“Optimal Exchange Rate Regime and Firm Dynamics” by M. Hamano & F. Pappada

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Question the optimality of fixed vs flexible exchange rate regimes in a model with heterogeneous firms, endogenous entry and tradability, pre-set nominal wages. Focus on demand shocks.

Key mechanism: sticky wages & firms heterogeneity \(\downarrow\) expenditure switching effect. Fixed XR \(\downarrow\) the positive welfare effect of a positive demand shock on output but \(\uparrow\) the positive welfare effect through the comovement between the shock & output.

The latter effect may end up dominating, making fixed XR preferable. In addition to larger labor supply elasticity, larger elasticity of substitution between varieties, the higher Pareto shape parameter plays a key role.
Very nice idea to investigate the optimal level of XR variability in this environment! Important effort to make the model tractable, quasi-closed form.

Scope: currently on the optimality of XR regimes when the economy is subject to demand shocks. And very specific demand shocks (home bias shocks). Why not focus on the broader question of optimal open-economy adjustments to various shocks with heterogeneous firms?
Comments

- Seems that many other (potentially more important) factors determine the choice of XR regime (credibility, geography of trade/financial flows, exposure to balance-sheet effects, openness, etc...)

- What about: look at the optimal (Ramsey) policies in this environment, and then look at the implied XR volatility. If low or zero, then points to superiority of fixed XR

- This way you would also show the instruments that implement optimal policies (tariffs vs. regulation (entry) vs. monetary policy). The model is perfectly equipped to address this agenda (for instance, merging section 4 with Appendix A, and making it the core of the paper)
Search for tractability comes at some (potentially crucial) costs:

▶ Pre-set wages: tends to lower the volatility of the real exchange rate *a lot* compared to Calvo/Rotemberg. This seems to be crucial.

▶ Monetary policy stance as in Corsetti-Pesenti: $\mu_t = P_t C_t$. No or little endogenous persistence, little intertemporal substitution.

▶ Full “depreciation”: all firms exit and re-enter at each period. Much less persistence in the distribution of existing firms.

▶ Not saying any of this is bad but the paper could acknowledge the potential impact of each of these simplifying assumptions, for instance against the baseline Ghironi-Melitz model with sticky wages.
Cobb-Douglas consumption aggregator: misses the potential role of the trade elasticity

Unit trade elasticity + log utility = equivalence between complete and incomplete markets

Also equivalent to balanced trade, as in Gali-Monacelli (2006): Equation (8) is basically the risk-sharing condition

Not necessarily the most interesting case because it is knife-edge (unless I missed something from the model)

So what exactly break divine coincidence with closed econ in the model?
Comments

▶ Entry and export costs paid in units of labor (which is standard), but then the dynamics of wages critically matter for XR volatility but you do not insist a lot on the entry channel in the paper. It is critical and could receive more attention (this is your key addition to the literature).

▶ Use the simple model to illustrate the mechanism, and then extend the model with more realistic assumptions to compute equilibria and optimal policies? Would certainly reinforce the power of the results.

▶ Overall, great & promising paper, with a lot to discuss!