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Essays on Small Open Economies

My dissertation research puts a focus on small open economies, whose policies do not affect world prices and interest rates, such as Canada and Australia. In particular, I analyze Canada's business cycle properties and examine the effectiveness of Australia's exchange rate policy.

In my job market paper, "The Effect of World Credit Spread Shocks on Business Cycles in A Small Open Economy", it is shown that recent Canadian data from 2001 to 2013 feature a notable procyclical trade balance, which contrasts with the countercyclical trade balance in 1981-2000. By using a dynamic small open economy model built based upon Mendoza's (1991) framework, driven by correlated domestic productivity shocks and world credit spread shocks, I can generate the observed trade balance pattern in the pre-2000 and post-2000 periods. In addition, my analysis shows that the world credit spread shocks explain a large portion of the considerable change in the cyclical nature of trade balance, and that the low world real risk-free interest rate after 2000 partially accounts for the procyclical trade balance in the same time period. Applications of the model to other developed small open economies, such as Australia and New Zealand, yield similar results, suggesting that the world credit spread shocks have an impact on macroeconomic dynamics and help improve model performance. This adds value to the existing macroeconomic literature on the debate of whether shocks to the world real interest rate are important in explaining model dynamics in a small open economy.

My second paper, titled "Does Jawboning on the Exchange Rate Work? Evidence from Australia", concerns an innovative exchange rate policy implemented by the Reserve Bank of Australia (RBA). In the paper, it shows that from 2013 to mid-2015, the Australia's real trade-weighted exchange rate index has dropped by almost 20%. During this time, in order to achieve balanced economic growth, the RBA tried to bring down the Australian dollar by presenting public speeches and monetary policy statements that expressed a strong preference for a lower exchange rate, which is known as jawboning down the currency. To investigate whether the central bank's jawboning strategy has any contribution to the large drop in the exchange rate and whether it has stimulated economic activities, I analyze the Australian economy with a structural vector autoregressive (SVAR) model, in which the Exchange Rate Stance Index (ERSI) is constructed to measure the magnitude of jawboning using the narrative approach pioneered by Romer and Romer (1989). The empirical results show that an unanticipated increase in the ERSI, which is equivalent to strengthened jawboning by the RBA, will lead to a significant and lasting fall in the real exchange rate, and that the ERSI shock explains more than 20% of the variance of the exchange rate at five years. However, although the ERSI shock causes a small but statistically significant rise in the Australia's business confidence index over the medium term, it fails to improve GDP. These suggest that the jawboning strategy is not an effective exchange rate policy tool to boost GDP growth.