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

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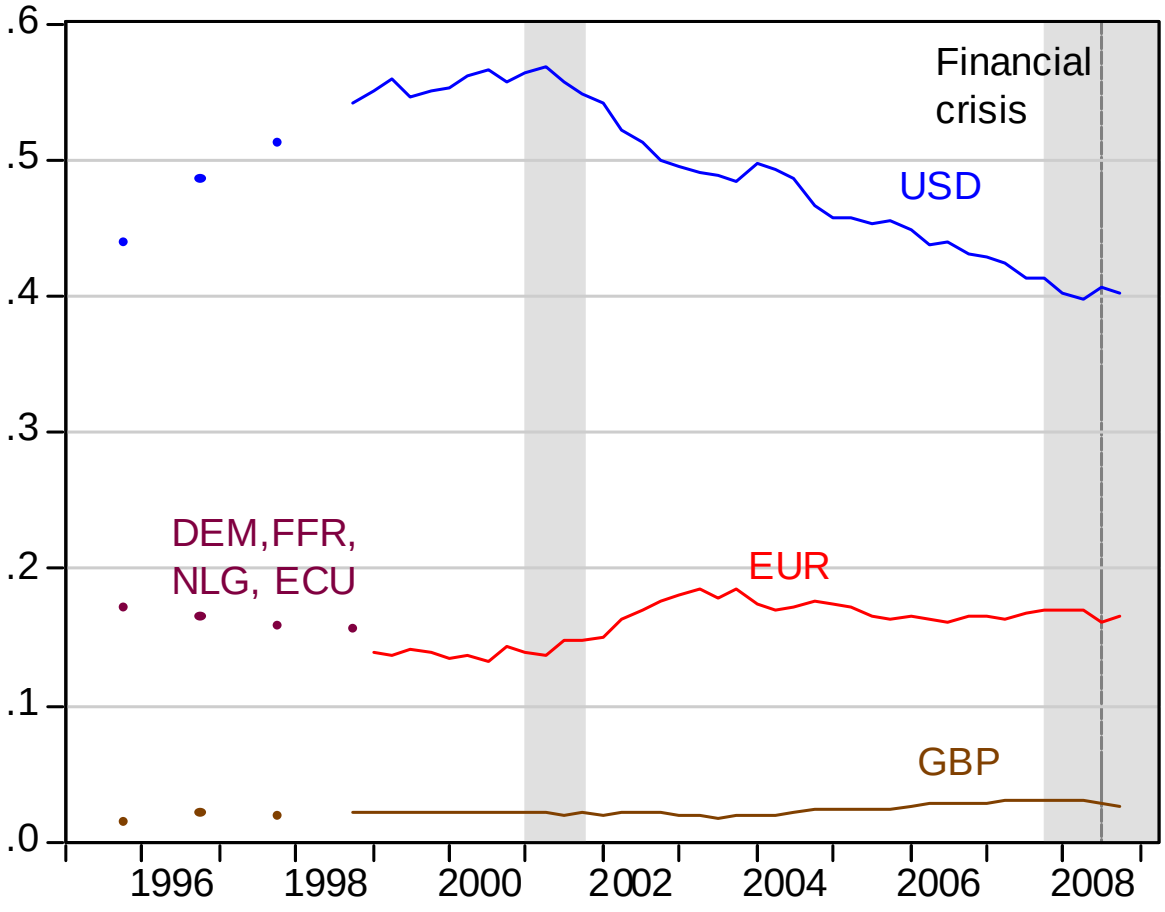
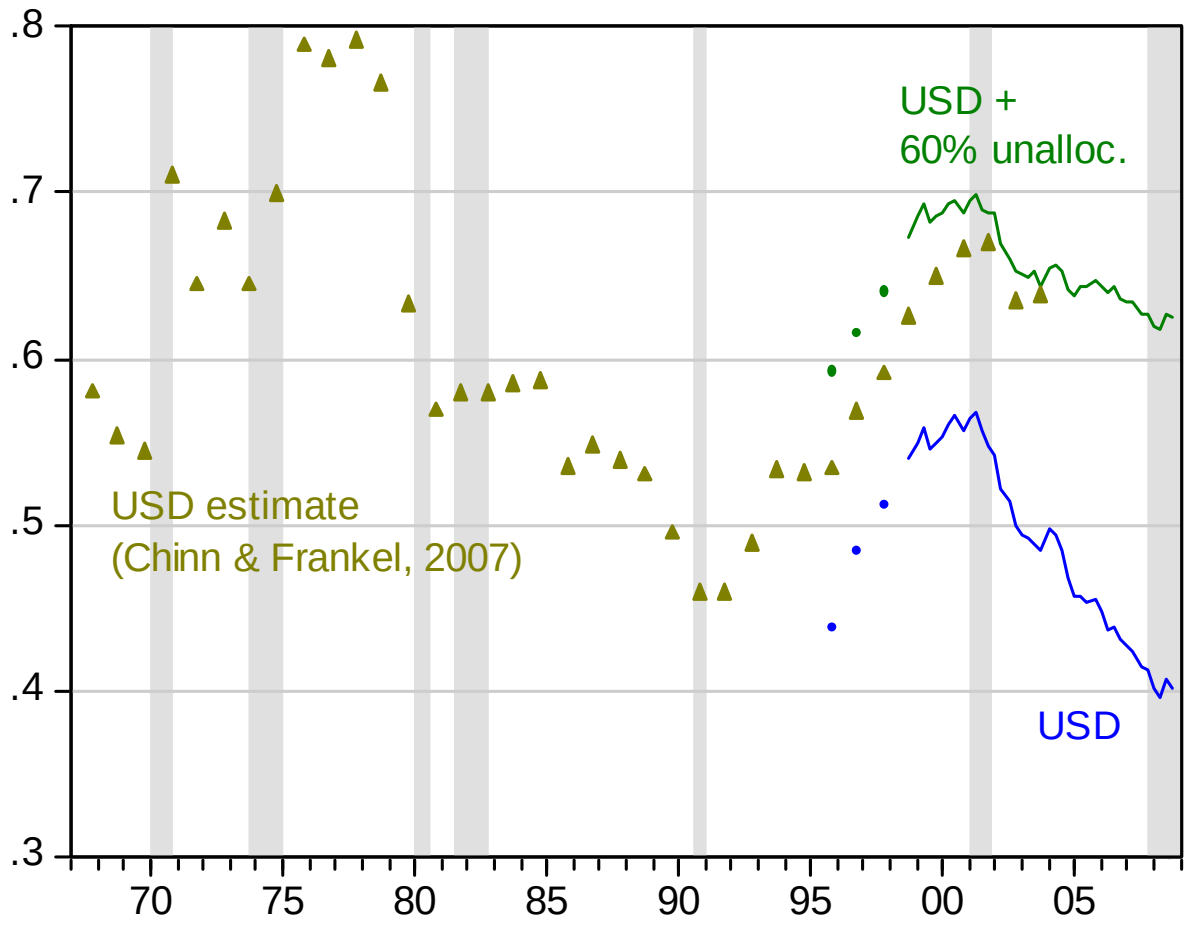
Three questions

- 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 a 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

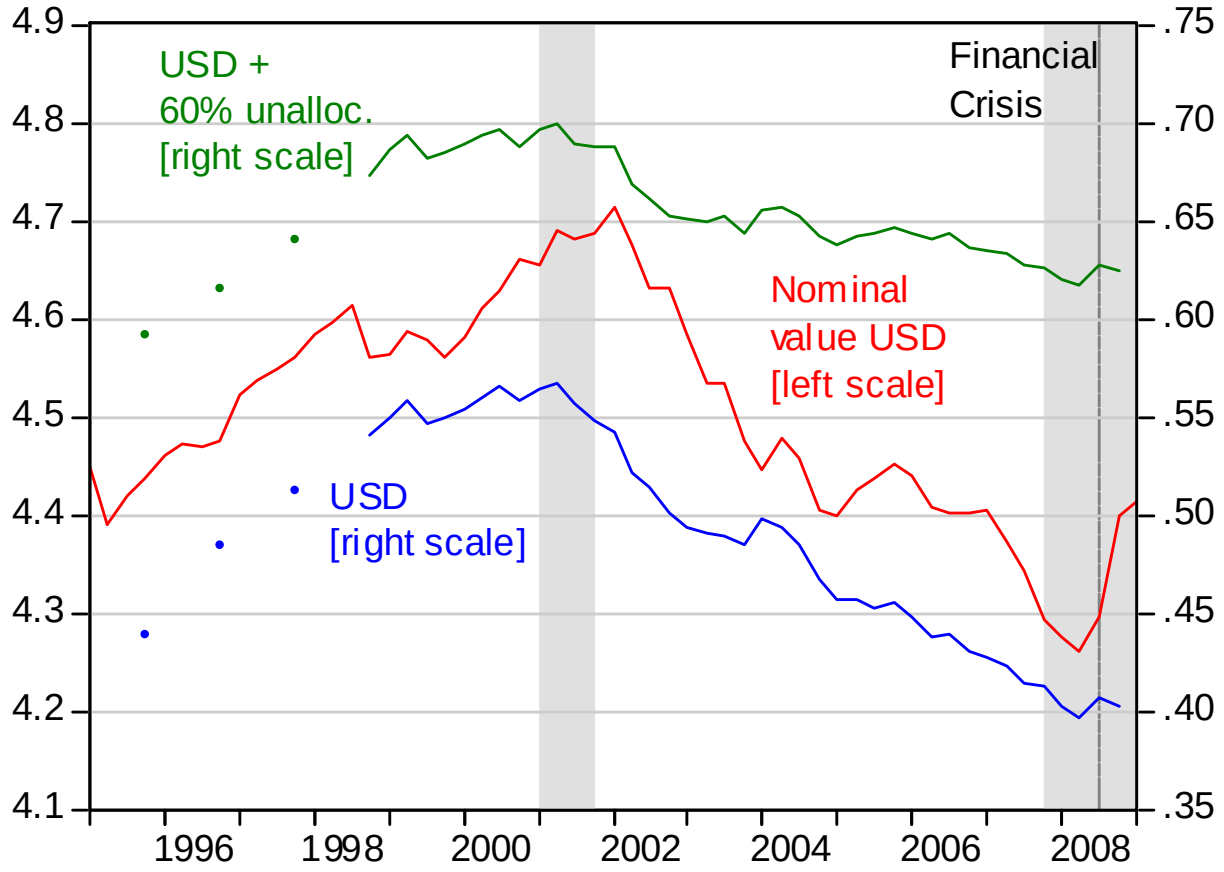


Reserves:
Longer term perspective



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

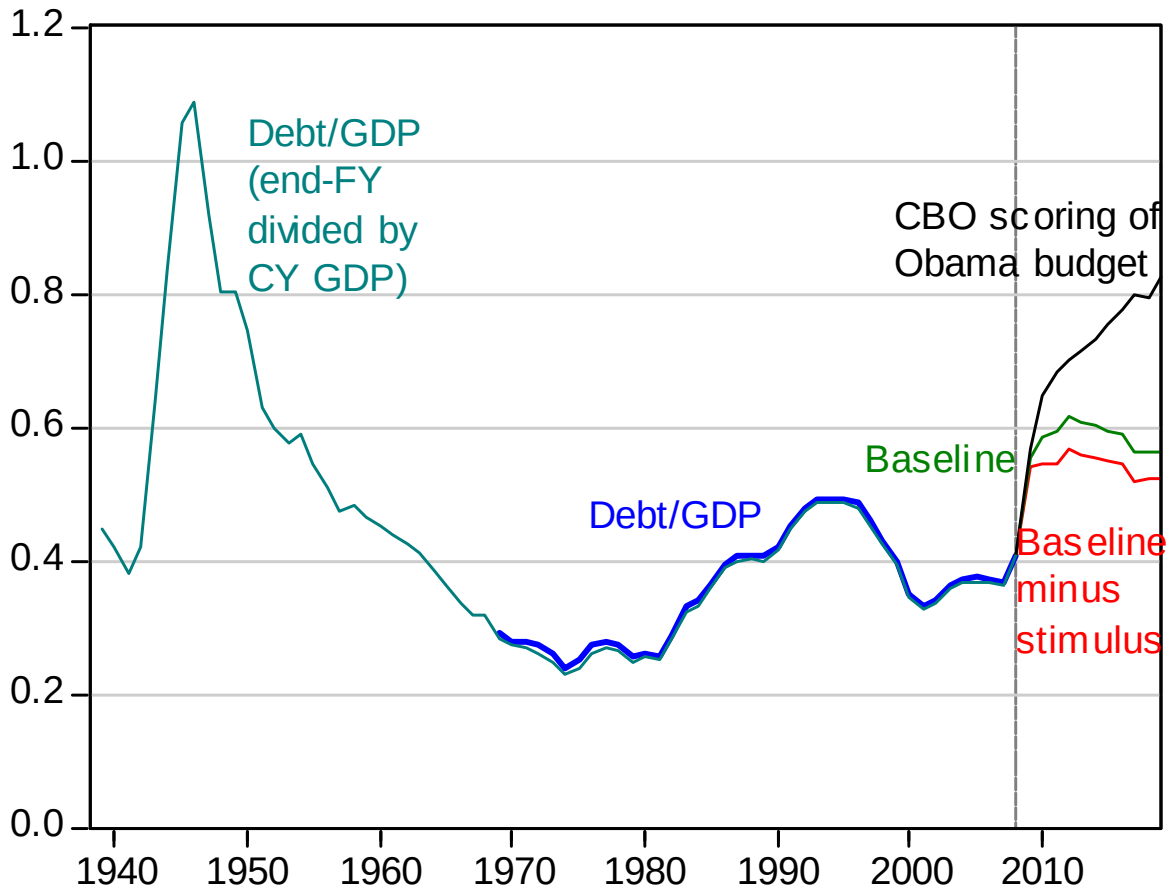
Financial Regulation and Capital Flows

- 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

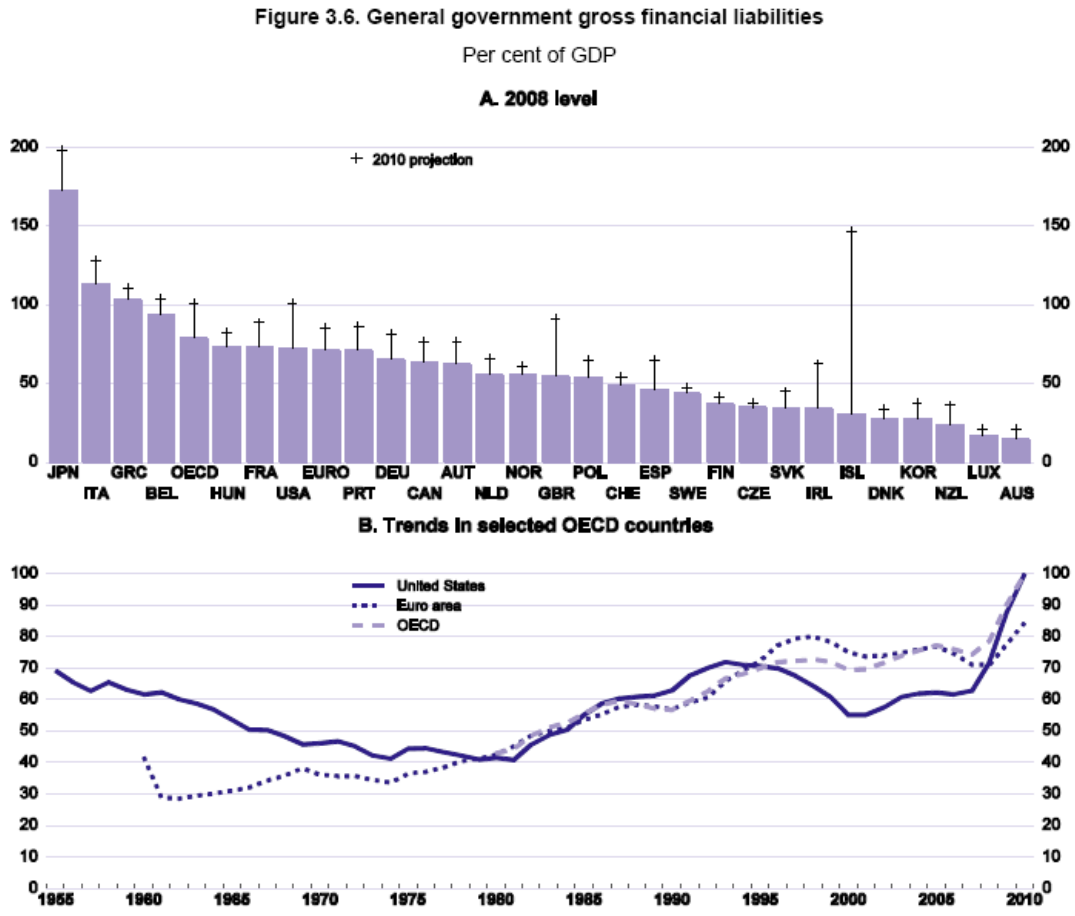
- What are the implications of monetary and fiscal policy for exchange rates?
- Quantitative easing has a role even if ST interest rates are at zero bound
- And LT interest rates can potentially be affected by monetary policy
- But to the extent many other countries pursue QE, then the possibility for exchange rate policy to spur aggregate demand is limited

Government debt and inflation



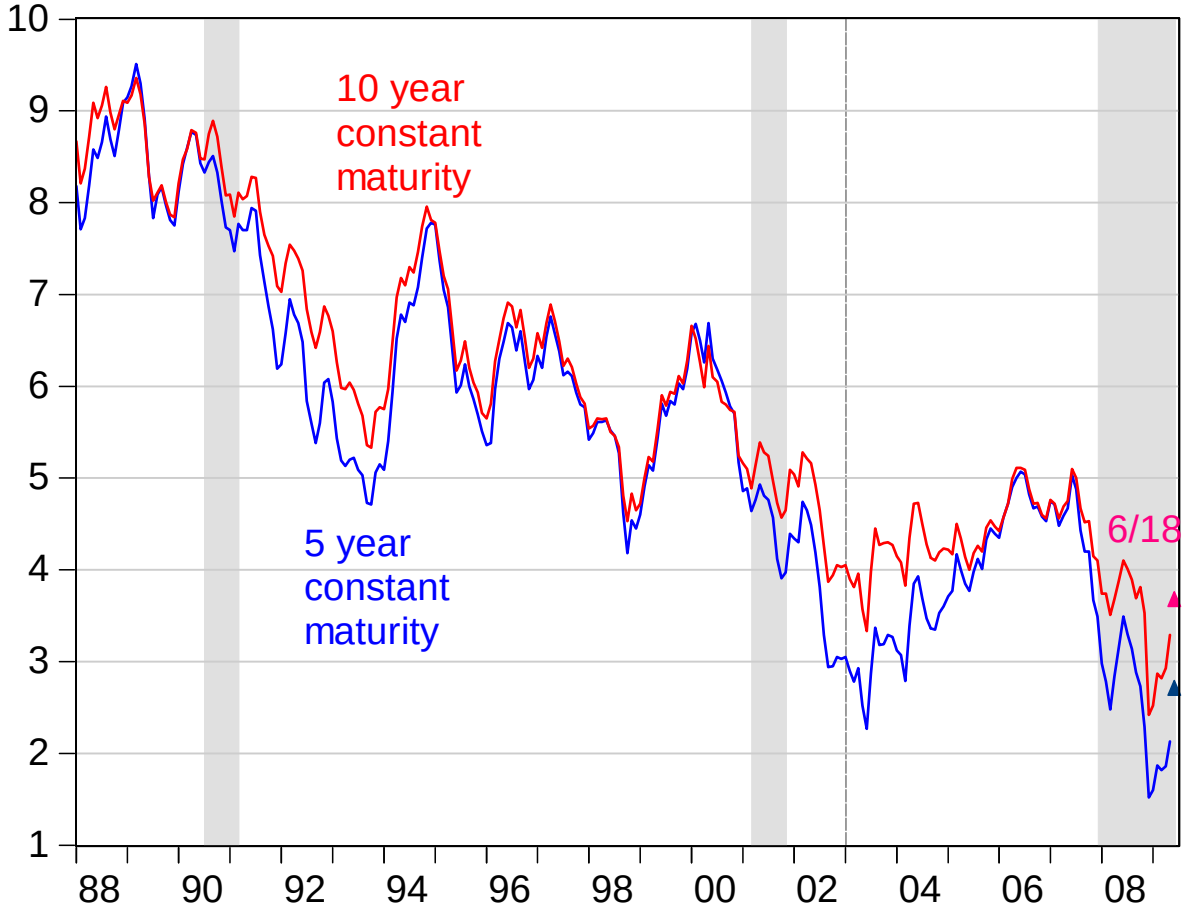
Source: CBO, *A Preliminary Analysis…* , March 2009; *Historical Statistics*

Government debt trajectories (gross)



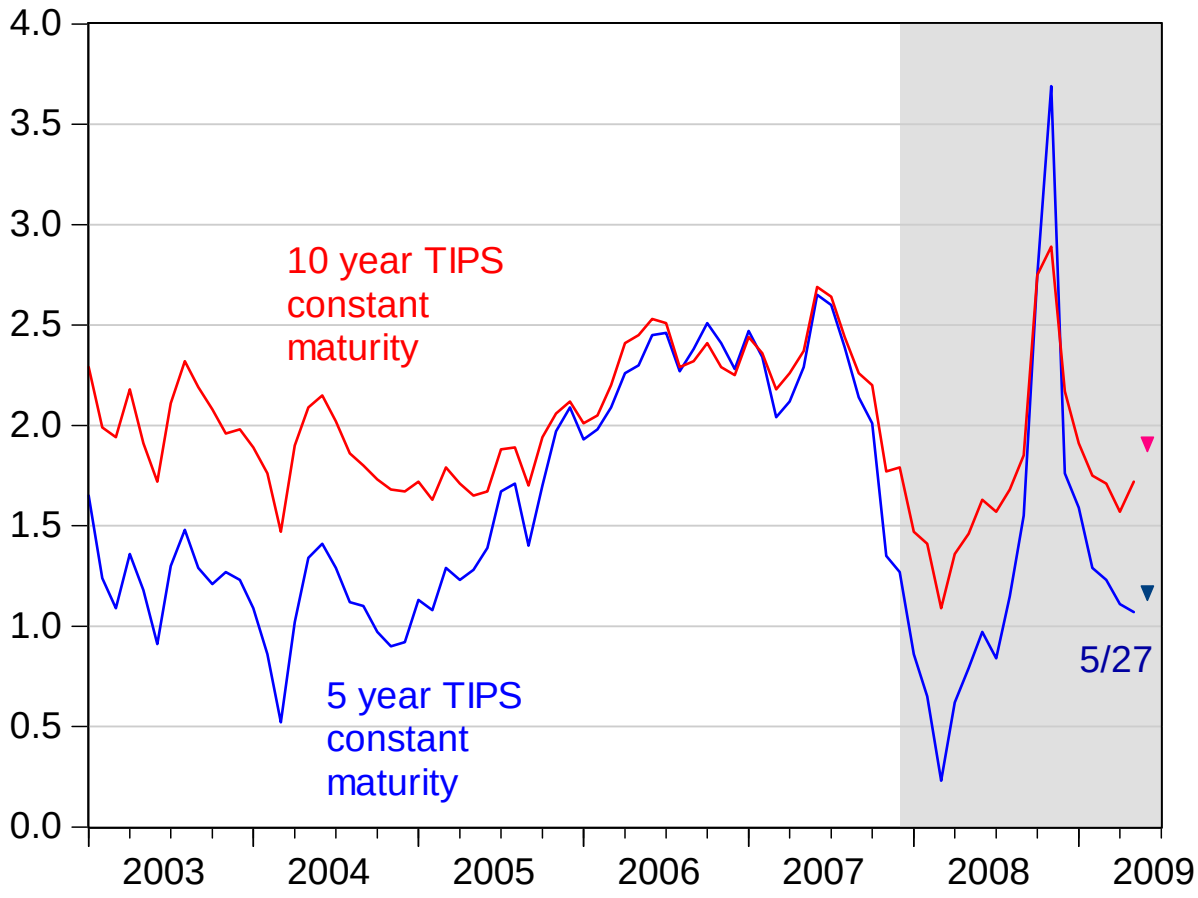
OECD, *Interim Economic Outlook*, March 2009

Nominal Interest Rates



Source: Federal Reserve Bank of St. Louis

Real Interest Rates



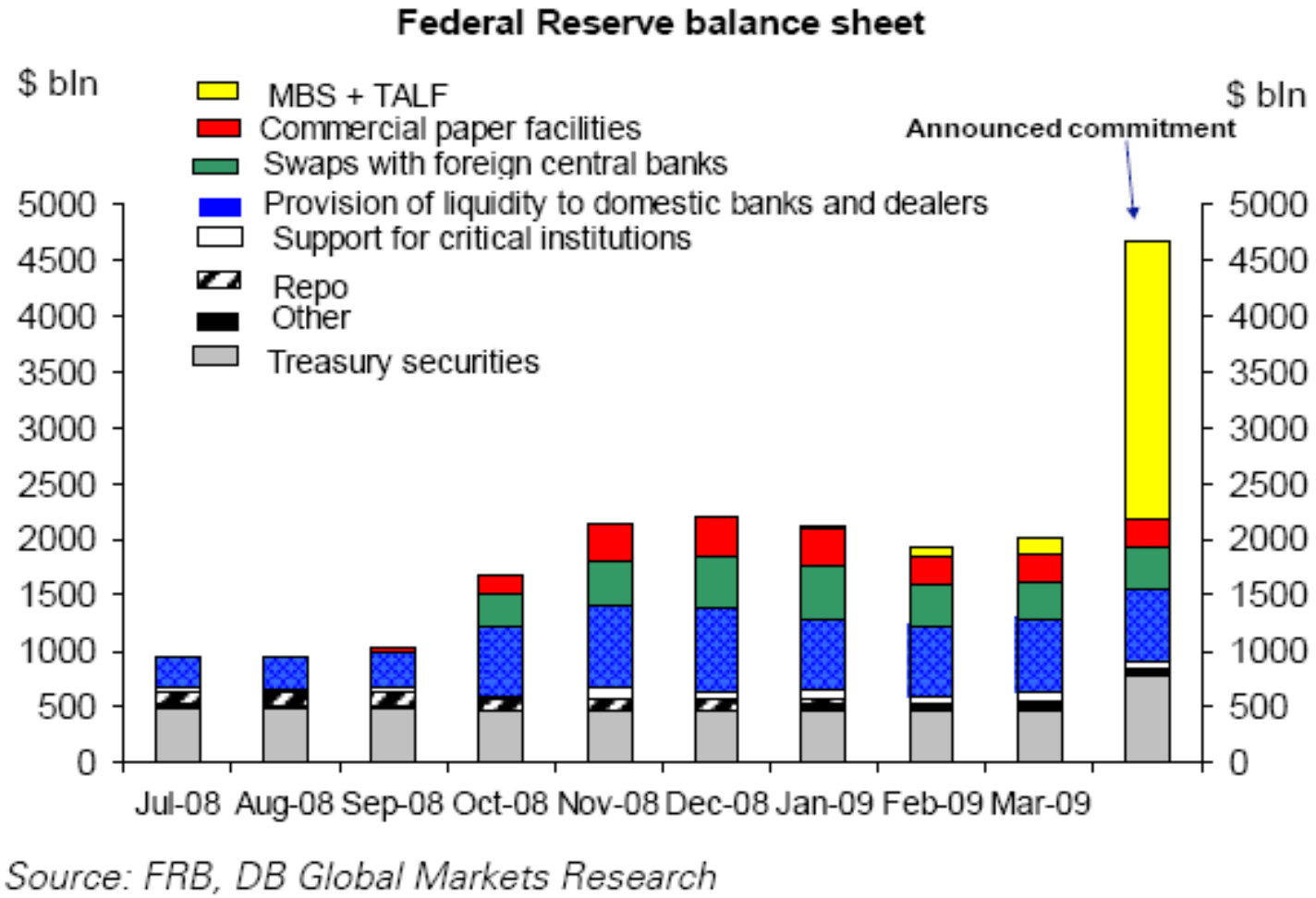
Source: Federal Reserve Bank of St. Louis

Interest Rate Effect of Debt

Studies that focus on stock fiscal variables			
Chinn and Frankel (2005)	Germany, France, Italy, UK and Spain	A 1% increase in current net debt	5-8 bps
		A 1% increase in net public debt ratio projected 2 years ahead	10-16 bps
	USA	A 1% increase in current or projected net debt	5 bps over period 1998-2002, but obscured when extended to 2004
Ardagna et al (2004)	16 OECD countries	Public debt	non-linear
Engen and Hubbard (2004)	United States	A 1% point increase in debt ratio	3 bps (with ranges)
Laubach (2003)	United States	A 1% point increase in projected debt ratio	4 bps
Chinn and Frankel (2003)	Germany, France, Italy, Japan, Spain UK and USA	A 1% increase in net public debt ratio projected 2 years ahead	3-32 bps (individual country) 7-12 bps (European interest rates)
Codogno et al (2003)	9 EMU countries	Debt-to-GDP ratio	Small and significant effects on spreads for Austria, Italy and Spain
Conway and Orr (2002)	7 OECD countries	A 1% point increase in net public debt	Less than 1 bps (Real 10-year bond yields, starting from zero net debt) 1.5 bps (Real 10-year bond yields, starting from 100% net debt)
O'Donovan, Orr and Rae (1996)	7 OECD countries	A 1% point increase in net public debt	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)
Ford and Laxton (1995)	9 countries World	A 1% point increase in world net public debt	14 - 49 bps (Real 1-year bond yields) 15 -27 bps (Real 1-year bond yields)

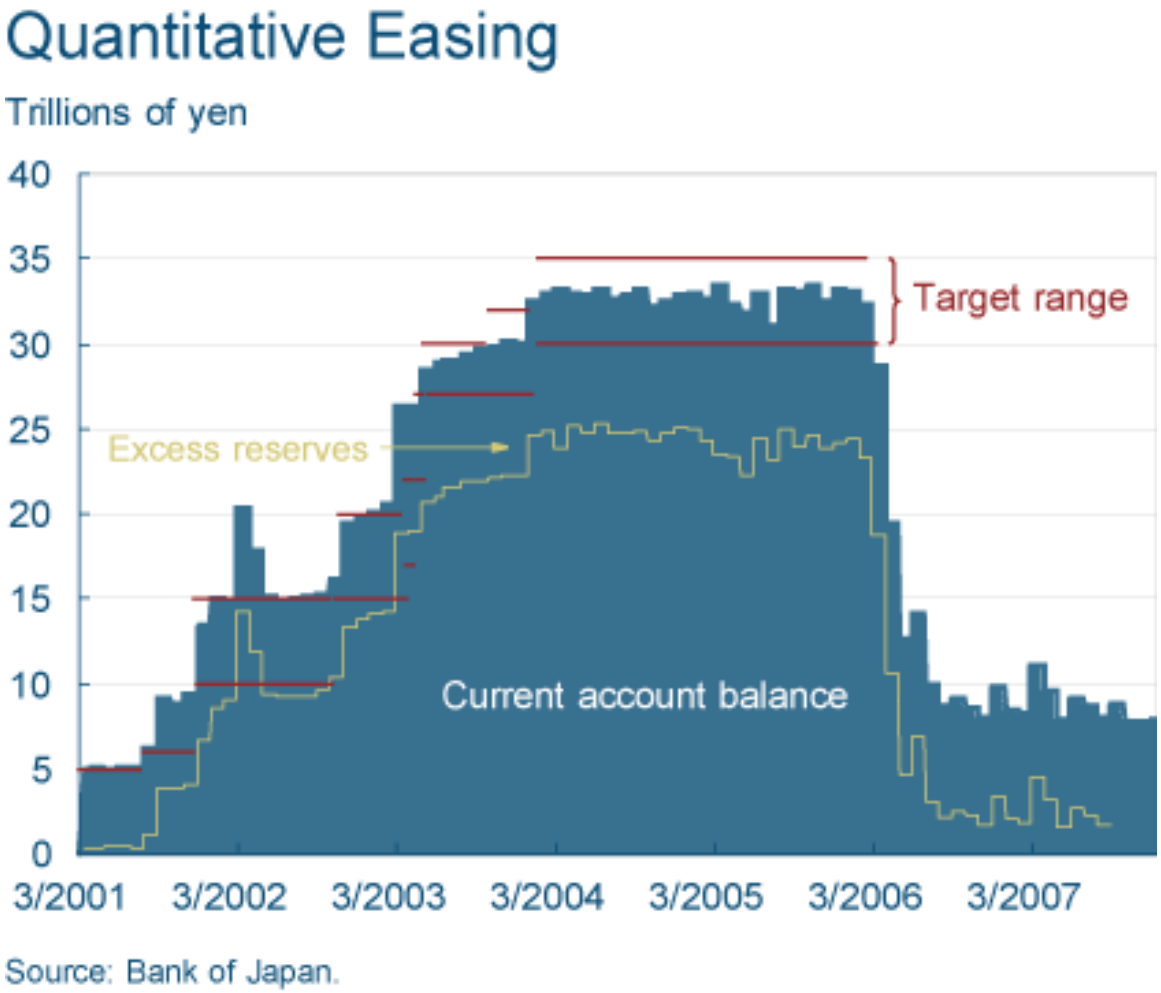
OECD, *Interim Economic Outlook*, March 2009, Table 3.5

Quantitative/Credit Easing: reasons to worry?



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