External imbalances, exchange rate regimes and firm dynamics

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Extended abstract

This paper explores the impact of a country exchange rate regime and firm size distribution on its external imbalances. Using current account data over the past two decades, we show that a flexible exchange rate regime reduces the persistence of the current account position, in line with the findings by Ghosh et al. (2013) and what predicted by Friedman (1953). We then use Compnet data on the distribution of firm turnover and productivity for 15 UE countries to show that the persistence of the current account is further reduced when the exchange rate is flexible and the dispersion of firm size distribution is smaller. We provide a thereotical model to rationalize this empirical finding. We build an open economy dynamic model with firm heterogeneity and wage rigidity. Monetary policy completely offsets aggregate shocks when the exchange rate regime is fixed, whereas it does not respond to aggregate shocks when the exchange rate regime is flexible. We also allow for an intermediate degree of response of monetary policy which corresponds to a more or less flexible exchange rate regime. We show that in response to an increase in the demand for home goods, a larger external adjustment - i.e. larger movements of the current account - is associated with a lower dispersion of firm turnover when the exchange rate is fully flexible. This reflects the larger impact of the extensive margin of trade on external adjustment as shown in Pappadà (2011). We then study the interaction between monetary policy and the dispersion of firm turnover, and show that the optimal degree of response of monetary policy to aggregate shocks is a negative function of firm size dispersion. Finally, we calibrate the full-fledged dynamic model to measure the quantitative dampening effect of a lower firm size dispersion on the persistence of the current account.

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