Comment: Will the Secular Decline in Exchange Rate and Inflation Volatility Survive Covid-19?

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The views expressed are those of the author and do not necessarily reflect those of the Bank of England, the Monetary Policy Committee, the Financial Policy Committee or the Prudential Regulation Authority.
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’?
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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’?
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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
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

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

- Bond purchase programmes in the order of 10-15% of national GDP
- Dedicated programmes targeted at easing credit constraints
- Central bank swap lines
**But MP Does Matter**

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- 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

15 Mar: Swapline rate and maturity enhanced
20 Mar: Swapline frequency increased

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

Source: SPF 3rd Quarter 2020, released August 14, 2020
Inflation & MP Outlook Remain Stable

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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**

- 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
**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)]

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- **Other (US-specific?) risks to stability of the international monetary system** despite low inflation and accommodative MP for years to come