1. Introduction

Since the financial liberalization wave of the 1980s, several countries have experienced financial crises characterized by sudden arrests of international capital inflows and sharp drops in output, consumption and asset prices. These episodes, known as sudden stops, have sparked great interest in the design of monetary and exchange rate policies in financially fragile economies. Should these economies let their exchange rate float or rather anchor it to a foreign currency? Should monetary policy be concerned only with its traditional objective of granting price stability or should it also care about financial stability?

In this paper, I address these questions focusing on a pecuniary externality originating from frictions on the international credit markets. I present a theoretical framework that shows how the combination of financial frictions and nominal rigidities gives rise to a trade-off between financial and price stability. The main result is that a narrow focus on offsetting nominal rigidities can lead to a sub-optimal monetary policy in sudden stop-prone economies, and that it is optimal to devalue the exchange rate during financial crises to sustain the value of collateral and access to international credit markets.
externalities that create scope for policy interventions in the financial markets.

Wages are nominally rigid. During a financial crisis nominal wages fail to adjust downward, potentially worsening the impact of financial turmoil on the real economy. The central bank can mitigate the downturn associated with a financial crisis by engineering an exchange rate depreciation that increases the competitiveness of the economy. Importantly, the stimulus provided by exchange rate depreciation has a positive effect on the aggregate demand for land and on the value of collateral. Through this channel, exchange rate policy affects domestic agents’ access to the international credit markets during crisis events.

I use the model to compare the performance of three alternative monetary rules: a fixed exchange rate rule and two types of floating exchange rate regimes. The first type of float considered is a policy of strict wage inflation targeting. This rule eliminates all the distortions arising from nominal wage stickiness, and corresponds to the price stability rule of closed-economy sticky price models. The second type of float is a financial stability regime under which the central bank is allowed to respond to developments on the financial markets. Under this regime, the central bank depreciates the exchange rate when the collateral constraint binds, sustaining the collateral value of land and access to international financial markets.

The main result of the paper concerns the role of financial frictions in determining the welfare ranking among the policy rules considered. In fact, once the Fisherian deflation mechanism is introduced the financial stability regime welfare-dominates wage inflation targeting, because under the financial stability regime exchange rate policy mitigates the fall in the price of land and in capital inflows during crisis events. In contrast, the peg is always welfare dominated by the other two rules. This happens because during tranquil times the peg does not remove the distortions due to wage stickiness, while during crisis times pegging the exchange rate amplifies the fall in the price of land and in capital inflows compared to the other two regimes.

These welfare results are derived in a model in which crisis events are endogenous and rationally anticipated by agents, and in which monetary policy affects precautionary savings and crisis probability. In fact, the currency peg is the regime that stimulates more the accumulation of precautionary savings, followed by the policy of targeting wage inflation and by the financial stability regime. The intuition is simple: the more crises disrupt economic activity, the more agents accumulate precautionary savings to reduce the probability that the collateral constraint binds. Since the peg is the regime under which crises have the strongest impact on output and consumption, the peg is also the regime under which the accumulation of precautionary savings is more pronounced. Moreover, since crises are milder when the central bank adopts a financial stability rule, agents accumulate less precautionary savings under the financial stability regime than under a policy of strict wage inflation targeting.

This paper is related to two strands of the literature. The first one focuses on the design of monetary policy in financially fragile small open economies. Cespedes et al. (2004), Moron and Winkelried (2005) and Devereux et al. (2006) compare the performance of different monetary regimes in small open economies featuring financial market imperfections. Contrary to this paper, their models focus on business cycle fluctuations and are not suited to study economies occasionally subject to financial crises. Christiano et al. (2004), Cook (2004), Gertler et al. (2007), Braggion et al. (2007) and Curdia (2007) all use quantitative models to analyze the impact of monetary policy interventions during crisis times. In their frameworks crises are unexpected one-shot events, while this paper presents a model in which crises alternate with tranquil times and crisis probabilities are rationally anticipated by agents. This literature typically finds that the presence of financial frictions does not alter the welfare ranking among monetary policy rules, while the main insight of this paper is that financial frictions are a key determinant of which policy rule delivers higher welfare. Aghion et al. (2004), Caballero and Krishnamurthy (2003), Bordo and Jeanne (2002) and Benigno et al. (2011) consider monetary economies featuring both tranquil periods and crises. However their focus is on static models, while the dynamics of debt accumulation play a key role in the model presented in this paper. This paper shares with Schmitt-Grohé and Uribe (2011) the focus on the performance of different exchange rate regimes in economies subject to the risk of experiencing a deep recession. The key difference is that their model does not feature a collateral constraint, while here the interaction between the exchange rate regime and Fisher’s debt deflation is crucial.

The second strand of related literature employs dynamic real business cycle models featuring occasionally binding credit constraints and financial accelerator mechanisms, building on Mendoza (2002, 2010), to draw implications about policy conduct in small open economies prone to sudden stops. Examples are Benigno et al. (2013), Bianchi (2011), Bianchi and Mendoza (2010) and Jeanne and Korinek (2010). The novelty of this paper with respect to this literature resides in the focus on monetary policy and on the interaction between Fisher’s debt deflation and nominal wage rigidities. In a recent paper Ottonello (2013) studies exchange rate policy in a model in which collateral is based on current income, as in Mendoza (2002). In his setting a depreciation reduces the value of collateral, because it leads to a reduction in the foreign currency value of income derived from the non-tradable sector, and exacerbates the pecuniary externality. Taken together, our contributions point toward the importance of empirically understanding the nature of the key sources of collateral for the conduct of exchange rate policy.

The rest of the paper is structured as follows. Section 2 describes the analytical framework. Section 3 presents the results using numerical simulations. Section 4 provides a sensitivity analysis. Section 5 concludes.
دریافت فوری متن کامل مقاله

امکان دانلود نسخه تمام متن مقالات انگلیسی
امکان دانلود نسخه ترجمه شده مقالات
پذیرش سفارش ترجمه تخصصی
امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
امکان دانلود رایگان ۲ صفحه اول هر مقاله
امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
دانلود فوری مقاله پس از پرداخت آنلاین
پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات