Discussion of Amador, Bianchi, Bocola and Perri’s “Exchange Rate Policies at the Zero Lower Bound”

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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


I like the paper

Summary

Comments
Real model (blend of ABBP and Jeanne, 2013)
Foreign exchange intervention: change in $F = a + a^*$
If $f > 0$ or $a^* < w$ **Ricardian equivalence**

Olivier Jeanne (Johns Hopkins University)

Discussion of Amador, Bianchi, Bocola and Perri’s “Exchange Rate Policies at the Zero Lower Bound”
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.
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
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.
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."
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

$$\frac{1 + i}{1 + i^*} E \left( \frac{e_1}{e_2} \right) > 1$$

$$a^* \left( 1 - \frac{1 + i}{1 + i^*} \frac{e_1}{\max e_2} \right) = w$$

- 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