Discussion of:
Nonlinear Pass-Through of Exchange Rate Shocks on Inflation

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19 May, 2016

Estimating pass-through is challenging

Endogeneity – can take many forms, e.g.,

- Domestic interest rates may rise due to a monetary policy response to inflationary pressure, leading to an <u>appreciation</u> of the exchange rate

    - i.e., appreciation may be linked to rising, rather than falling prices

- Among other things, exchange rates influence, and are influenced by domestic/foreign: inflation, future monetary and fiscal policies, productivities, nominal rigidities, economic integration, ...

Estimating pass-through is challenging

- Engel has argued questions about PT should be addressed in the context of the **sources** of exchange rate changes, e.g.,

  in LR: ↑M ⇒ d.c. depr (and) ↑P, then PT = 1, **but a similar**

  ↓M* ⇒ d.c. depr (and) $\Delta P=0$, then PT = 0

  i.e., the **<u>source</u> matters**

- But surely this is too restrictive for SR analysis
  - It is a long run proposition
  - Barriers (e.g., pricing power) are absent and free trade is assumed
  - In the SR, a d.c. depr, regardless of the source, may lead to ↑P

- Nonetheless, the monetary authority still cares about the source

This paper

- Argues its focus is on the inflationary consequences of an exchange rate change ∴ no need to consider the source
  - Not really defensible
  - Despite making a good point that one (favored) alternative approach, i.e., a DSGE model, would embed a PPP assumption, which seems to be rejected by the data

- However, the paper partly addresses this identification problem via its focus on shocks to exchange rates after controlling for many of these exchange rate influences (VAR)
  - And, the 'Historical Decomposition' isolates (historical) sources
  - Pass-through of an 'orthogonal' exchange rate change – in the context of various states of the economy?
  - I think it would be more convincing to bring in additional <u>foreign</u> variables in the VAR (currently only mc*)

This paper

- Focuses on several (too many?) things:

  - The dependence of pt on the state of the economy, the size of the exchange rate shock

  - At various 'stages' along the distribution chain

  - Historical Decomposition

  - Asymmetry (+/-)

  - The 'completeness' of pass-through
    - In SR and LR

  - Policy implications

Orentiation

- My view: focus on pt at various horizons is distracting
  - Leads to no new conclusions
    - e.g., pt is incomplete
    - e.g., pt increases over time
    - e.g., estimates are less precise as time increases
  - Pushes the identification assumption too hard
  - Competes with other points authors make
    - e.g., pt to different stages

- My view: Asymmetry is over-emphasized
  - pt is roughly the same for +/- shocks
  - Similarly for acceleration/deceleration of exchange rate change (pt is roughly the same)

Puzzles

- Q: Lack of 'foreign' variables in VAR

  - Could solve puzzles, e.g., pt is negatively related to openness

- Q: Is the focus on dichotomization forced: (Large/Small), (Positive/Negative); have there been truly 'big' differences in e.g., inflation, exchange rate shocks, ... over the sample?

  - Are we talking about many more, much larger <0, than >0?

  - Were there significant reductions in trade barriers or other state variables?

  - Summary statistics would answer these questions

Orentiation

- A negative conclusion: "....there should <u>not</u> exist a specific rule on pass-through on inflation for policy making…"

However,

  - Your conclusions emphasize many influences, esp., state of the economy, and size of shocks
  - And you note that '…decisions cannot wait up to the time when experts identify shock…"
  - What to do?

- Table 8 (important) needs better motivation
  - This table, and the Historical Decomposition should form the key take-a-ways. This should let you frame the discussion in terms of sources explicitly

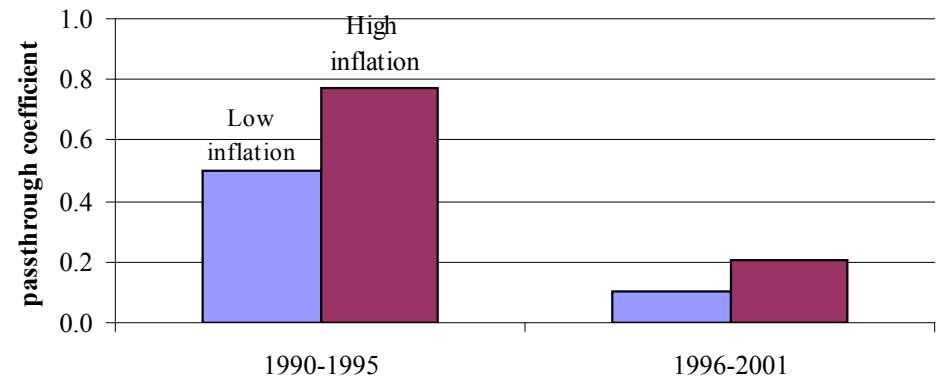# A comparison to Frankel-Parsley-Wei

(1)

(2)

**Exchange Rate Passthrough
to Domestic Prices**
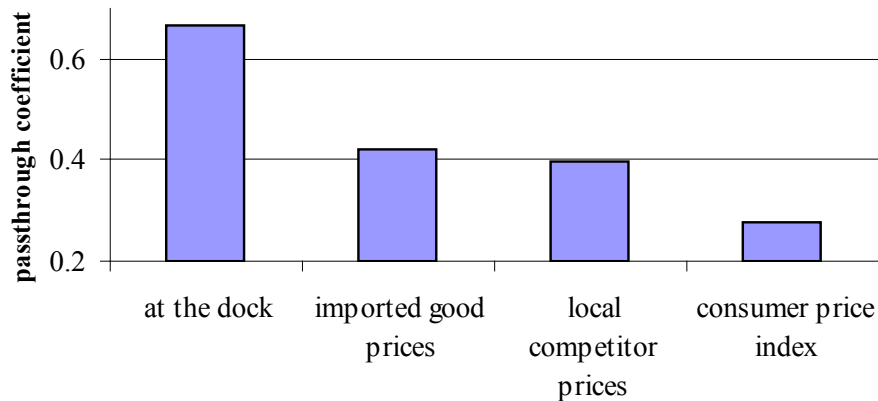
**Passthrough and Inflation
(Above and below median inflation country groups)**

(1) Similar to Rincon and Rodriguez's Historical Decomposition results

(2) The monetary climate seems important: pt is significantly higher in an environment of high inflation

Conclusion

- Interesting paper on an important subject
- Nice methodology
- I learned a lot

- Thank you!