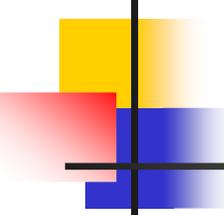


**Panel: Recent (and prospective)
International Experiences**
Monetary policies and exchange rates

Richard Portes

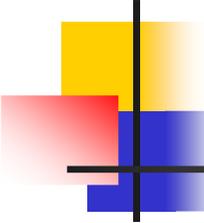
London Business School and CEPR

*Revisiting monetary policy in a low inflation
environment, FRB Boston, 14-16 October 2010*



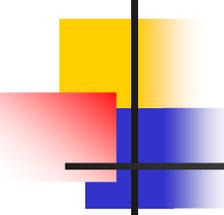
Road map

- Euro area
- UK
- Monetary policies and exchange rates at the zero lower bound – currency wars?
- What about fiscal contraction at ZLB?



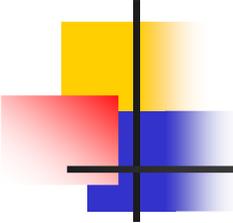
Monetary policies in the euro area

- Monetary policy in crisis must respond not only to inflation and real activity, but also to interest rate spreads (policy rate and money market rate)
- Dynamics of monetary aggregates reflect those of interest rate spreads →
- When transmission mechanism is impaired and interest rates don't co-move, monetary aggregates carry information additional to policy rate
- *E.g.* strong negative correlation between growth of (M3 – M1) and term spread (10-yr – 2-yr)
- ECB didn't 'formally' operate QE or ZIRP – but...



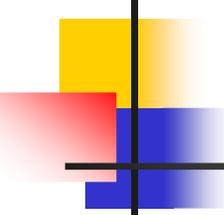
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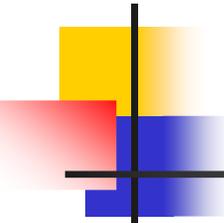
Monetary policies in the UK

- BoE asset purchases so far are £200 bn (14% of GDP), mainly gilts
- Effects on yields mainly through portfolio balancing
 - gilt yields cut by ~ 100 bp
 - investment-grade corporate yields by ~ 70 bp
 - high-yield by ~ 150 bp
- Sterling down 4% on impact but rebounded (possibly because of QE elsewhere)
- Bean (2010) Table 1 shows Fed, BoE, BoJ active in more dimensions than ECB
- But CB balance sheet expansions look fairly similar



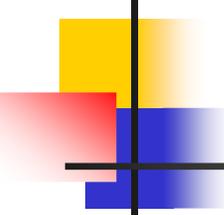
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- S. Dale, Bank of England, speech 12 March 2010



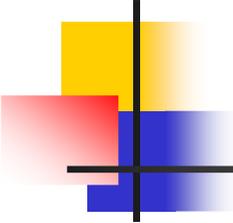
Monetary policy and exchange rates at ZLB

- Large open economy: Japan and 'Foolproof Way' (Svensson)
- Need to create temporary inflation expectations and accept SR inflation rate above LR target
- So price level target with jump: bring down exchange rate, if necessary with (unsterilized) intervention, which also expands monetary base (a form of QE)
- If ER doesn't depreciate, then markets don't expect inflation – you have failed



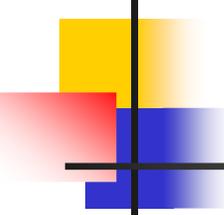
Spillovers

- Escaping liquidity trap doesn't hinder RoW from achieving their monetary policy objectives unless they too are in liquidity trap
- If so, expansion in home country (escape from liquidity trap) raises world natural rate of interest, hence alleviates RoW liquidity trap



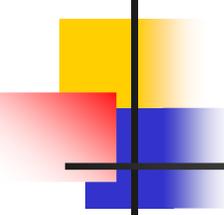
Small open economy (SOE)

- CB can force short rate to ZLB, and ER depreciates
- Can (threaten to) intervene to keep ER down
- Weak currency not 'competitive devaluation' – just a normal part of an easy monetary policy
- And for SOE, little effect on RoW anyway
- And if expansion raises home demand for imports, that's good for RoW



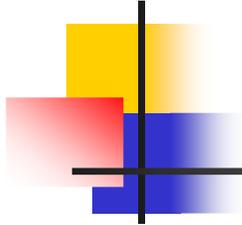
A world of big countries all at ZLB

- You'd like them all to inflate in a coordinated way so that ERs aren't affected
- With simultaneous QE, might not have first-order effects on ERs
- Could get simultaneous expansion, which could have first-order effects on natural rate of interest
- So a move towards more normal monetary conditions

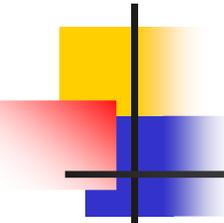


QE and 'currency wars'

- QE everywhere (big economies) might wash out in ERs
- But some of additional liquidity in QE/ZLB countries goes to countries with higher interest rates and appreciating currencies [yes, carry trade profitable when UIP violated...]
- Global liquidity up – exporting bubbles to RoW – but we want higher consumption in RoW, not higher investment in financial and real estate assets
- ECB already tightening in money markets, may not play – euro appreciates, political and trade tensions

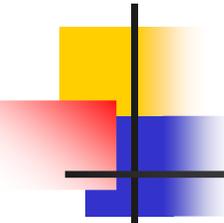


- Note: simultaneous QE not the same as simultaneous exchange-rate intervention
- In latter case, central banks typically hold reserve increments in *short-run* debt – net effect is that of open-market operations in short-dated Treasurys
- So simultaneous ER intervention not expansionary at ZLB, whereas simultaneous QE should be



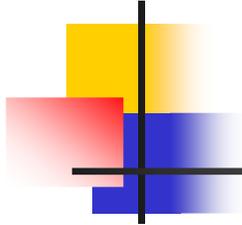
If large advanced countries do more QE, RoW may intervene in FX markets: competitive devaluation

- ER volatility, capital controls, maybe trade policies – cf. Brazil, Thailand, ...
- If peg and can't sterilize, then inflationary pressures
- 'US will win this war: it will either inflate RoW or force their ERs up against the dollar' (M. Wolf, *FT* 13 October)



Finally, fiscal (IMF back to 'it's mostly fiscal'?) – austerity at ZLB

- Consider fiscal contraction in large economy with all countries at ZLB: $r = r^* = 0$
- Normally, Mundell-Fleming would say fiscal contraction lowers r , hence ER depreciates, hence contraction abroad (and at home too, where increase of $[X-M]$ doesn't fully compensate for fall in $[G-T]$)
- But at ZLB, no effect on r , so no ER depreciation through that channel
- But still risk premium in UIP: $\zeta = E(\Delta e)$
where ζ is combined risk premium on exchange rate and on interest rate (bonds)



- All depends on whether austerity raises confidence – does ζ vary positively or negatively with expectations of future activity, and how does austerity affect those expectations?
- If austerity doesn't raise confidence in home economy, then RoW takes double hit: fall in activity in home economy and RoW exchange-rate appreciation against it
- How might RoW respond? – ER intervention!
Another salvo in currency wars