Comments of “Direct and Spillover Effects of Unconventional Monetary and Exchange Rate Policies”

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Discussion on “Direct and spillover effects of unconventional monetary and exchange rate policies”

Carlos Vegh
Johns Hopkins University and NBER

Annual Research Conference (IMF)

November 6, 2015
Questions

- What are the effects of unconventional monetary policy on the current account?

- What are the effects of unconventional exchange rate policy on the current account?

- What are the effects of U.S. unconventional policy announcements on foreign financial prices?
QE (purchases of domestic assets):

- No effect on current account when capital mobility is high
- Small (but significant) positive effect when capital mobility is low

Official purchases of NFA:

- Large positive effect on current account when capital mobility is low
- Effect becomes smaller (but remains significant) as capital mobility rises
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Main comments: Basic theory to the rescue!

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- Not really ....
- A simple sticky prices model (with no imperfect substitution) can explain their “puzzling” QE results.
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You do need imperfect substitution if you want an independent role for $M$ and $i$
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A simple sticky prices model (with no imperfect substitution) can explain their “puzzling” QE results

You do need imperfect substitution if you want an independent role for $M$ and $i$

Forex intervention also has effects even under perfect asset substitution
QE: An old analytical friend

QE is really an increase in $M$, which is the first shock we used to analyze in theoretical models!
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- Take a simple, standard, microfounded, Keynesian model:
  - Small open economy

Suppose permanent increase in $M$. What happens?

- Real depreciation
- Increase in consumption/output of non-tradables
- No effect on current account!

Perfect capital mobility is critical to the result.
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  - **Flexible exchange rates**
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\frac{c_t^T}{c_t} = \frac{c_t^N}{e_t}
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$$c^T_t = \frac{c^N_t}{e_t}$$

- With imperfect capital mobility, the current account would change
In search for conventional and unconventional policies

- To have a role for both $M$ and $i$, you do need imperfect substitution (Calvo-Vegh, EJ 1996).
In search for conventional and unconventional policies

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- How does it work?

$$M = H + Z$$

where $H$ is high-powered money and $Z$ is a highly liquid bond, with policy interest rate $i^Z$. 
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- But effects of $M$ would be very similar to previous model
In same model, suppose a fall in world real interest rates, and forex intervention on impact.
Foreign exchange market intervention

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Foreign exchange market intervention

- In same model, suppose a fall in world real interest rates, and forex intervention on impact.
  - Makes the initial real appreciation less pronounced
  - Trade balance (CA) falls by less than it would otherwise

What is “unconventional” about it?

Overwhelming evidence that international reserves are procyclical
- Countries buy forex to avoid too much appreciation in good times
- Countries sell forex to avoid too much depreciation in bad times
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(Annual Research Conference (IMF) Discussion Bayoumi et al) November 6, 2015
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- More thought needs to go into interpreting results
Figure 2. Permanent increase in money supply

A. Money supply

B. Real money balances

C. Inflation rate

D. Real exchange rate

E. Consumption of non-tradables

F. Domestic real interest rate
Fall in world real interest rate

Figure 15. Temporary fall in world real interest rate under flexible rates with intervention (non-separable)

A. World real interest rate
B. Consumption of tradables
C. Trade balance
D. Consumption of non-tradables
E. Real money balances
F. Inflation of non-tradables
G. Real exchange rate
H. Net foreign debt