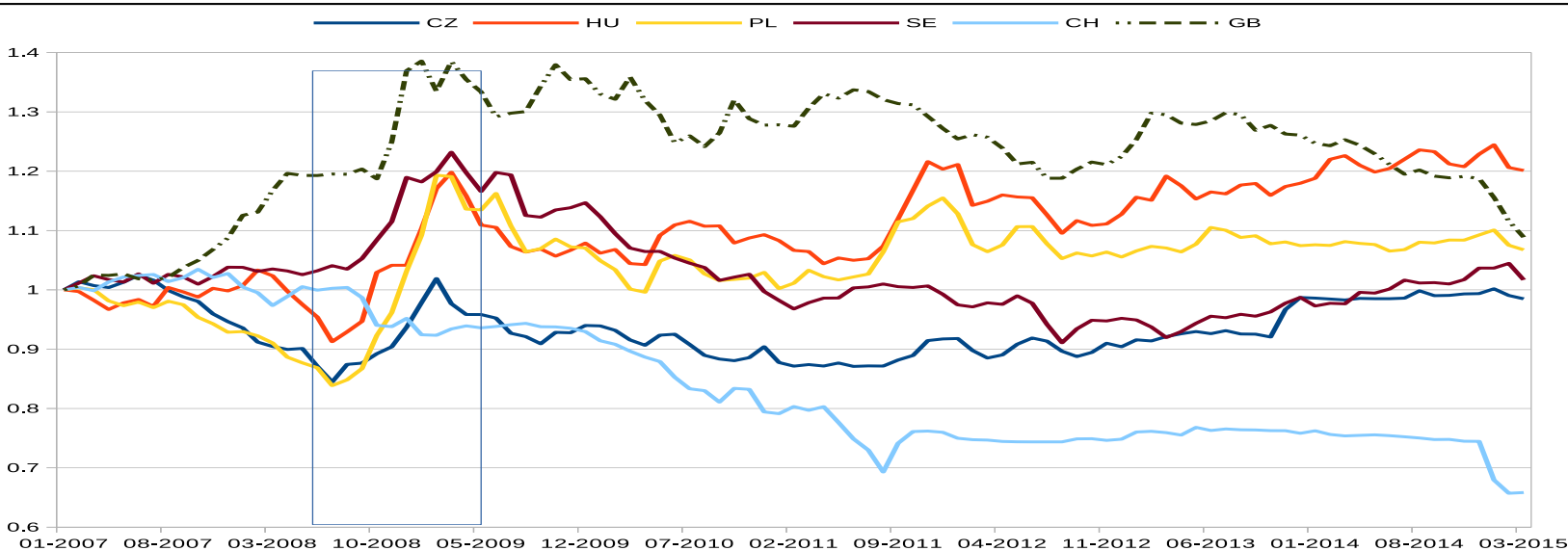
Policy accommodating FX pressure? Resisting it?

- Future work could allow for two key channels
  1. Financial intermediation and capital flows
  2. Unconventional monetary policies

Policy Rates vs ECB-MRO



Currrency vs Euro



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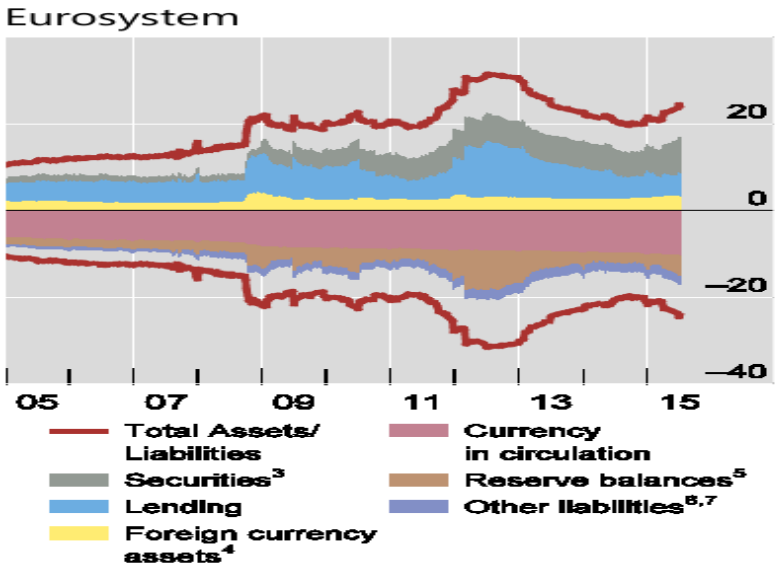
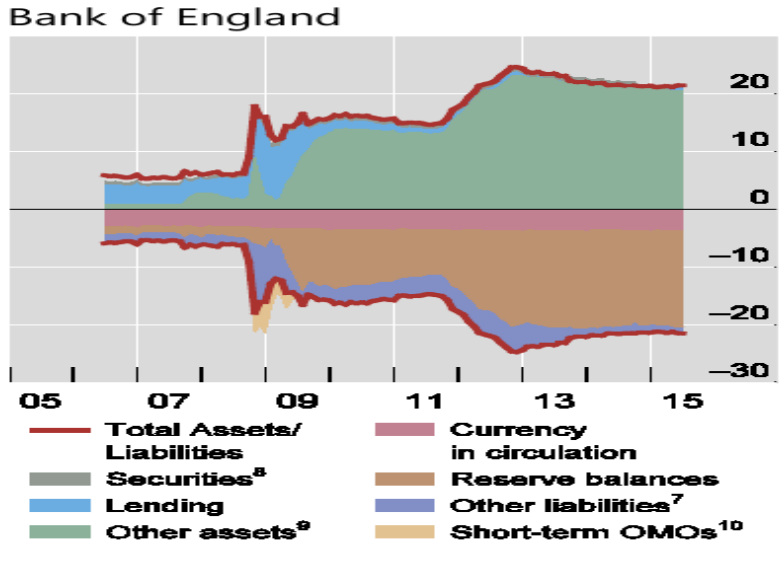
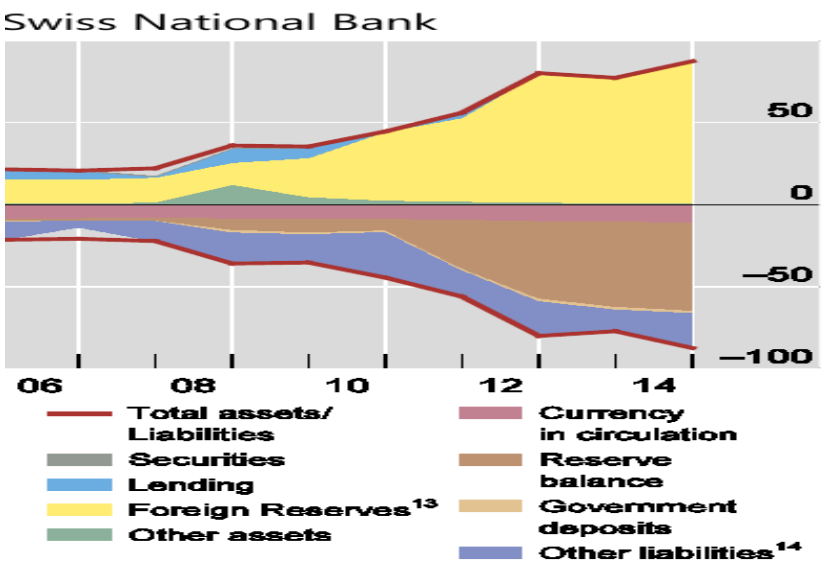
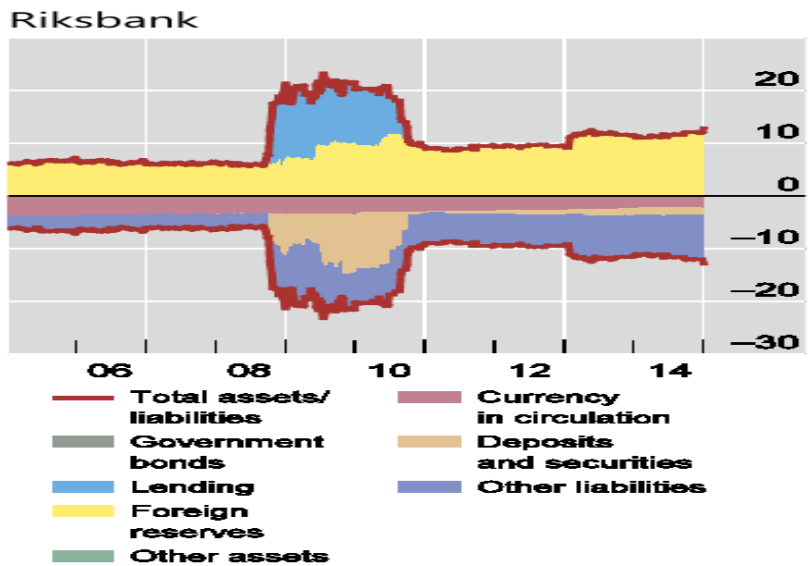

Eurosystem
20
0
−20
−40
05
07
09
11
13
15
Total Assets/ Liabilities
Securities[3]
Lending
Foreign currency assets[4]
Currency in circulation
Reserve balances[5]
Other liabilities[6,7]


Bank of England
20
10
0
−10
−20
−30
05
07
09
11
13
15
Total Assets/ Liabilities
Securities[8]
Lending
Other assets[9]
Currency in circulation
Reserve balances
Other liabilities[7]
Short-term OMOs[10]


Swiss National Bank
50
0
−50
−100
06
08
10
12
14
Total assets/ Liabilities
Securities
Lending
Foreign Reserves[13]
Other assets
Currency in circulation
Reserve balance
Government deposits
Other liabilities[14]


Riksbank
20
10
0
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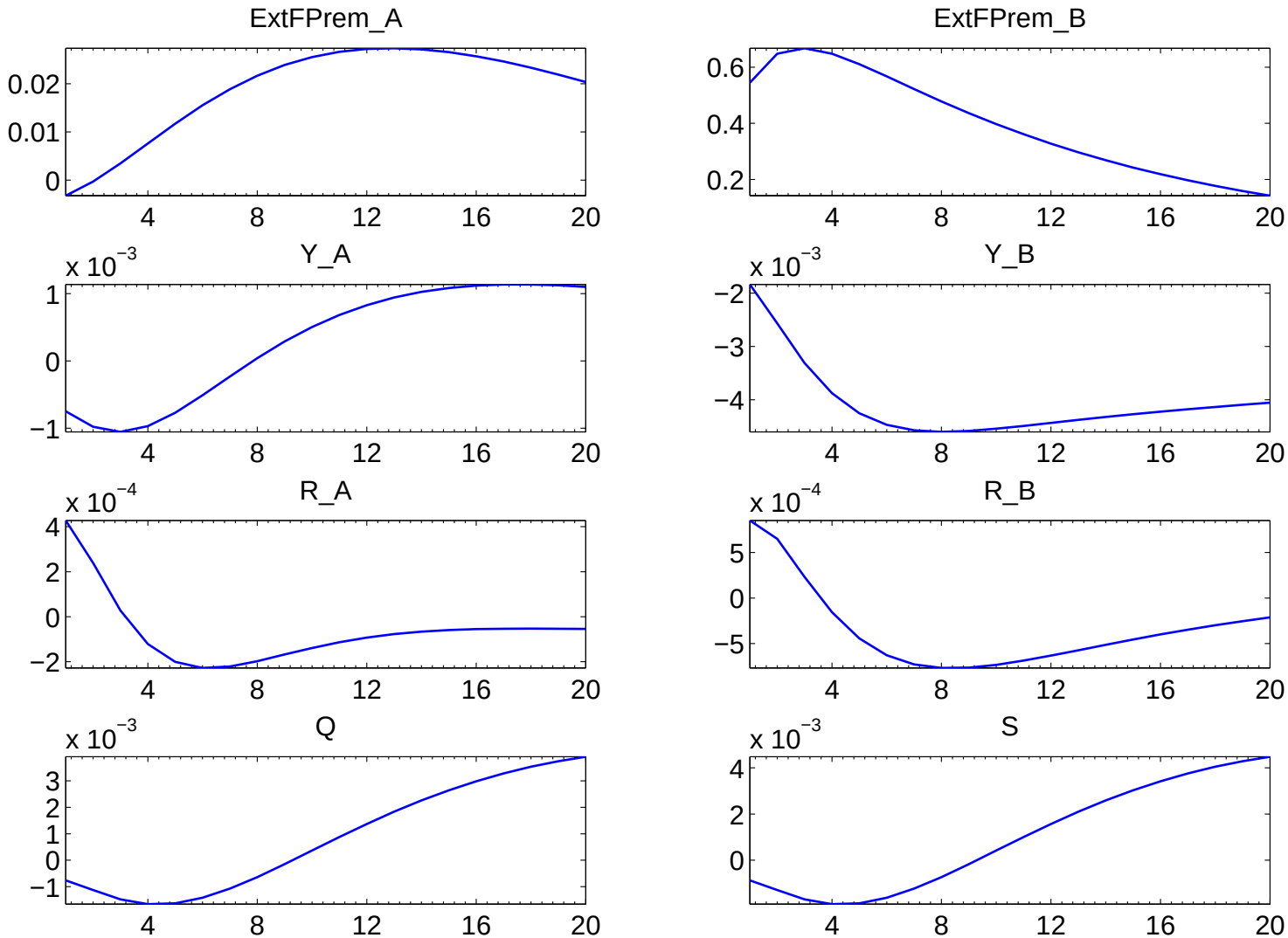
−20
−30
06
08
10
12
14
Total assets/ liabilities
Government bonds
Lending
Foreign reserves
Other assets
Currency in circulation
Deposits and securities
Other liabilities

Finance and exchange rates

- What if foreign shock is not a preference shock? What if it is a financial shock?
- FX adjustment could go either way:
  - Devereux et al. 2016: Smaller economy more vulnerable than epicenter: Optimal FX appreciates on impact; Taylor-FX depreciates
  - Kolasa-Lombardo 2014: Smaller country same frictions as large: FX appreciates persistently
- could this matter?

Foreign NW shock (KL)



Beggar thy neighbor depreciation

- So, is the SOE result pointing to competitive devaluations?
- Or are the results pointing to "regional devaluations" (coalitions): e.g. should the whole EMEs try to devalue?
- If so, can we still call the region SOE?
- What about the EMU?

Trade and exchange rates

- Even leaving out financial frictions the structure of production (e.g. GVCs) could play important role
- (e.g. Lombardo-Ravenna, 2014)

$$\mathcal{E} = -\frac{1}{\gamma_v}\varepsilon_{P_H^*} + \frac{1-\gamma_v}{\gamma_v}\varepsilon_{P_M^*}$$

Quibble: The magic of expectations

- This class of models, without financial frictions, generates the Forward Guidance Puzzle (Del Negro et al. 2016)
- Extending the ZLB beyond its natural path can have unrealistic positive effects
- In the model ZLB is not really a constraint for a credible central bank
- Fiscal policy works through expectations too.
- If take that seriously, why not considering forward guidance? Helicopter money?

Conclusion

- This was a very instructive reading
- Other things equal, at the ZLB, floating FX is particularly beneficial
- A peg greatly reduces the effectiveness of fiscal policy
- It calls for further research on the costs of floating exchange rates
- It suggests to me that policy prescription is managed float
- Assume social preferences favor a monetary union: Which policies would improve allocations?