

The Case of Flexible Exchange Rates in a Grate Recession

Giancarlo Corsetti Keith Kuester Gernot J. Müller

Discussion by
Giovanni Lombardo
BIS

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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 |

Extensions: 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?**



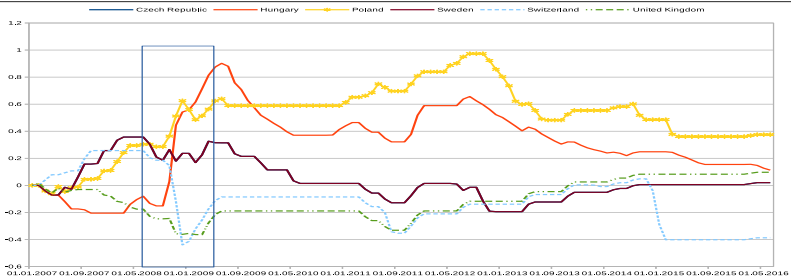
The story seen from the other side

- ▶ 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?**

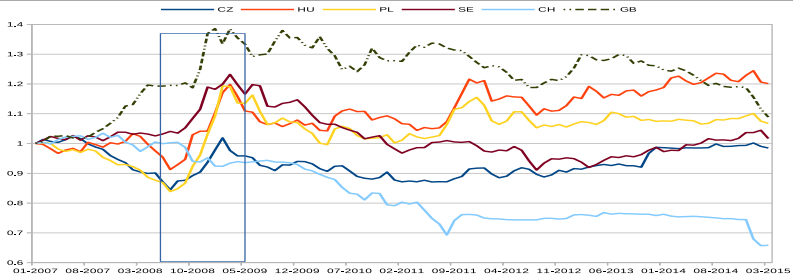
Policy accommodating FX pressure? Resisting it?

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

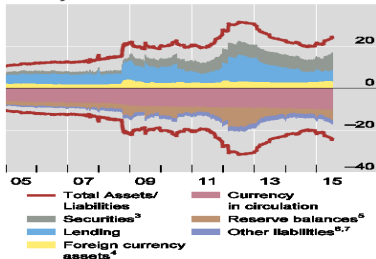
Policy Rates vs ECB-MRO



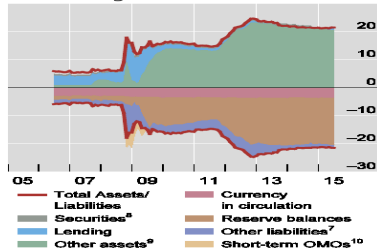
Currency vs Euro



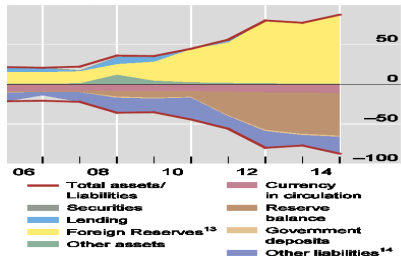
Eurosystem



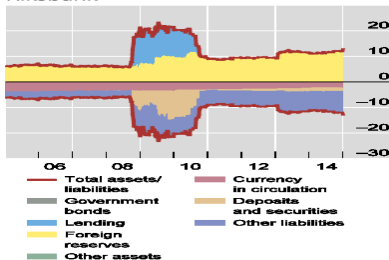
Bank of England



Swiss National Bank



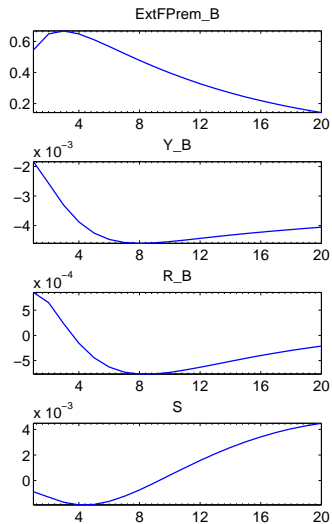
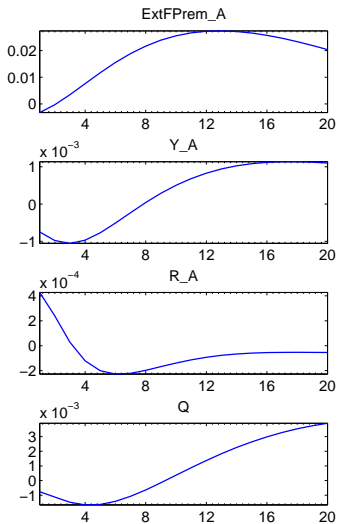
Riksbank



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?