

Discussion of
*“Expenditure Switching vs. Real Exchange Rate
Stabilization: Competing Objectives for
Exchange Rate Policy”*

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Overview

- Main idea: trade-off between smoothing real exchange rates and adjusting to real shocks
- Use an extension of recent NOEM models with nominal rigidities
- Crucial feature: difference between consumer prices and price of imported intermediate goods
- Exchange rate pass-through much higher for consumer prices

- Difference between import and consumer prices may be caused by a distribution sector
- Alternatively, different market structure leads to different pricing strategies
- Related to Obstfeld (2001)
- Bacchetta and van Wincoop, JEEA 2003, show that the assumed difference in pass-through may be optimal for firms
- But richer and more diversified asset markets

Initial comments

- Useful application of NOEM literature, gives a much richer analysis
- In Mundell-Fleming, full pass-through to consumer prices
- Here, full pass-through for exporters, but no pass-through for consumers
- Important improvement to understand the implications of exchange-rate movements
- Good to have analytical results

Main results

- Policy makers try to minimize:
- Real exchange rate deviations: $\frac{SP^*}{P} - 1$
- Terms-of-trade deviations: $\frac{SP_F^*}{P_H} - \left(\frac{K^*}{K}\right)^\beta$
- With flexible prices these deviations are zero

- Assume final good prices P and P^* are fixed, but import prices are flexible
 - ⇒ Only first deviation to minimize: fix S
- But import prices are not totally flexible
 - ⇒ Trade-off between the two objectives
 - ⇒ Flexible exchange rate
 - ⇒ But should not try to fully offset terms-of-trade shocks

Discussion

- Trade-off between exchange stability and exchange rate flexibility is interesting. Not in MF
- In MF, the main determinant is the relative variance of shocks
- Here only one type of shocks
- How would other shocks affect the analysis?

Exchange rate stability

- How robust is the stabilization objective? I.e., how realistic is it to wish a constant real exchange rate?
- Based on complete markets; realistic ?
- Optimal real exchange should move if there is a home bias in final goods or with non-tradable goods (Duarte-Obstfeld, 2004)
- How much of the stabilization objective remains?

Optimal exchange rate policy

- A flexible exchange rate is always optimal
- Should we get rid of fixed exchange rates?
- Or is there something missing/flawed in the analysis?

- Is policy so flexible that you can always choose exactly your degree of volatility?
- In practice you may choose between a fixed exchange rate and flexible rate with inflation targeting or 'standard' Taylor rule
- Thus, you face a discrete choice rather than a continuous one
- Analyses with continuous choice are naturally biased towards flexible rates

- Stability may matter for reasons other than international risk sharing
- Volatility is bad for growth: exchange rate stability may reduce volatility and foster growth
- In a model with credit-constrained firms, exchange rate volatility can reduce growth (Aghion-Bacchetta-Rancière-Rogoff, 2005)
- The empirical evidence shows that exchange rate flexibility dampens terms-of-trade shocks, but lowers growth for less developing countries
⇒ Fixed rates are better

Conclusions

- Very nice extension of NOEM literature
- Richer analysis of exchange rate policy: one step forward
- We are not here yet for policy advice:
 - The analysis of policy choices is too ‘optimistic’
 - Some important features are missing