Exchange rate behaviour and policy: Before, during and after the global economic crisis

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Three questions

- What are the medium and long-term implications of the financial crisis on the international role of major currencies?
- Is there a role for strengthened financial sector regulation vis à vis size of capital flows?
- Is there a role for exchange rate policy in an environment of large fiscal deficits and heightened inflation expectations?
Reserve currency role of US dollar: COFER data
Reserves: Longer term perspective

USD estimate (Chinn & Frankel, 2007)

USD + 60% unalloc.

Source: IMF, COFER (May 2009), and Chinn and Frankel (2007)
Reserves and the dollar’s value

Source: IMF, COFER, May 2009; and Federal Reserve Board
The outlines of financial regulation are yet to filled in

Nationalistic approach to bank interventions suggests higher risk of cross-border asset holding

Implying financial de-globalization (assets- and liabilities-to-GDP decline)

Suspicion: we’ve seen end of “light touch” regulation
Recasting the question

○ What are the implications of monetary and fiscal policy for exchange rates?

○ Quantitative easing has a role even if ST interest rates are at zero bound

○ And LT interest rates can potentially be affected by monetary policy

○ But to the extent many other countries pursue QE, then the possibility for exchange rate policy to spur aggregate demand is limited
Government debt and inflation

Source: CBO, A Preliminary Analysis... , March 2009; Historical Statistics
Government debt trajectories (gross)

OECD, *Interim Economic Outlook*, March 2009
Nominal Interest Rates

Source: Federal Reserve Bank of St. Louis
Real Interest Rates

Source: Federal Reserve Bank of St. Louis
# Interest Rate Effect of Debt

<table>
<thead>
<tr>
<th>Studies that focus on stock fiscal variables</th>
<th>Description</th>
<th>Impact</th>
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<tbody>
<tr>
<td>Chinn and Frankel (2005) Germany, France, Italy, UK and Spain</td>
<td>A 1% increase in current debt</td>
<td>5-8 bps</td>
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<tr>
<td>USA</td>
<td>A 1% increase in current or projected net debt</td>
<td>5 bps over period 1998-2002, but obscured when extended to 2004</td>
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<td>Engen and Hubbard (2004) United States</td>
<td>A 1% point increase in debt ratio</td>
<td>3 bps (with ranges)</td>
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<tr>
<td>Laubach (2003) United States</td>
<td>A 1% point increase in projected debt ratio</td>
<td>4 bps</td>
</tr>
<tr>
<td>Chinn and Frankel (2003) Germany, France, Italy, Japan, Spain UK and USA</td>
<td>A 1% increase in net public debt ratio projected 2 years ahead</td>
<td>3-32 bps (individual country)</td>
</tr>
<tr>
<td>8 EMU countries</td>
<td>Debt-to-GDP ratio</td>
<td>Small and significant effects on spreads for Austria, Italy and Spain</td>
</tr>
<tr>
<td>Conway and Orr (2002) 7 OECD countries</td>
<td>A 1% point increase in net public debt</td>
<td>Less than 1 bps (Real 10-year bond yields, starting from zero net debt)</td>
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<tr>
<td>O’Donovan, Orr and Rae (1996) 7 OECD countries</td>
<td>A 1% point increase in net public debt</td>
<td>Less than 1 bps (Real 10-year bond yields, starting from zero net debt) 2 bps (Real 10-year bond yields, starting from 100% net debt)</td>
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<tr>
<td>Ford and Laxton (1996) 9 countries World</td>
<td>A 1% point increase in world net public debt</td>
<td>14 - 49 bps (Real 1-year bond yields) 15 - 27 bps (Real 1-year bond yields)</td>
</tr>
</tbody>
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OECD, *Interim Economic Outlook*, March 2009, Table 3.5
Quantitative/Credit Easing: reasons to worry?

Federal Reserve balance sheet

Source: FRB, DB Global Markets Research

Source: Deutsche Bank, Global Economic Perspectives, 22 May 2009
QE in Japan

Source: Humpage and Schenk (2009)
Concluding remarks

- My natural inclination has been (since 2005) – and remains – to be worried
- But I think the main worries are *not* inflation and rising interest rates
- Rather, the main worry is prolonged stagnation due to deficient aggregate demand and deleveraging