

COMMENT: WILL THE SECULAR DECLINE IN EXCHANGE RATE AND INFLATION VOLATILITY SURVIVE COVID-19?

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THE PAPER

- ▶ Hugely important topic at the centre of the policy discussion in the coming years
- ▶ Is the Covid-19 shock planting the seed of a ‘Triffin event’?
[Gourinchas & Rey (2007), Farhi & Maggiori (2018)]



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IRR:

1. **G3 FX vol has been trending down** since BW-I, the trend accelerated in 2014, and again with Covid-19
2. **“Paralysis” of MP is key driver:** declining and converging inflation and short & long term rates
3. **Covid is a supply shock:** risks of rising inflation and MP divergence threatens stability of international monetary/financial system

1. Complementary view around drivers of FX vol

- ▶ Discarding risk cycles may be a “risky strategy”
- ▶ MP played very active role in taming risk during Covid-19 crisis

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2. Focus on 2020 & (speculative!) look ahead

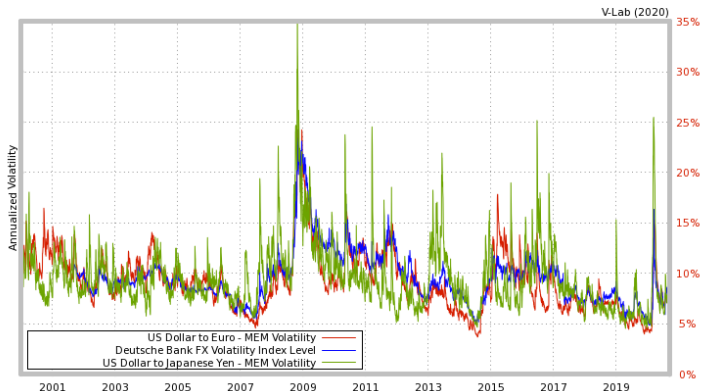
- ▷ Covid-19 transmission so far not dissimilar from past recessions
- ▷ But broad-based depreciation of US dollar
- ▷ Risks to international monetary system despite low inflation & low rates

FX VOLATILITY DYNAMICS AT THE CORE



G3 FX Vol

- ▷ Stability was dramatically broken over GFC, in 2015, and during **Covid-19**
- ▷ DB CVIX Index tracks low frequency dynamics across currency pairs. **CVIX measures stress in currency markets**

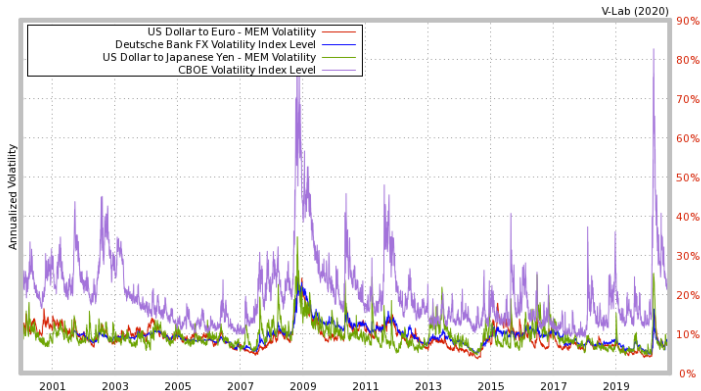


Source: NY Stern Volatility Lab <https://vlab.stern.nyu.edu/>



CORRELATION WITH RISK CYCLES

- ▷ Gabaix & Maggiori (2015), Itskhoki & Mukhin (2019a, 2019b)



Source: NY Stern Volatility Lab <https://vlab.stern.nyu.edu/>



BUT MP DOES MATTER

- ▶ Covid-19 news triggers “**Dash for Cash**” in March 2020 [Hauser (2020)]
 - ▶ Disorderly trading conditions originate in bond markets
 - ▶ Huge demand for liquidity
 - ▶ Sudden rise in volatility across the board

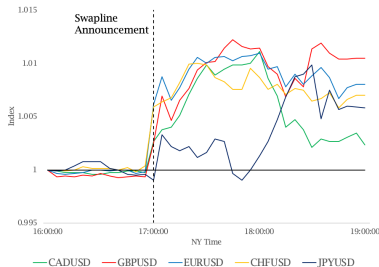
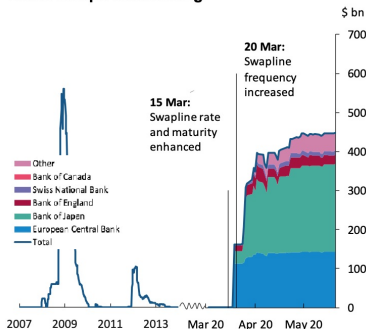


- ▷ Covid-19 news triggers “**Dash for Cash**” in March 2020 [Hauser (2020)]
 - ▷ Disorderly trading conditions originate in bond markets
 - ▷ Huge demand for liquidity
 - ▷ Sudden rise in volatility across the board
- ▷ Prompt, large, & synchronised intervention of major central banks
 - ▷ Bond purchase programmes in the order of 10-15% of national GDP
 - ▷ Dedicated programmes targeted at easing credit constraints [Gilchrist, Wei, Yue & Zakrajsek (2020), Altavilla, Barbiero, Boucinha & Burlon (2020)]
 - ▷ **Central bank swap lines**

CB SWAP LINES DURING COVID-19

- ▷ Dollar swaps outstanding and HF reaction of major bilateral FX pairs

Dollar swaps outstanding



Source: Hauser (2020) and Eguren-Martin (2020)

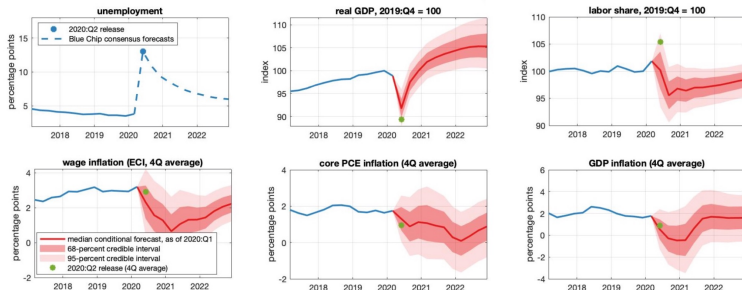


IN WHAT WAY IS THIS CRISIS DIFFERENT?



COVID-19 SHOCK HAS LARGE 2ND-ROUND DEMAND EFFECTS

- ▷ **Transmission so far not different from previous recessions** [Del Negro, Lenza, Primiceri & Tambalotti (2020a, 2020b)]



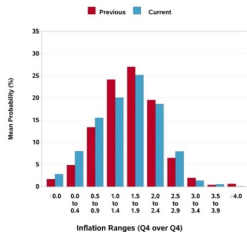
Source: Del Negro, Lenza, Primiceri & Tambalotti (2020b)

- ▷ Covid as a **Keynesian supply shock** [Guerrieri, Lorenzoni, Straub, & Werning (2020)]

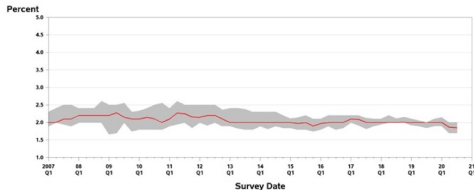
INFLATION & MP OUTLOOK REMAIN STABLE

- Higher probability of low-inflation states in the near and longer term

Mean Probabilities for Core PCE Inflation in 2021



Projections for the 10-Year Annual-Average Rate of PCE Inflation
(Median and Interquartile Range)



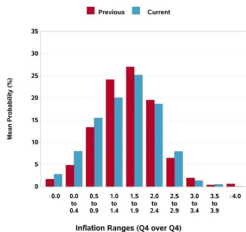
Source: SPF 3rd Quarter 2020, released August 14, 2020



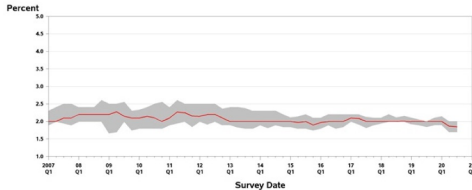
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- ▶ **Fed's new AIT operating framework, rates not predicted to rise until end 2023**



BUT THIS TIME USD IS LOSING GROUND

- ▷ Broad based depreciation



Source: Eikon Refinitiv



AGAINST THE EUR

- ▷ Surprising? EUR is 2nd largest traded currency



Source: Eikon Refinitiv



BUT ALSO AGAINST GBP

- ▷ *Despite* heightened UK-specific risks



Source: Eikon Refinitiv



RISKS GOING FORWARD?

- ▷ USD is the safe currency par excellence

anchor, invoicing, trade, financial transactions,... [Rey (2013), Gopinath (2015), Ilzetzki, Reinhart & Rogoff (2017, 2019, 2020), Maggiori, Nieman & Schreger (2020)]

- ▷ But safety is a relative concept. **Confidence remains key.**

- ▷ US typically behaves as a world banker [Gourinchas & Rey (2007a)]

- ▷ In bad times US acts as world insurer (**“exorbitant duty”**) [Gourinchas, Rey & Govillot (2017)]

- ▷ Net wealth transfers to ROW due to USD appreciating & other risky assets losing value



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 - ▷ Net wealth transfers to ROW due to USD appreciating & other risky assets losing value
- ▷ **Other (US-specific?) risks to stability of the international monetary system** despite low inflation and accommodative MP for years to come

