Discussion of :

Exchange Rate Undershooting: Evidence and Theory

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Exchange rate undershooting

Dornbusch (1976) vs. empirical evidence

- ▶ Dornbusch (1976): in response to a contractionary monetary policy shock, the exchange rate responds immediately by overshooting (appreciation on impact)

- ▶ Empirical evidence: the exchange rate rather undershoots and appreciates in the long run

What could explain the observed dynamics of the exchange rate in response to a contractionary monetary policy shock?

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Summary

This paper does the following :

1. it provides new evidence on the response of exchange rate (both spot and forward) to monetary policy shocks: the high-interest rate currency keeps appreciating after the shock (*undershooting*)

2. it gives a rationale for this empirical evidence by building a model where informational frictions do not allow agents to fully disentangle monetary policy from natural rate shocks

3. the estimated model is able to reproduce the dynamics of the spot and forward exchange rates, thus also addressing the issue of the *forward premium*

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$$x_{t+h} - x_{t-1} = c^{(h)} + \sum_{j=1}^{J} \alpha_j^{(h)}(x_{t-j} - x_{t-j-1}) + \sum_{k=0}^{K-1} \beta_k^{(h)} u_{t-k} + \epsilon_{t+h}$$

- In your preferred empirical specification, you control for past shocks and past values of the endogenous variable during the year preceding the shocks, i.e. J=K=4

- Does the sign and series of shocks matter for the results? Does this explain why results are partly affected by the time period used? E.g. post-Volcker (1988M01-2007M07): depreciation then appreciation

- Narrow nominal effective exchange rate BIS: 15 countries, which ones? What if broad? Currencies pegged or semi-pegged to dollar?

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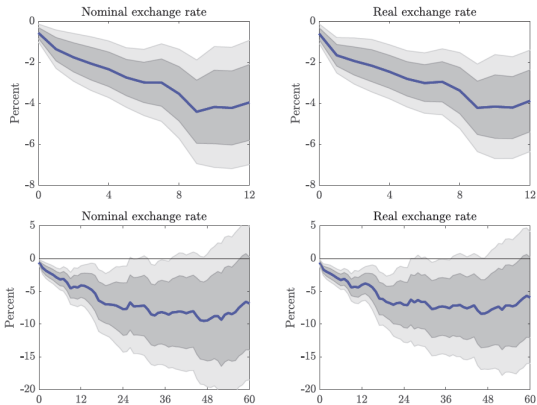
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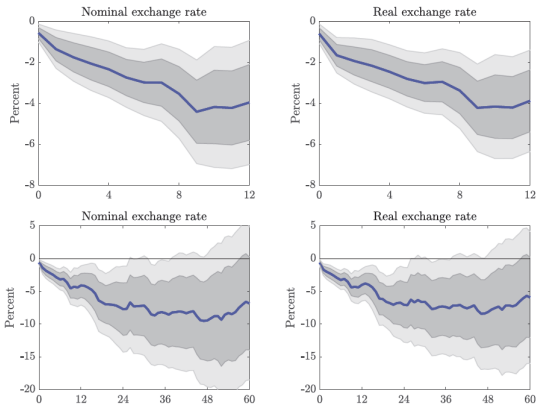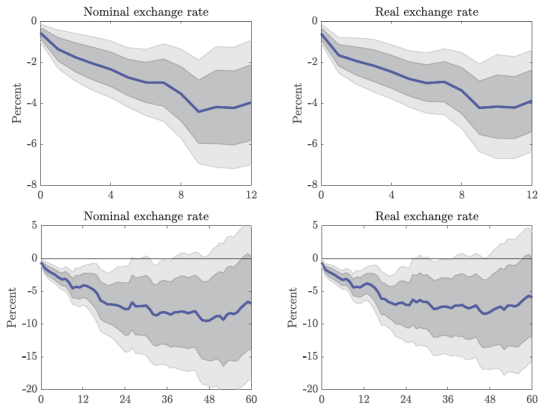
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Why do nominal and real exchange rates move so close to each other? This is consistent with the sluggish adjustment of CPI over the first 18 months past the shock, but why is it the case at longer horizons too?

Are foreign CPIs moving hand in hand with domestic one? Evidence on the CPIs of the 15 countries used for the effective exchange rate?

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▶ The response of the exchange rate to a TFP shock (depreciation) is crucial for the mechanisms of your model: shouldn't you put this more upfront? (now in External validity - Fig. 11)

▶ The role of the interest rate rule (in response to shocks to the natural interest rate): what if you had discretionary monetary policy or an alternative rule?

▶ The estimated variances of the shocks: $\sigma_y = 0.063$ and $\sigma_\eta = 0.007$: quite close to full information as σ_η is close to zero.

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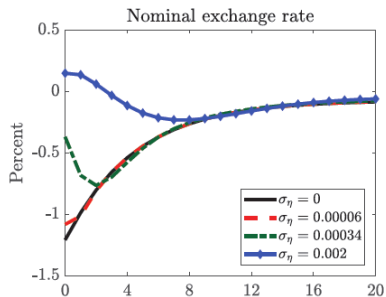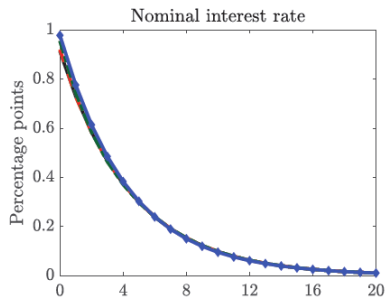
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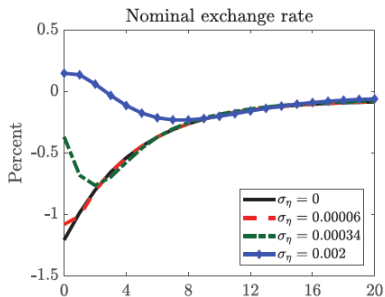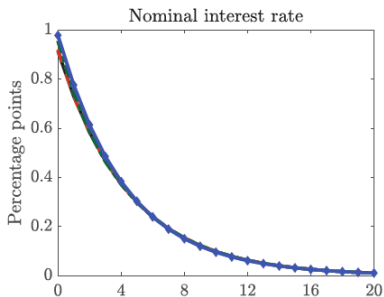
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▶ Learning from the history of observed monetary policy vs. natural rate: what is the frequency of each of the shock?

▶ Symmetry: would you observe an undershooting *depreciation* of the exchange rate after an expansionary monetary policy shock?

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▶ Is there a way to select subsamples in your data where the disconnect is larger or smaller? If yes, it would then be interesting to see whether the variance of η_t and u_t changes in the subsamples

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