

DISCUSSION OF DEDOLA, RIVOLTA AND STRACCA “IF THE FED SNEEZES, WHO CATCHES A COLD?”

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The views expressed are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Dallas or the Federal Reserve System

Mantega “Currency War” claim

Last updated: September 27, 2010 7:18 pm

Brazil in ‘currency war’ alert

By Jonathan Wheatley in São Paulo and Peter Garnham in London

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An “international currency war” has broken out, according to Guido Mantega, Brazil’s finance minister, as governments around the globe compete to lower their [exchange rates](#) to boost competitiveness.

Mr Mantega’s comments in São Paulo on Monday follow a [series of recent interventions](#) by central banks, in Japan, South Korea and Taiwan in an effort to make their currencies cheaper. China, an export powerhouse, has continued to suppress the value of the renminbi, in spite of [pressure from the US](#) to allow it to rise, while officials from countries ranging from Singapore to Colombia have issued warnings over the strength of their currencies.

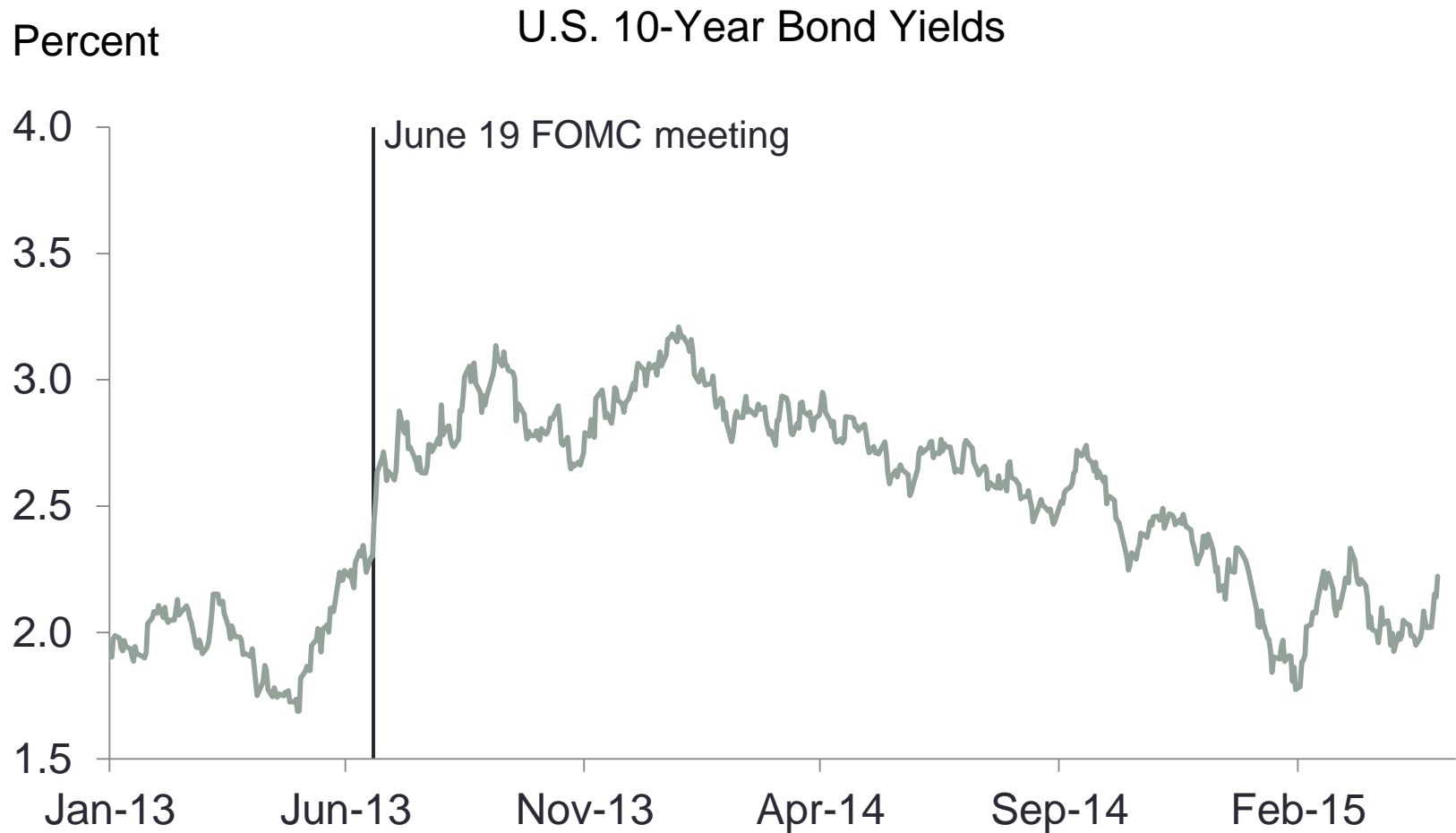
Rajan interview with FT, 2010

AH: So to a certain degree the Fed hides behind the narrow mandate.

RR: To some extent, but I also think that many Fed governors think this is what needs to be done, and some fully believe that they have the weapons to deal with it. I think people who are not so dyed in the wool monetary economists or macro economists worry about the spill-over effects of the financial sector into stability and wonder whether we are in the process of inflating yet another series of asset bubbles, not just in the United States but around the world.

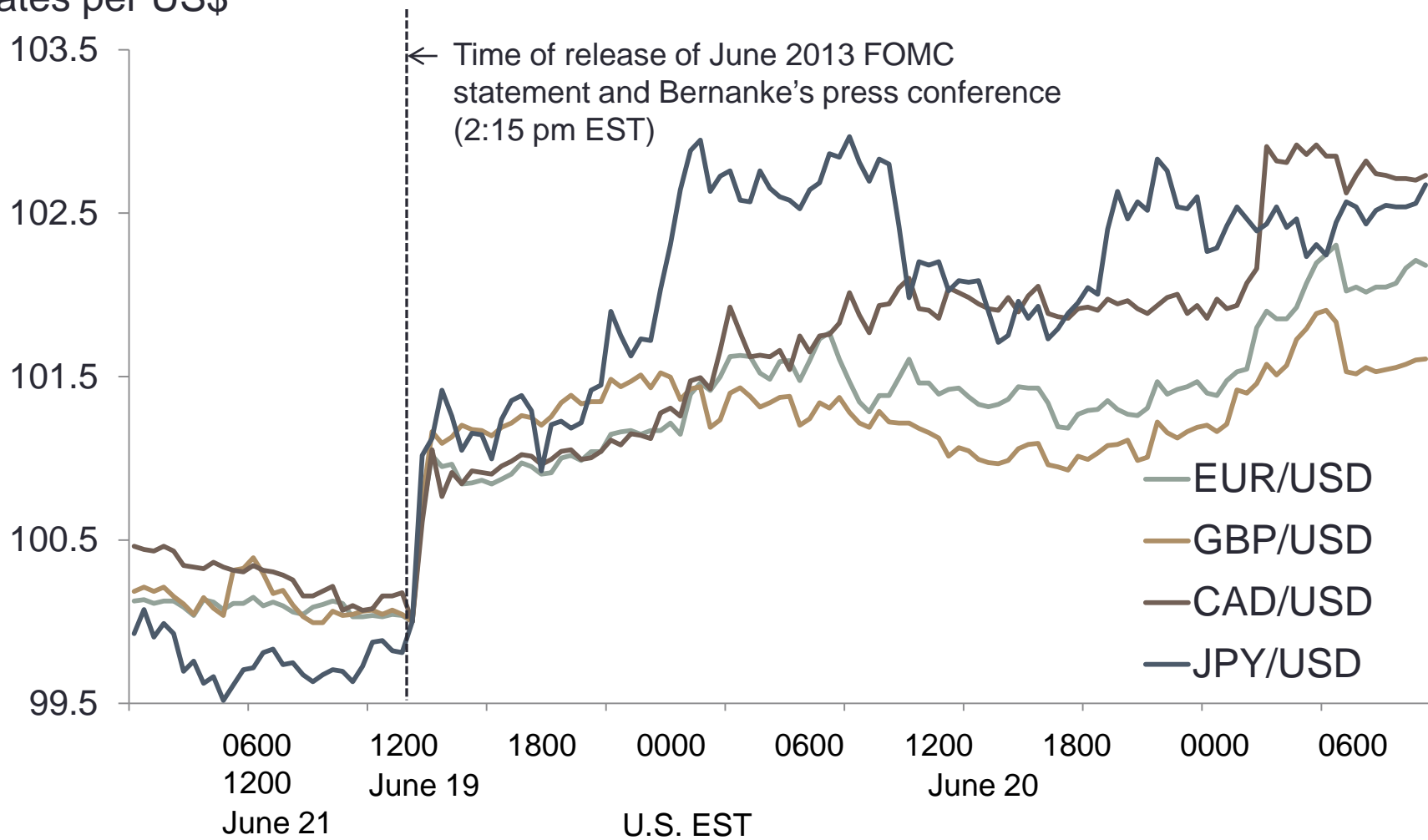
The Fed of course determines in some ways the interest rate for the world, the short term interest rate, and the ECB is under pressure now with the euro appreciating to also follow some longer term accommodative policy. It becomes very hard for the ECB to start raising rates when the Fed is stuck at the levels at which it's stuck, so in a sense you're driving the whole structure for the world economy but you focus only on the United States. I think that's part of the reaction you get from the rest of the world, which is we're back to "It's my dollar your problem, it's my monetary policy, your problem, and use your exchange rates to insulate yourself from my monetary policy". That's again easier said than done.

Asset Prices Around the June 2013 FOMC Meeting and Press Conference

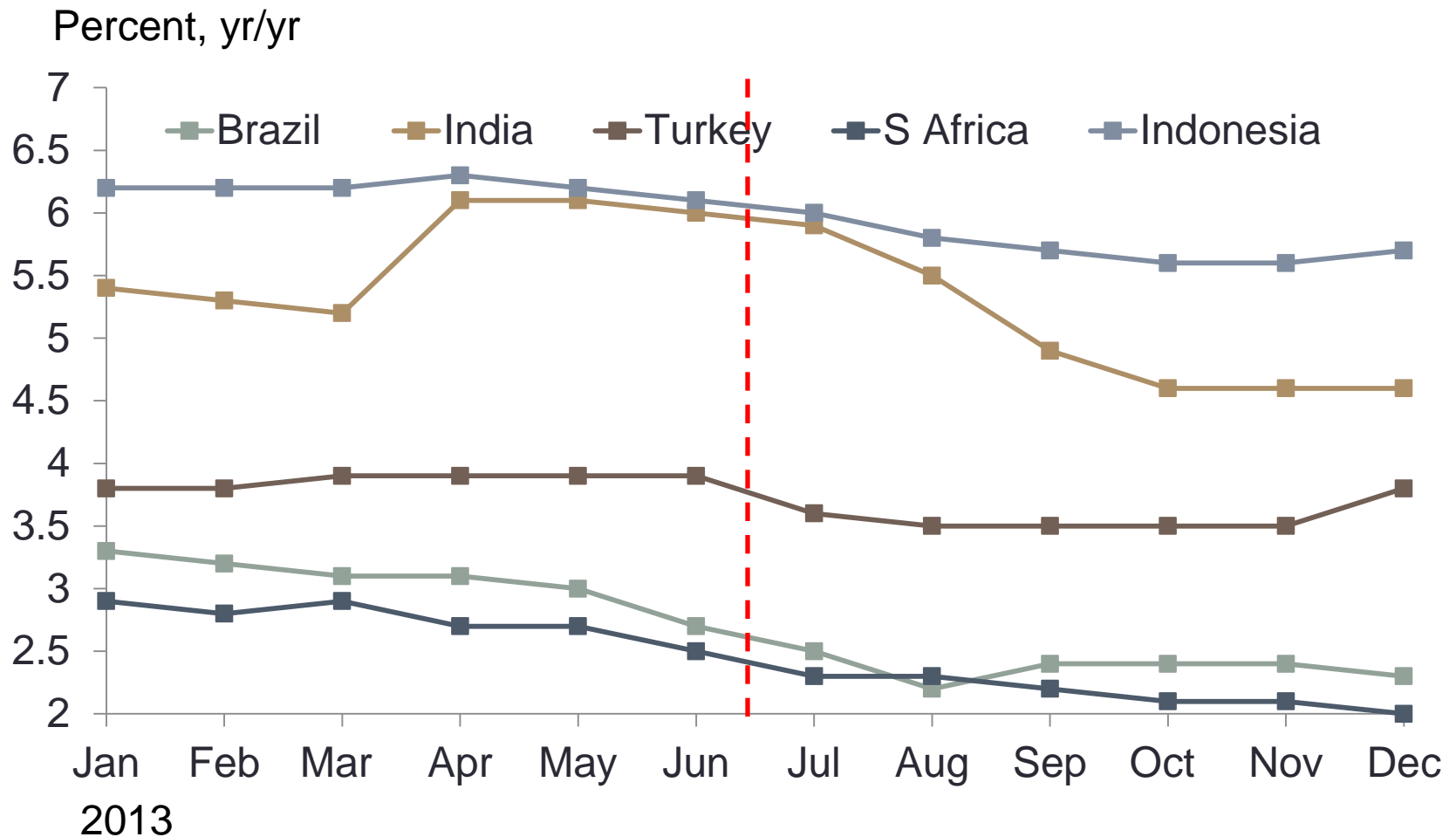


Dollar Exchange Rates

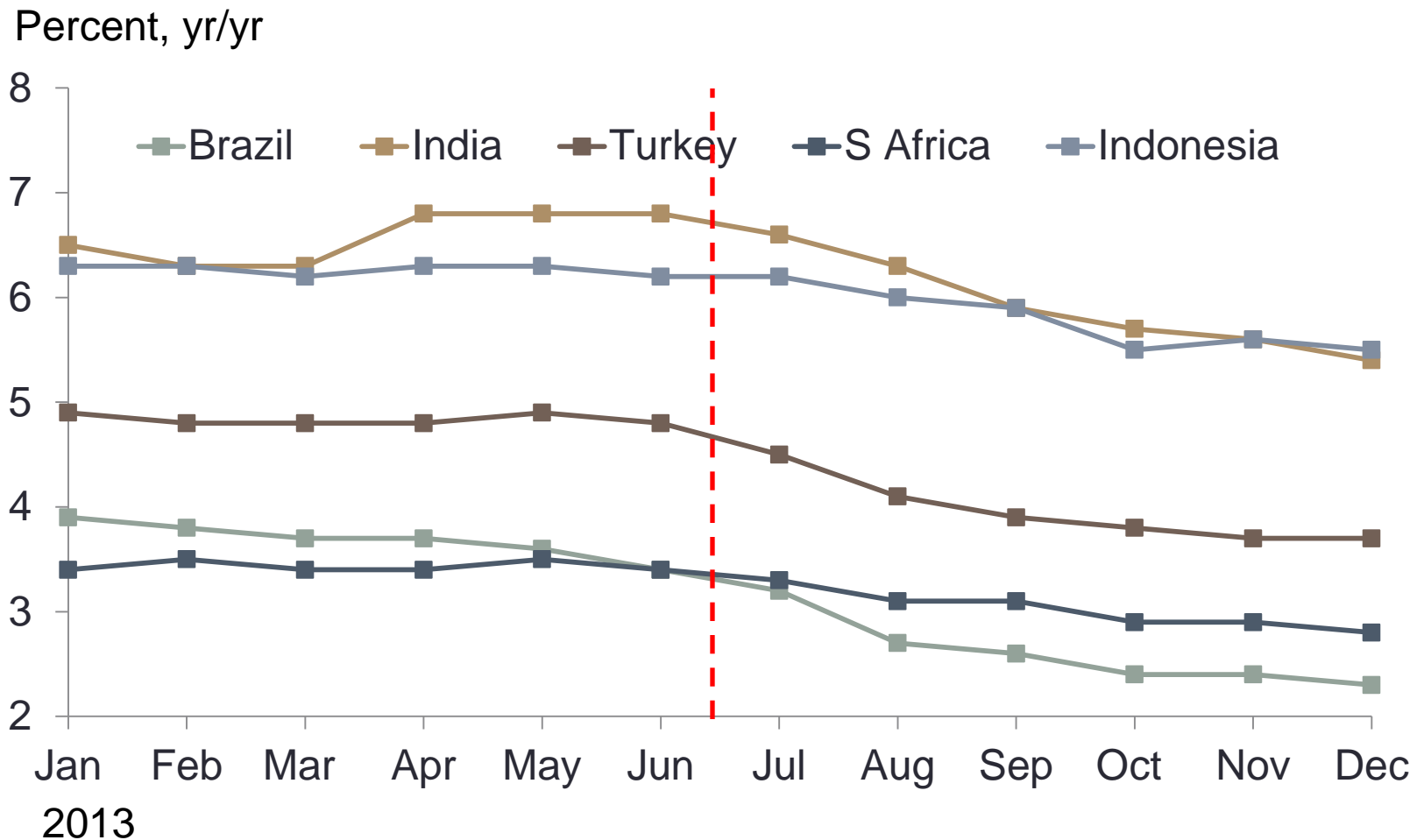
Normalized foreign exchange rates per US\$



Evolution of 2013 GDP Growth Forecasts



Evolution of 2014 GDP Growth Forecasts



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Comments



Fed chair Janet Yellen has promised that any interest rate rises will be gradual

More gains by the dollar could leave US growth “significantly debilitated” and have repercussions across emerging markets, the International Monetary Fund says.

In a health check on the US, the fund reiterated its advice that the [Federal Reserve](#) should delay [raising interest rates](#) until next year, partly because of a risk that a rate increase would trigger another rise in the dollar with destabilising consequences globally.

Summary of paper

- Identify U.S. monetary policy shocks using sign restrictions in a 13-variable monthly Bayesian VAR
- Compute IRFs for real, nominal and financial variables for heterogeneous group of advanced and emerging market economies by estimating ARDL models
- Group countries based on characteristics to summarize results:
 - Income level, exchange rate regime, capital account openness, dollar exposure
- Key findings:
 - Tighter US monetary policy spills over to foreign economies in the form of lower real activity
 - Differential effects in advanced and emerging market economies
 - Only EMs also experience capital outflows, domestic credit crunch and falling house prices
 - Floating exchange rate regime offers some degree of insulation

Comments – Specification of VAR

- Inclusion of both U.S. and global industrial production in the VAR
 - The two series are highly correlated since global IP series includes U.S. IP
 - Why not global IP ex. U.S.?
- Likewise VAR includes S&P500 and a global stock price index
 - Why not global stock index ex. US?
- Note similarity of responses of US and global variables to US monetary policy shock in Fig. 1A/B
- Short rates included in VAR limited to (average of) short rates in advanced economies (Canada, Euro area, UK, Japan)
 - Why not include (average of) short rates for all 27 countries listed in Table 2?
- Exchange rate included in VAR is against 20 trading partners
 - Why not against all 36 countries included in study?

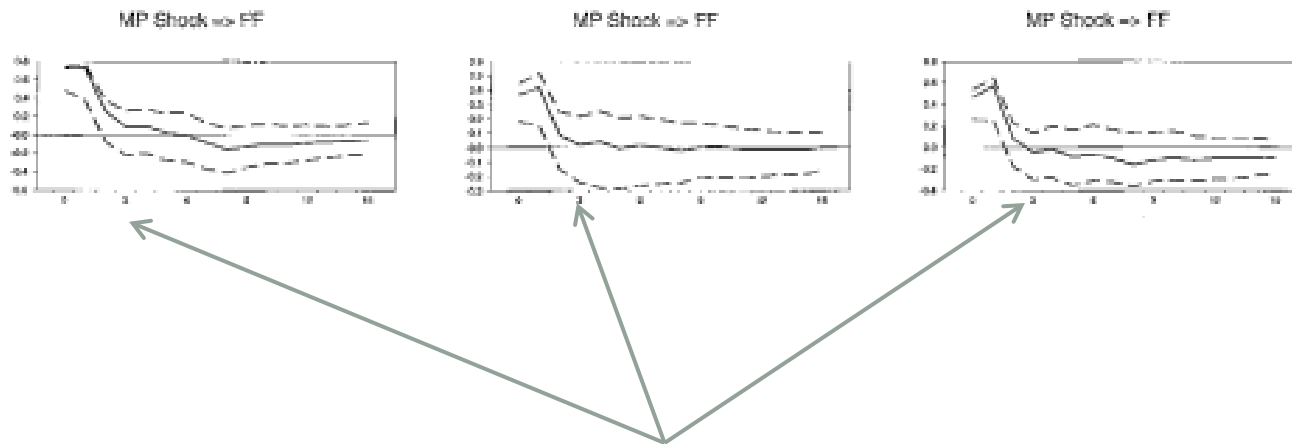
Comments – Identifications scheme (sign restrictions)

- Generally uncontroversial
 - Tightening of monetary policy has positive effect on fed funds rate, negative effect on industrial production, positive effect on nominal exchange rate (on impact),etc.
- Restriction on movement of foreign interest rates relative to US rates to identify US-specific shock:
 - $DiffIR \equiv i^{G7-US} - i^{US} < 0$ for $t=1$
- Why not restrict $\Delta i^{G7-US} \leq 0$ for $t=1$?

Comments – Identified shocks

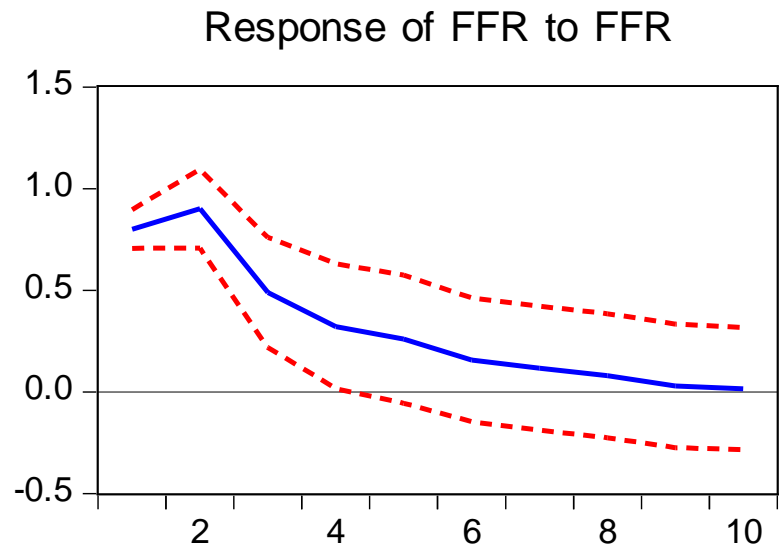
- Monetary policy shocks identified using sign restrictions on IRFs
 - Identified shocks includes news on forward guidance (per Gertler & Karadi (2015))
- Are the identified monetary policy shocks plausible?
- Comparable in their effects on key aggregates to the effects found by other authors
- But...response of fed funds rate to fed funds rate shock shown in Figure 1 seems (to me) a bit too persistent to be the result of a true “shock”
 - Look more like a bout of heavy coughing than a “sneeze”!
 - Identified shocks include a relatively large forward guidance component?

Christiano, Eichenbaum & Evans Handbook of Macro, 1999



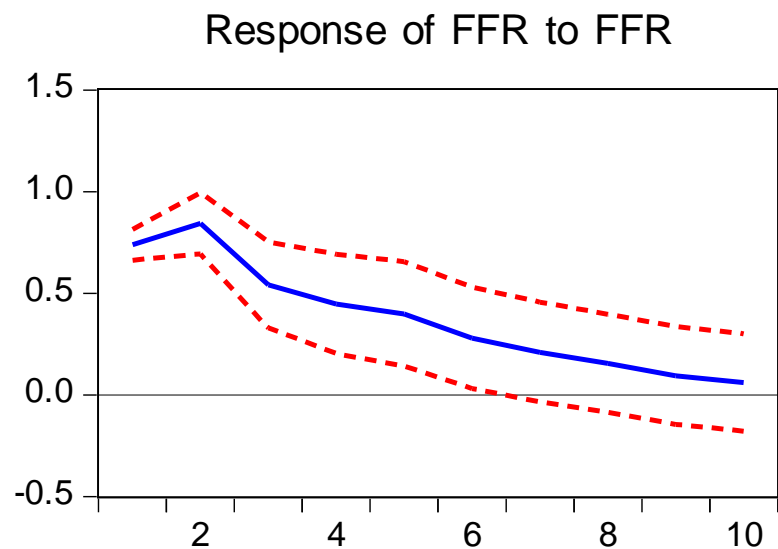
Effects of monetary policy shock on fed funds rate dissipated after three quarters

Response to Cholesky One S.D. Innovations ± 2 S.E.



Basic CEE VAR estimated over 1960-95 sample

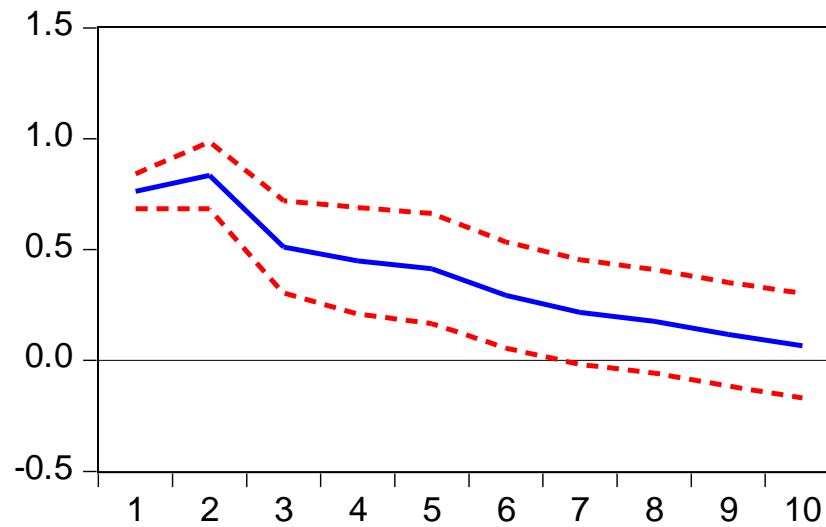
Response to Cholesky One S.D. Innovations ± 2 S.E.



Basic CEE VAR estimated over 1960-2007 sample

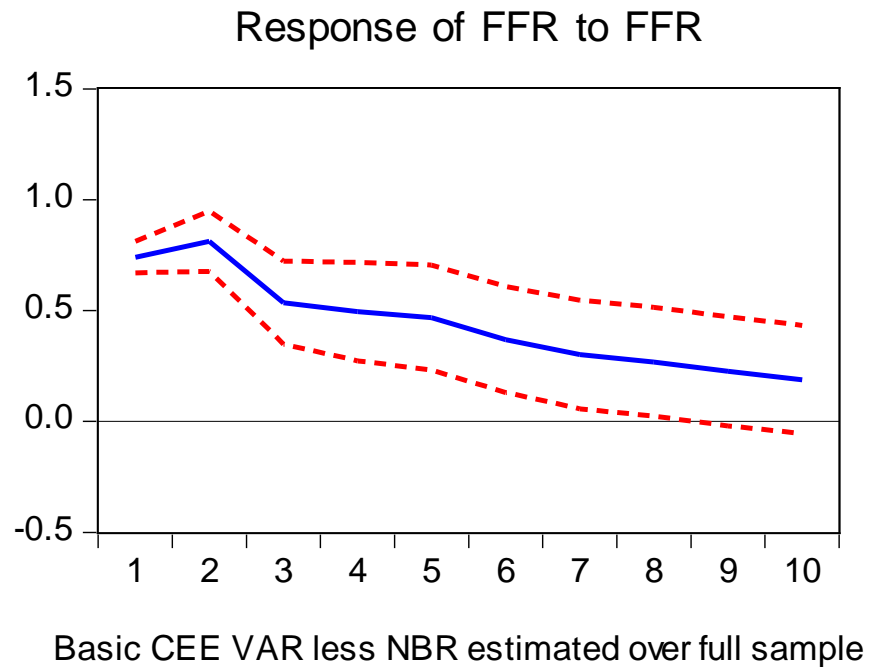
Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of FFR to FFR



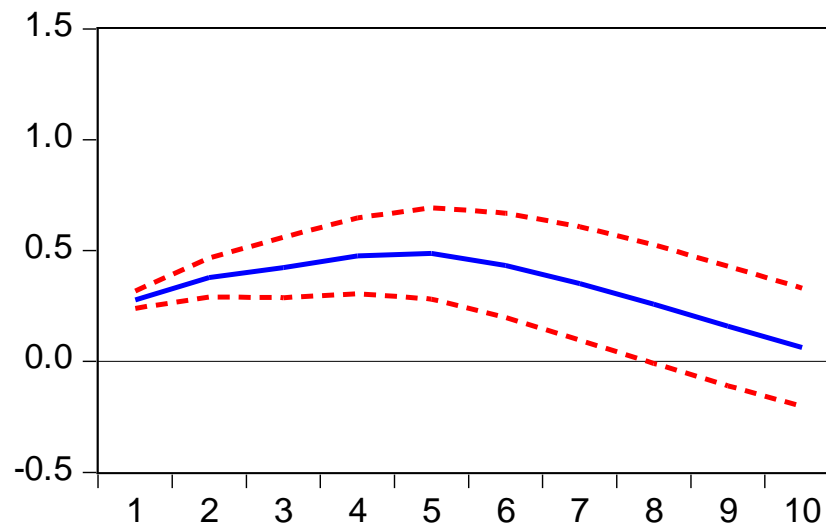
Basic CEE VAR less NBR estimated over 1960-2007 sample

Response to Cholesky One S.D. Innovations ± 2 S.E.



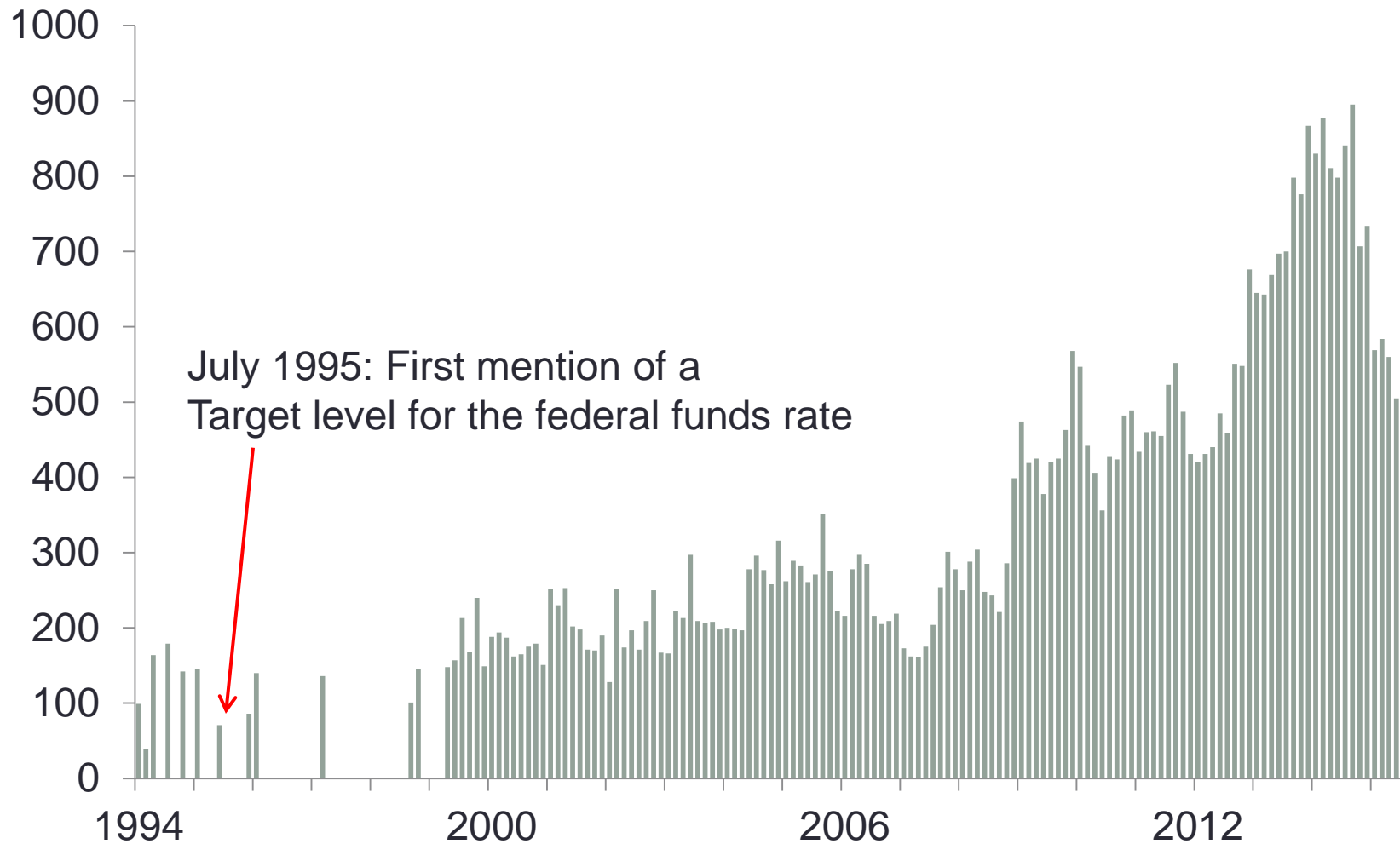
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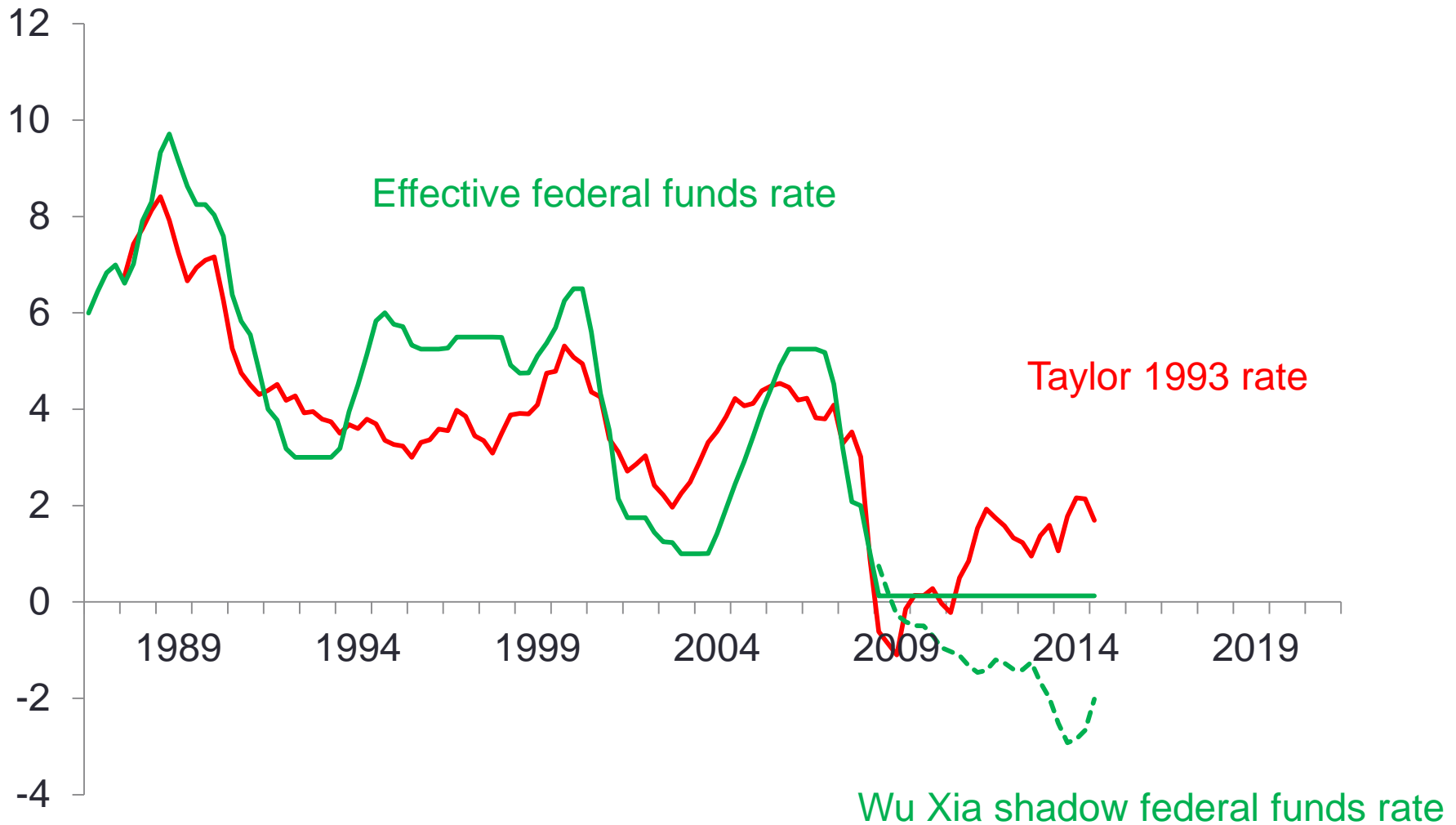


Basic CEE VAR less NBR estimated over 1990-2015 sample

The wordiness of the FOMC statement



Federal funds rate – past, present




A general comment on monetary policy shocks identified from VARs

$$S_t = f(\Omega_t) + \sigma_S \epsilon_t^S$$

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Advances in estimation of $f(\Omega_t)$ - Bayesian methods etc.


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← Advances in identification of ϵ_t^S - sign restrictions etc.

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Policy time not the same as calendar time - FOMC meetings irregularly
Scheduled over the course of the year:
8 (regularly scheduled) meetings;
Timing relative to data releases varies;
Timing of unscheduled meetings and associated policy actions endogenous to (perceived) state of the economy

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Real time data issue:

$$\Omega_{t+1} \neq \{\omega_{t+1}, \Omega_t\}$$

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Fed funds rate a discrete rather than a continuously valued variable – 25 b.p. Moves or (since Dec 2008) ranges

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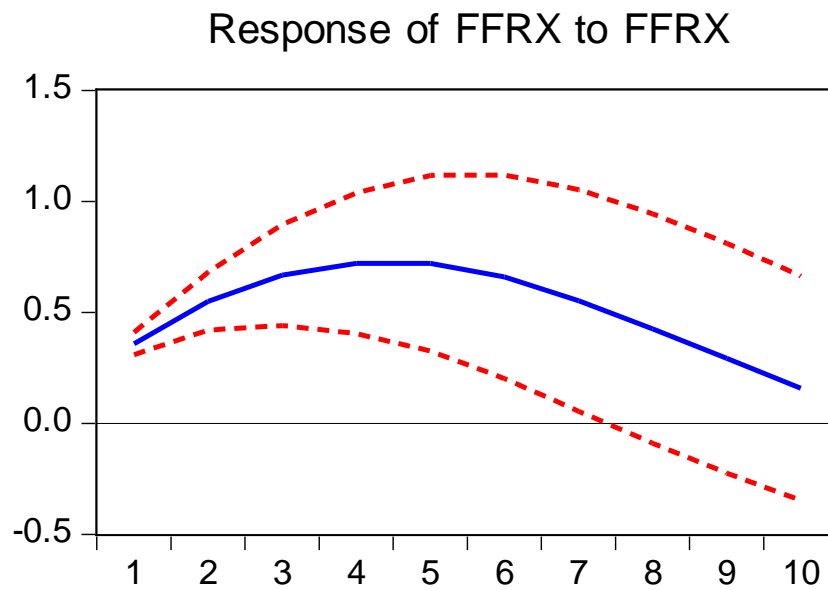
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Comments – Post 2008 ZLB period

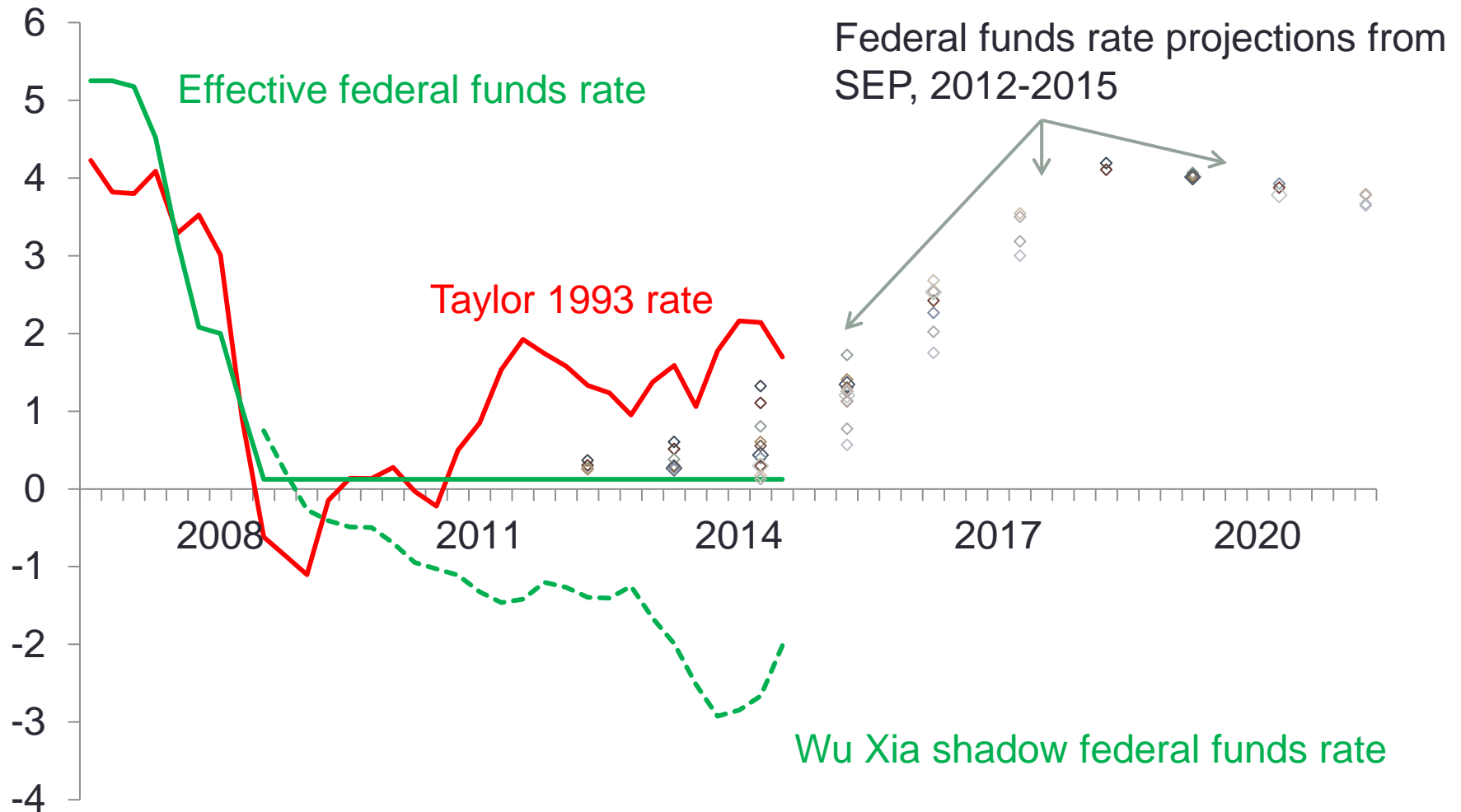
- Federal funds rate stuck at zero lower bound since December 2008
- Fed engaged in unconventional monetary policy actions
 - Large scale asset purchases
 - Forward guidance
 - Starting in 2012, Survey of Economic Projections (SEP) includes projected path of fed funds rate
- Authors address this issue by comparing IRFs estimated over 1980-2013 with those estimated over 1980-2008

Response to Cholesky One S.D. Innovations ± 2 S.E.



Basic CEE VAR less NBR with Wu-Xia shadow fed funds rate, 1990-2015 sample

Federal funds rate – past, present and future?



Comments – country groupings

- Comparative impact on AEs and EMs
- Comparative impact on peggers & floaters
 - Countries assigned based on average behavior in the sample
 - Whether to float or peg is a policy choice
 - Repeat exercise for countries that pegged/floated for all of the sample?
- Comparative impact depending on financial openness
 - As with the exchange rate regime, degree of financial openness is an endogenous policy variable
- Exclusion of some countries with “extremely large responses e.g. Brazil in the case of short-term interest rates and inflation...”
 - Criteria used to determine how big “large” is?
 - Better to have common set of countries for all IRFs?

Final observations

- A really useful contribution to the literature on monetary policy spillovers, a topic likely to be of enhanced interest in the coming year(s)
- Questions for future research:
 - Dealing with forward guidance
 - Use of balance sheet (size, duration, composition) as a tool
 - Does Wu-Xia shadow rate capture everything that is relevant?
 - Changes to the FOMC's operational tools (IOER, RRP, TDF, etc.)
 - How do the quasi permanent swap lines change things?
 - Why do floating exchange rates fail to insulate? Political economy of monetary policy? Or other concerns?