Discussion of "Optimal Exchange Rate Policy" by Itskhoki and Mukhin

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[1]The views expressed are those of the author and do not necessarily represent the views of the IMF and its Executive Board.

What does the paper do?

- SOE with nominal rigidities, monetary policy (MP) to address the output gap
- Add a financial friction that creates a dual role for the exchange rate (in goods and financial markets)
- Segmented markets and risk aversion of intermediaries in the foreign exchange market
- Generally a trade-off between addressing the output gap and the financial friction
- Consider additional policy instruments and their joint use to balance wedges
- Examples: IMF's Integrated Policy Framework and others

Modeling of the intermediary friction

- Earlier work considered exogenous FX market depth ("Γ friction"): Gabaix-Maggiori 2015, Cavallino 2019, Fanelli-Straub 2021, Basu-Boz-Gopinath-Roch-Unsal 2020
- In this paper, intermediaries are risk averse and require compensation for risky carry trade
- Endogenous FX market depth that depends on the exchange rate volatility

$$\beta R_t^* \mathbb{E}_t \frac{C_{Tt}}{C_{Tt+1}} = 1 + \underbrace{\omega \sigma_t^2}_{\Gamma} \frac{B_t^* - N_t^* - F_t^*}{R_t^*}$$

Does the richer modeling of intermediaries matter?

- Proposition 6– "Probably not"
  - Allow some intermediaries and noise traders to be foreign
  - Transfers vis-a-vis the rest of the world
  - With noise trader shocks, use MP to close the output gap, and a combination of FXI and capital controls to fully address the risk sharing wedge
  - Not optimal for FXI to eliminate the wedge because of carry profits
  - Similar result to Basu et. al 2020
    - Use FXI and capital controls to address the intermediary friction (for all $\Gamma \neq 0$)

Does the richer modeling of intermediaries matter?

- Proposition 1 – "Probably not "
  - Special case of Proposition 6
  - With intermediaries owned by HHs, no carry profits to be made, FXI addresses the intermediary friction

$$\beta R_t^* \mathbb{E}_t \frac{C_{Tt}}{C_{Tt+1}} = 1 + \underbrace{\omega \sigma_t^2}_{\Gamma} \frac{B_t^* - N_t^* - F_t^*}{R_t^*}$$

- Proposition 2 – "Probably yes"
  - Special case of Proposition 1
  - If exchange rate adjustment is not needed for the goods market, FXI is not needed because FX market becomes deep anyway

What does the intermediary friction mean for FXI and market depth?

- FXI has more reasons to smooth the exchange rate in this paper as it can also improve market depth
- As FX market deepens even larger amounts of FXI are needed for it to be effective
- MP can in principle make the FX market deep, though generally not optimal
- Can FXI deepen FX markets?
  - Contrary to what the countries would typically say
  - UIP wedges can incentivize market entry but FXI eliminates the wedges