Discussion on "Rethinking the link between Exchange Rate and Inflation: Misperceptions and New Approaches"

Gianluca Benigno (LSE and CEPR)

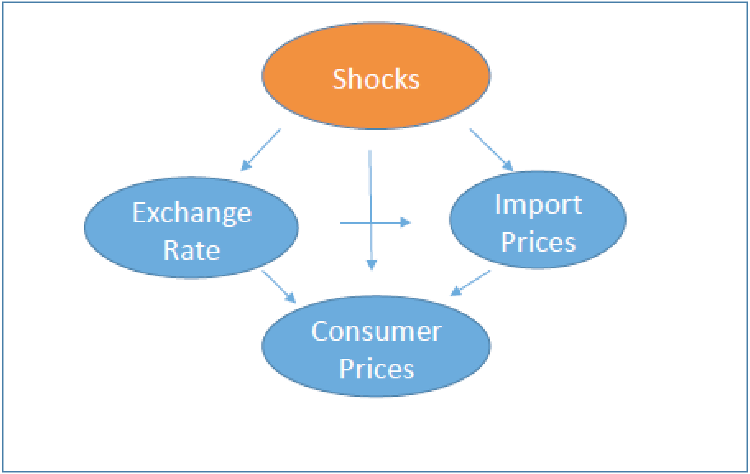
EABCN Forum

Brief Summary

- Important question: how do exchange rate movements affects inflation?
- This is a relevant paper for the understanding of this link (exchange rate pass through).
- Measure of exchange rate pass-through for the UK varies over time: high during crises, low after; In general measures of pass-thorugh vary over time and across countries.
- Analysis is conducted along two dimensions: econometric and model-based.

Standard Analysis

This paper:



Discussion

- Challenges from the approach;
- Role of monetary policy
- Conclusions

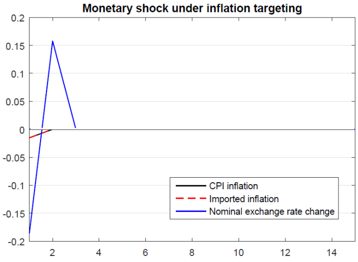
Challenges from the approach

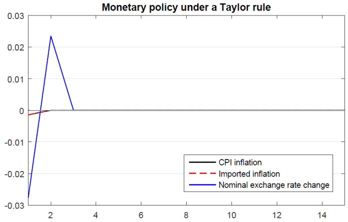
- Implicit assumption is that you have a good model of exchange rate determination.
- Puzzles in exhange rate determination:
  - Forward discount puzzle and Engel's puzzle;
  - Consumption real exchange rate anomaly;
  - Real exchange rate persistence;
- Need of a good theory of exchange rate determination.
  (theory determines transmission mechanism of shocks for given structure of the model)

Challenges for this approach

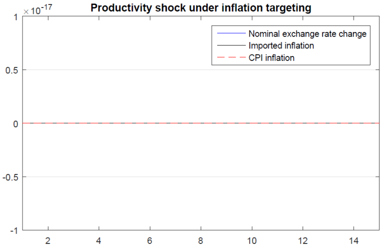
- Focus on exchange rate determination based on interest rate rule (Benigno, G (2004) and Benigno, G and P. Benigno (2008).
- Simpler version of the model used in the paper:
  - 2-country, 2-tradeable goods
  - pricing to market
  - complete markets
  - no persistence in the shocks.
- Changes interest rate rules: design of policy rules affect transmission of shocks.

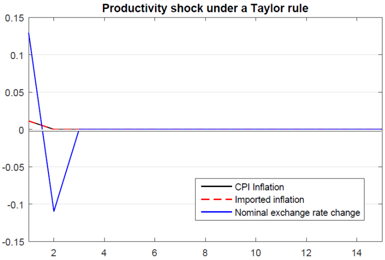
Challenges for this approach





Challenges from the approach





Challenges from the approach

- What do we learn from this?
  - Transmission of shocks is determined by monetary policy behavior;
  - Exchange rate and price dynamics is also affected by the design of monetary policy;
  - Identification strategy in the SVAR is conditional on monetary policy;

Challenges from the approach

- Why is it interesting to look at monetary (wicksellian) theory of exchange rate determination?

1. Liquidity trap; (Cook and Devereux, 2013):
    1. Cook and Devereux (2013): In a global liquidity trap, a negative demand shock lead to appreciation of relative prices Topsy-turvy behaviour of the exchange rate?
    2. Role of unconventional monetary policy.
2. Forward guidance;
    1. Bank of England forward guidance: "*In particular, the MPC intends not to raise Bank Rate from its current level of 0.5% at least until the Labour Force Survey headline measure of the unemployment rate has fallen to a threshold of 7%, subject to the conditions below.*"

Conclusion

- Excellent work: interesting and stimulating!
- Interpretation might not be univocal: understanding exchange rate pass-through for the UK economy after the crisis could be conditional on monetary policy framework. The transmission mechanism of shocks and the determination of the exchange rate in a liquidity trap could be different than normal times.
- Disentangle different forces both in the theory and in the empirical part.