

# Optimal Exchange Rate Policy Discussion

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# A Great Trilogy



**Exchange Rate  
Disconnect in GE**



**Mussa Puzzle  
Redux**

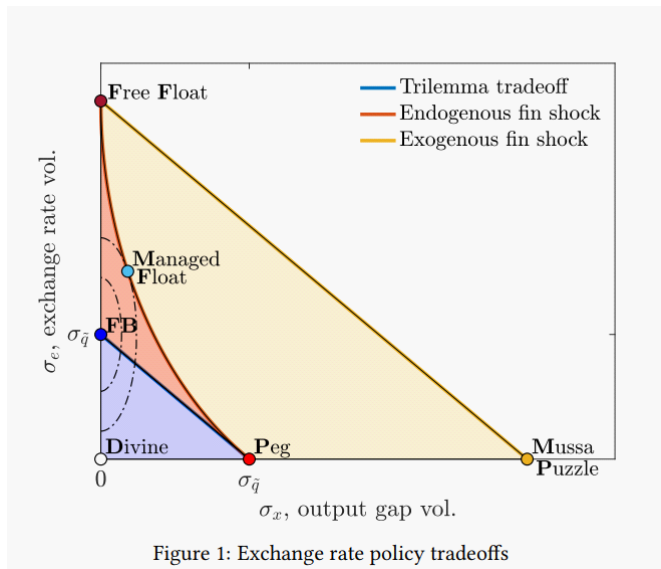


**Optimal Exchange  
Rate Policy**

- The paper adds normative analysis to the general framework
- Endogenous (financial) exchange rate volatility is welfare reducing because it distorts the international risk-sharing condition
  - EX volatility enters in the second order approximation of CB objective function
- **Excessive** exchange rate volatility can and should be reduced by a combination of FX interventions and MP.
- Managed float is the optimal exchange rate regime
  - manage high-frequency exchange rate movements
  - intervention is state contingent
  - anchored by strong commitment to intervention

## Great Paper - Essential Reading

# The Paper in One Picture



- Focus on three aspects (beyond the usual doubts about fx interventions) :
  - Discuss a possible a mapping between the paper framework and the policy context
  - Is there more to monetary policy?
  - Is Optimal Policy always Optimal?

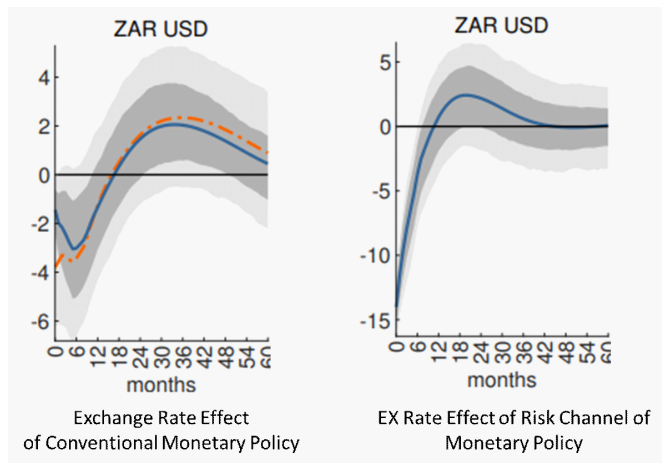
- The paper does not define an "optimal" FX intervention - instead it derives an optimal exchange rate policy
  - FX intervention should always be used as much as feasible (they are constrained but costless)
  - Monetary Policy works on the trade off between macroeconomic stability and ex rate stability once the FX intervention instrument is exhausted
  - Very Powerful FX intervention, one dimensional monetary policy
- Is FX intervention so powerful?
- Can monetary policy do more to stabilize the exchange rate?

# On the power of FX intervention

- With imperfect information optimal policy not feasible - too many unobservable
- The "satisficing" practice:
  - FX intervention Small and frequent (smoothing while managing FX reserves)
  - FX intervention when the signal of deviation is very clear - large capital flow shocks (GFC, COVID, Taper Tantrum)
  - Fx intervention when the deviation is very persistent (Brazil, Switzerland)
- Imperfect information put more weight on the monetary policy side of the policy mix

# Can Monetary Policy Do More?

- Monetary Policy as a multidimensional policy
- Pirzohkova et al (2024) - Strong influence of monetary policy on risk premium





# Is Optimal Monetary Policy always Optimal? (Davig and Gurkaynak, 2015)

- Monetary policy as a strategic game among different policy makers with possibly contradictory objectives
- Overloading MP with functions change the objective functions of other policy makers that do not internalize the effect of their policies
- Managed exchange rates fail if the overall policy set is incompatible with the objective of monetary policy
- By stabilizing the exchange rate we reduce the signal role of exchange rate movements

## SA foreign-exchange reserves reach record high

The data comes amid calls for the Treasury to use the foreign-exchange reserves to ease its financial problems

BL PREMIUM

08 JANUARY 2024 - 13:32

UPDATED 08 JANUARY 2024 - 16:59

## Budget cuts: Why doesn't the government use some of the money in this R459-billion account?

The reasons for not using money from the Gold and Foreign Exchange Contingency Reserve Account are political, not legal or economic

31 October 2023 | By Gilad Isaacs and Kelle Howson

Opinion | South Africa

## Reserve Bank and Treasury in discussions over access to R497 billion forex reserves



The central Bank and National Treasury are in active talks to help stem the tide of South Africa's growing budget deficit. File picture: Carlo Allegri / Reuters