The Optimal Currency Area in a Liquidity Trap

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Discussion by

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**Big issue**

- 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
Conventional wisdom

• 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

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

• 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
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

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