

## **The Optimal Currency Area in a Liquidity Trap**

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*Discussion by*

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### **Big issue**

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- **Contribute to the general literature on the optimal currency area in the face of country-specific macro shocks**
- **Particularly important in light of the current eurozone crisis**

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### Conventional wisdom

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#### **• Independent currencies with flexible exchange rates welfare-dominate a single currency area**

–they allow automatic exchange-rate adjustment to partially offset the effect of country-specific shocks to help achieve more efficient risk sharing

- Following a negative relative demand shock, the terms of trade depreciation and relative price deflation is accompanied by an exchange rate depreciation which serves as an endogenous stabilizer

–they give policy-makers the freedom to adjust interest rates to directly counter the effects of the country-specific shocks and to facilitate the exchange rate movement

- Following asymmetric negative demand shocks, a relative national interest rate decrease is feasible if interest rates are significantly above the zero lower bound

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### But, when interest rates are at the zero lower bound...

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- **Further interest rate decreases become infeasible**
- **Under independent currencies with flexible exchange rates, the exchange rate can move in the “wrong” direction to compound rather than counter the impact of the country-specific shocks (*owing much to complete world asset markets and the temporary nature of the shocks*) ; and, constrained by the zero lower bound, independent interest rate policy is powerless in restraining such perverse exchange rate movement**
- **A single currency area may act as a pre-commitment device to prevent a perverse exchange rate movement**
  - As such, a single currency area may dominate independent currencies with flexible exchange rates in a liquidity trap environment

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### Provocative results under fairly mild assumptions

- Complete world financial markets
- Home bias in consumption
- Subsidies that remove steady state monopolistic distortions
- Cross-country symmetry
- Temporary nature of the shocks

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### The lower bound represents an occasionally binding constraint

- That makes the model and policy nonlinear (the max-rule)
- Transition dynamics between normal and liquidity trap environments can be a non-trivial issue
- Expectation effects: If agents anticipate the possibility of reaching the lower bound in the future, this may amplify the effects of adverse shocks well before the bound is reached
- The presence of large (binding) shocks may alter optimal policy response to small (non-binding) shocks (preemptive)
- Higher-order effects of large shocks
- Fiscal conditions and unconventional monetary policy

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