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Comment

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The paper analyzes the role of monetary policy in an open economy model where the nominal exchange rate responds to news about future fundamentals. Extending their previous work (Devereux and Engel 2006), the authors present a two-country model in the class of the New Open Economy Macro literature, where prices are sticky and a stochastic component of future productivity becomes known a period in advance. The model also includes an internationally traded commodity input, but this feature is not essential to the analysis of the optimal policy.

The authors show that price rigidity, combined with the news shock to a future fundamental and the presence of home bias in preferences, generates an inefficient allocation: while in the flexible price case current consumption depends only on *current* fundamentals, in the sticky price case it depends on the news about future productivity. They then show how to devise a monetary policy in the form of an instrument rule—they consider in turn a money supply rule and an interest rate rule—to replicate the flexible price equilibrium. Monetary policy should be designed to offset the effect of the news on the nominal exchange rate.

With their stylized model, Devereux and Engel intend to offer an example of the tension between the role of the exchange rate as an asset price and its role as determinant of relative goods prices. Their paper is very interesting and provocative, and provides them with a new ground to argue for the desirability of a monetary policy that promotes exchange rate stability.

I do not have the expertise in international macro to discuss the analytics of the paper. Nonetheless, I am uncomfortable with the paper's conclusion about the desirability of offsetting exchange rate fluctuations. I will therefore limit my comments to raising a few questions about the nature of their monetary policy prescription, and discussing the implications that the authors draw from their analytical results.

Observation 1

The proposed policy is able to reproduce the flexible price equilibrium: to what extent is it the policy that maximizes consumers' welfare? Also, how do we know that the proposed policy does not create undesirable side effects? The policy prevents the transmission of information through prices, which is what a well-functioning market should do. Perhaps the authors should give a better intuition for the nature of the inefficiency that such diffusion of information causes and clarify to what extent their result is driven by the very simple form of price rigidity—with all prices set a period in advance—which is assumed in the paper.

Observation 2

The derived optimal policy dampens those fluctuations in the exchange rate that derive from its response to the news. To what extent should it be characterized as an exchange rate policy, which would involve monitoring the exchange rate?

Devereux and Engel state at some point that "Common wisdom (supported by the empirical work of Devereux and Engel 2006) is that short run exchange rate movements are largely driven by news about the future . . . therefore the policies that target news about the future are far more important in delivering desirable terms of trade movements and real exchange rate movements than the policies that target current fundamentals" (p. 18).

This statement suggests that, if one wants to stabilize the exchange rate, one should target the news, because most of exchange rate shocks come from news. However, news are very hard to pin down, and the policy suggestion of the paper seems to be that stabilizing the exchange rate would achieve an approximately optimal policy.

But, should stabilization of the exchange rate be the objective of the policymakers? The problem with such a policy is that it would offset as well those fluctuations that reflect instead the relative prices of goods, leading to inefficient allocations. Even according to the authors' calculations (see Devereux and Engel 2006), fundamentals still represent some 20 percent of exchange rate fluctuations.

Observation 3

The paper, however, raises the interesting issue of the importance of news about future fundamentals. Recent research (Evans and Lyons

2007) explores the empirical relevance of changes in fundamentals expectations using data on transaction flows. The idea is that there is more information than what is publicly known, which is dispersed and assimilated by the market through the trading process. The paper finds that transaction flows predict how the market will react to information about future macro fundamentals, and exchange rates respond to transaction flows precisely because they reflect this change in market expectations.

But there is a sense in which the proposed reaction of monetary policy to the news is problematic. The news that matter for exchange rate movements, in fact, might as well be news about future interest rate movements. A change in expectations of the future policy path is, for example, often generated by speeches of the Federal Open Market Committee (FOMC) members, or by the FOMC post-meeting statement, even in the absence of any policy change, or when a policy change occurs that is exactly anticipated. It would indeed be very interesting to explore this hypothesis using information on daily exchange rate movements, looking at the times of policy announcements.

The case of whether monetary policy should aim at stabilizing the exchange rate is highly debated in the literature. Commonly cited reasons why an exchange rate should not be included in the policy rule rest essentially on the asset price nature of exchange rates: they are very volatile, and their movements are hard to explain. In the model of this paper the particular nominal rigidity assumed makes innovations in the exchange rate equal to innovations in the terms of trade. The arguments for excluding the terms of trade from explicit consideration in the policy rule are weaker than for the exchange rate because terms of trade are more predictable, at least since the 1980s (see Rogoff 2006). But again, the literature offers several plausible cases where it is not necessary to include them in a policy rule to achieve the monetary authority's objectives.

Concluding Comments

To conclude, I want to go back to the motivation of the paper, the observation about the large swing in the relative price of oil in the United States versus the euro area between 2002 and 2004. Carrying over the conclusions of the Devereux-Engel model, should the European Central Bank (ECB) and the Federal Reserve System have prevented the dollar depreciation? Such a recommendation not only runs counter to the theoretical considerations discussed previously, and the resistance of policymakers to offset exchange rate movements, but overlooks the fact

that there might have been good reasons for a dollar depreciation at that time, and that preventing it could have caused more inefficiencies.

By the end of 2004, according to Obstfeld and Rogoff (2006), a large fall in the real value of the dollar was a necessary by-product of the needed reduction of the U.S. current account deficit. While there may be no agreement on the size of the forecasted dollar depreciation, most economists would agree that the current account deficit would require an increase in the American national savings. Such a rebalancing would indeed imply a decline of the real value of the U.S. dollar, and it is not clear to what extent such a process could be obtained without a decline in the nominal value of the exchange rate, a realignment that we are still experiencing. (The alternative would be deflation, surely not a desirable way to bring about this adjustment.)

Note

The views expressed in this discussion do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

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