# Discussion of Amador, Bianchi, Bocola and Perri's "Exchange Rate Policies at the Zero Lower Bound"

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# Introduction

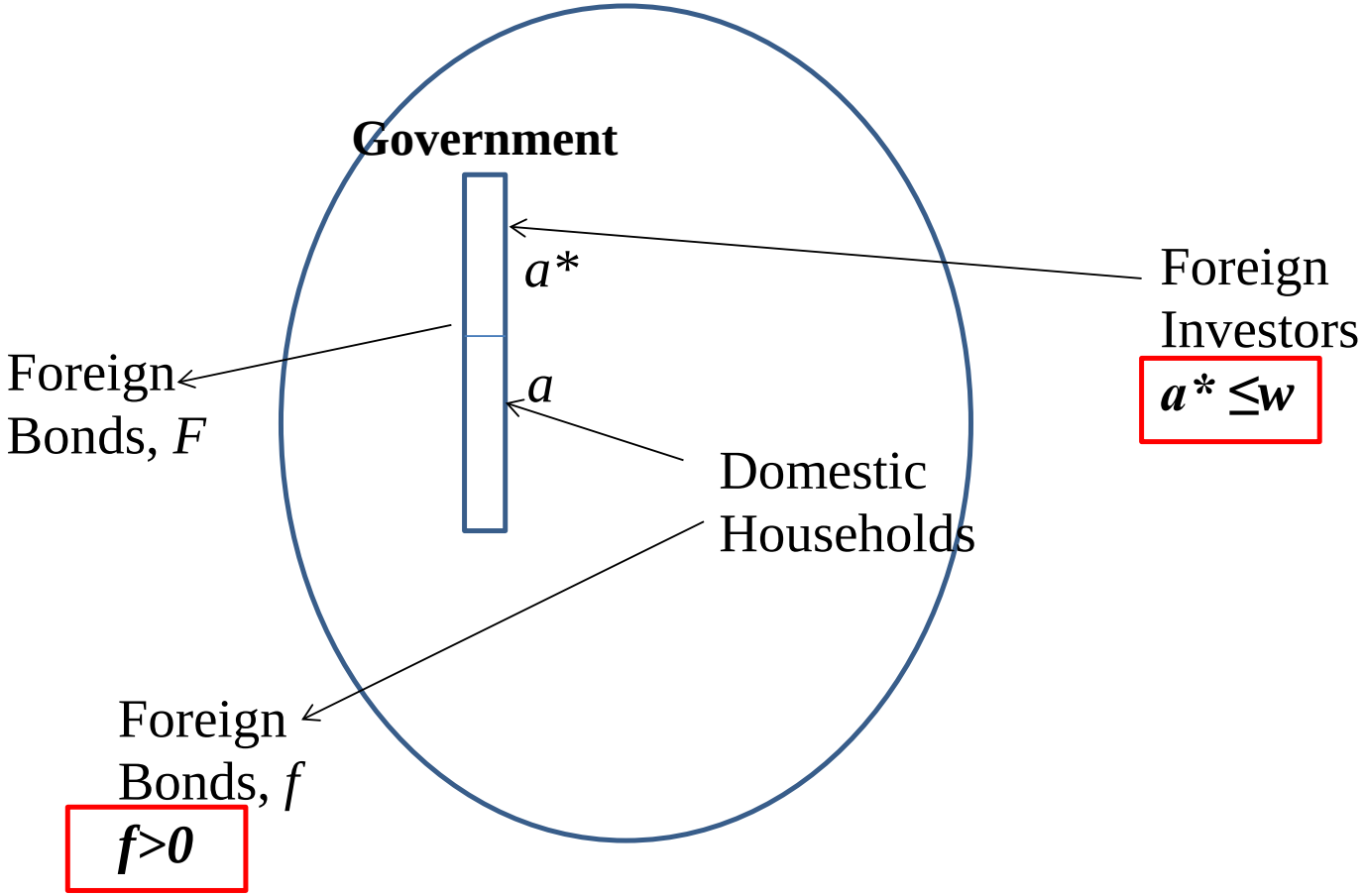
- This paper is about foreign exchange interventions at the ZLB
  - a case of sterilized intervention (in the sense of keeping the interest rate constant)
- The conventional wisdom used to be that sterilized interventions do not work
- This is revised: both on empirical and theoretical fronts
  - empirics: Adler, Blanchard and Carvalho-Filho (2015), Bayoumi, Gagnon and Saborovski (2015), Choi and Taylor (2017), etc.
  - theory: Cavallino (2017), Cespedes, Chang and Velasco (2017), Fanelli and Straub (2017), Jeanne (2013), etc.

# Introduction

- I like the paper
- Summary
- Comments

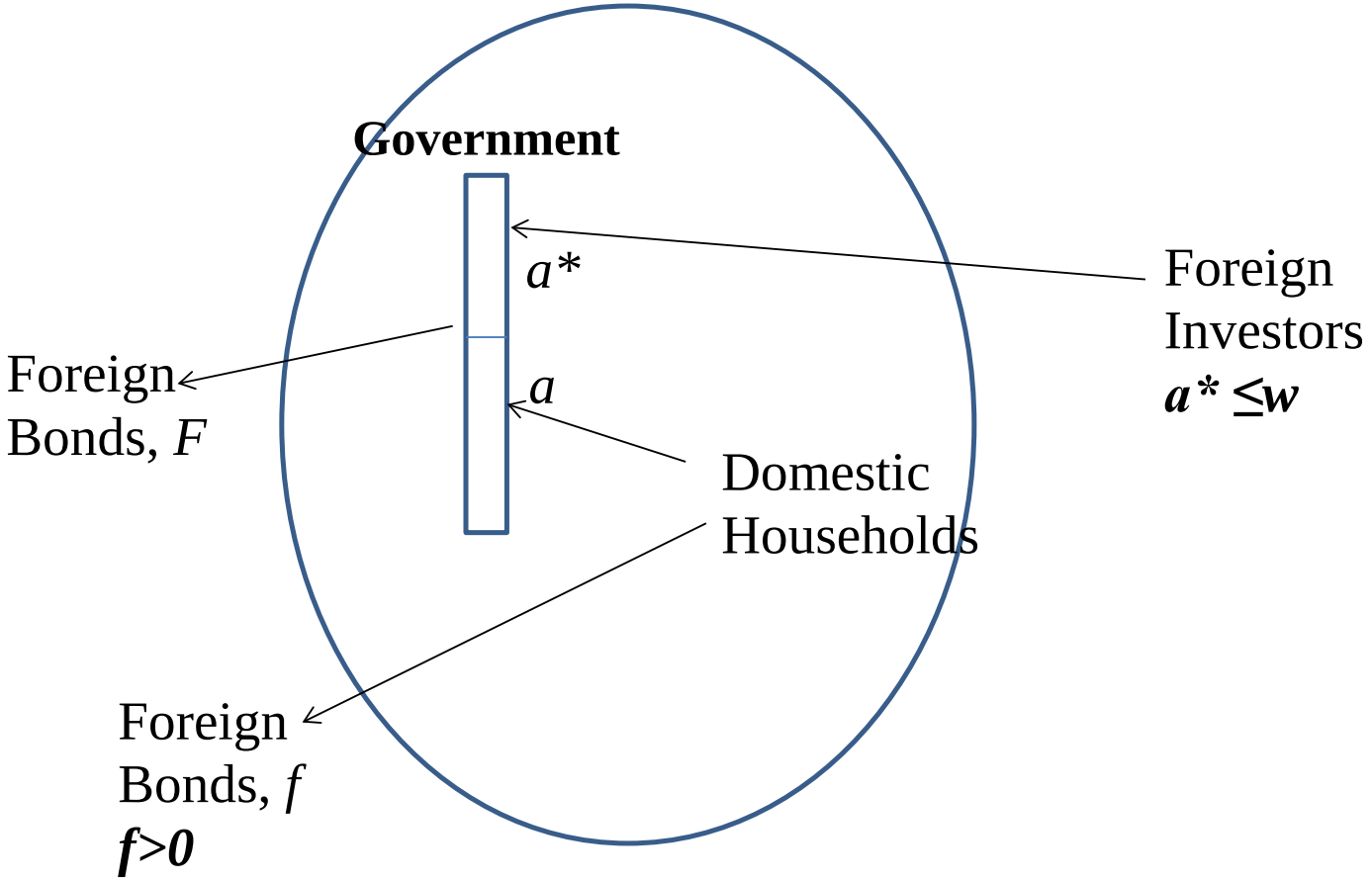
# Summary

Real model (blend of ABBP and Jeanne, 2013)
Foreign exchange intervention: change in $F = a + a^*$



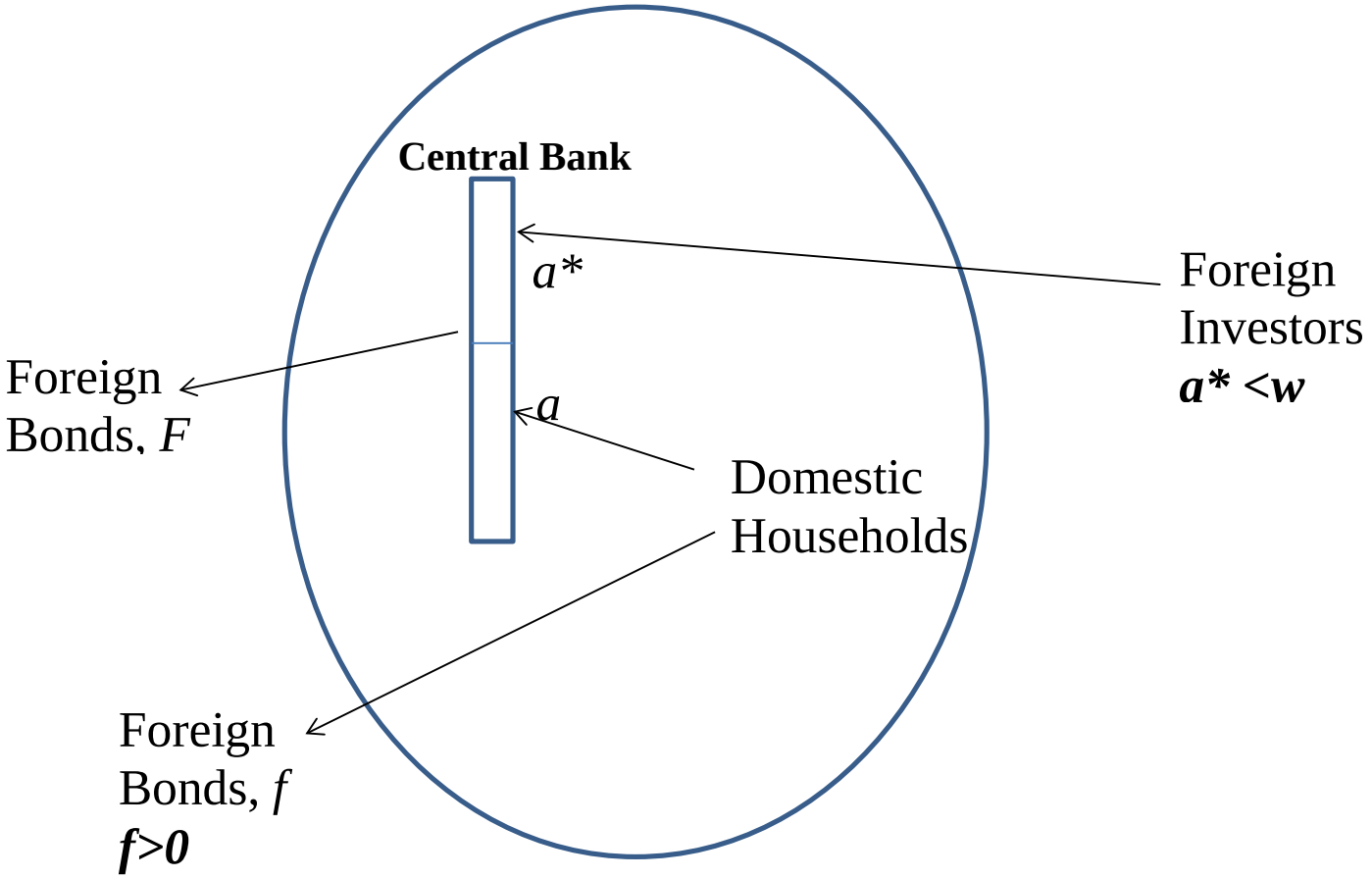
# Summary

If $f > 0$ or $a* < w$ **Ricardian equivalence**



# Summary

If $f = 0$ **and** $a* = w$ increase in $F$ induces forced saving by domestic households, and excess return on domestic bonds that foreign investors cannot arbitrage



# Summary

**Extension 1:** Why do foreign exchange interventions?

- Foreign interventions are costly
  - domestic consumption distortion
  - carry cost of reserves paid to foreigners
- ABBP present model with tradable and nontradable sectors and sticky wages
- First-best allocation can be achieved with $i$ as long as ZLB not binding
- Pecking order: first use $i$, and use $F$ only if ZLB is binding

# Summary

**Extension 2:** risk

- Period-2 exchange rate target is state contingent: $e_2 \rightarrow e_2(s)$
- Complete markets
- There could be a deviation from UIP due to pure risk premium
- However deviation from UIP is fair compensation for risk
- Only deviation from CIP generates a true carry cost of reserves

# Comments

1. Foreign exchange interventions are used by countries that are not at the ZLB, but the model could be generalized to account for that
2. A wedge in UIP is a true cost if it is generated by a financial friction

# Comments

## Comment 1

- In Keynesian version of ABBP's model one instrument, $i$, is sufficient to achieve first-best allocation (divine coincidence)
- So no need for forex interventions unless $i$ is constrained by ZLB
- But in general, one instrument does not achieve first-best allocation
  - for example, assume in their N-T model that labor is not mobile between the two sectors
  - then there are 2 labor targets instead of 1
- When conventional monetary policy is not blessed by divine coincidence, forex interventions will be used even when the interest rate is not constrained by the ZLB
  - the two-target two-instrument point of Ghosh, Ostry and Chamon (2016)
  - "rounding the corners of the trilemma"

# Comments

## Comment 2

- Alternative financial friction: foreign investors are risk neutral but must cover maximum loss with a given level of equity $w$ (VaR regulation)
- No deviation from CIP, since a covered position involves no risk
- Deviation from UIP

$$\begin{aligned} \frac{1+i}{1+i^*} E\left(\frac{e_1}{e_2}\right) &> 1 \\ a^*\left(1 - \frac{1+i}{1+i^*}\frac{e_1}{max e_2}\right) &= w \end{aligned}$$

- The deviation from UIP is a true carry cost for the reserve-holding country
- General point: a deviation from CIP or UIP contributes to the carry cost *if* it is generated by a financial friction

# Conclusions

- Nice paper

THANK YOU