The Magic of the Exchange Rate: Optimal Escape from a Liquidity Trap in Small and Large Open Economies

Abstract

The optimal escape from a liquidity trap involves generating private-sector expectations of a higher future price level. This lowers the real interest rate and reduces the recession during the liquidity trap. The problem, emphasized by Krugman, is that central-bank promises of a higher future price level may not be credible. The current exchange rate will be a good indicator of private-sector expectations of the future price level. An intentional currency depreciation (which is technically feasible) will create private-sector expectations of a future weaker currency and a higher future price level. An intentional currency depreciation and a crawling peg (as in the Foolproof Way) can implement the optimal escape from a liquidity trap and make this credible. Optimal escape from a liquidity trap in a large economy does not prevent the rest of the world from achieving its monetarypolicy objectives, if the rest of the world is not in a liquidity trap. For negative international output externalities (which may not be very realistic, since they rely on optimal international risk sharing), the rest of the world may fall into a liquidity trap. This nevertheless moves the world equilibrium towards the equilibrium corresponding to optimal international cooperation. For positive international output externalities, any initial liquidity trap in the rest of the world is alleviated or eliminated.