

Discussion of "Exchange Rate Adjustment in Financial Crises"

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Overview of the Paper

- This paper quantitatively studies macroeconomic and welfare implications of alternative monetary and exchange rate policies for a "sudden stop" economy.



Monetary Policy {
inflation targeting (IT)
optimal monetary policy (OP) + Capital Controls
peg the exchange rate (Peg)

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- Two distortions: price rigidity and pecuniary externality
 - Price rigidity: Rotemberg price adjustment cost
 - Pecuniary externality: external borrowing subject to collateral constraints

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Summary of the Paper (Cont.)

- **Welfare Rank: OP \approx IT $>$ Peg.**

- shock $R^* \uparrow \rightarrow$ real depreciation $\varepsilon_{t+1} \uparrow$: how to generate the real depreciation is the key.
- UIP:

$$E_t \left(\Lambda_{t+1} \frac{R_{t+1}}{\pi_{t+1}} \right) = E_t \left(\Lambda_{t+1} \frac{e_{t+1}}{e_t} R_{t+1}^* \right)$$

- Flexible: adjustments in the RHS, nominal depreciation \rightarrow less change in real interest rate
- Peg: adjustments in the LHS, $R \uparrow \rightarrow$ deflation \rightarrow real interest rate $\uparrow \rightarrow$ contractionary
- Without financial frictions, Peg cannot stabilize prices and thus is inferior.

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Section 1

Comments

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- Why countries peg in the first place?
- Benefits of Peg: Balance Sheet effect
 - less real devaluation \rightarrow collateral value higher?

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- can Peg be desirable or less undesirable in the presence financial frictions? $\varepsilon_{t+1} \uparrow$ less vs. $Q_{t+1} k_{t+1} \downarrow$ more

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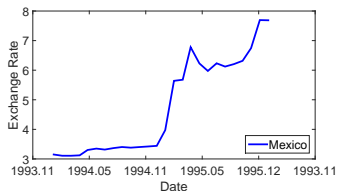
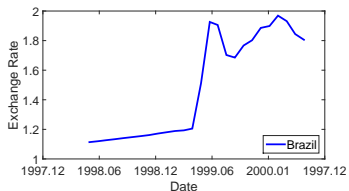
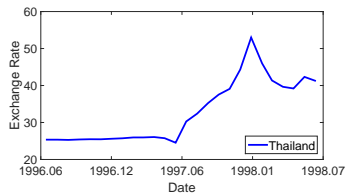
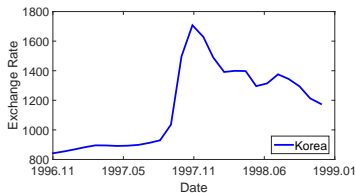
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Exchange Rate Regime Switch

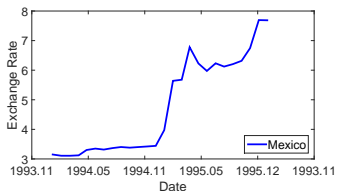
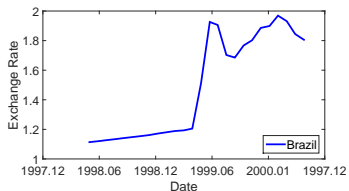
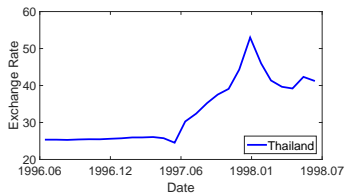
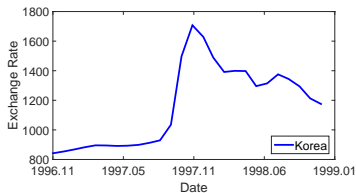
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- Capital inflow tax/subsidy: over-borrowing vs under-borrowing ex-ante

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- Characterize the parameter regions of the two equilibria: Schmitt-Grohe and Uribe (2016)

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 - magnitude of crises
 - exchange rate dynamics after crises
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