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COMMENT

Equilibrium exchange rates: Are they suited for policy purposes?

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Main motivation/results of the paper

- Real appreciation not only of the CPI-based real exchange rate but also the PPI-based real exchange rate.
  - Balassa-Samuelson effect is only part of the story
- At least part of this appreciation may be an equilibrium phenomenon ($\rightarrow$ current account behaviour).
- Comprehensive country-by-country analysis and panel data analysis to identify fundamentals driving the RER.
  - Finding cointegration is difficult task.
  - Specifications for long-term relationships vary quite a bit.
- Equilibrium exchange rates.
  - Strong overvaluation of most AC currencies.
  - Consistent with the existing literature.

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Which approach is best suited? Methodological issues

Country-by-country analysis

Problems:
- Biased estimates
- Short sample
- Data properties

Cross section analysis

Panel data analysis

"In-sample" approach

Includes acceding countries (plus other countries)

→ biased intercept

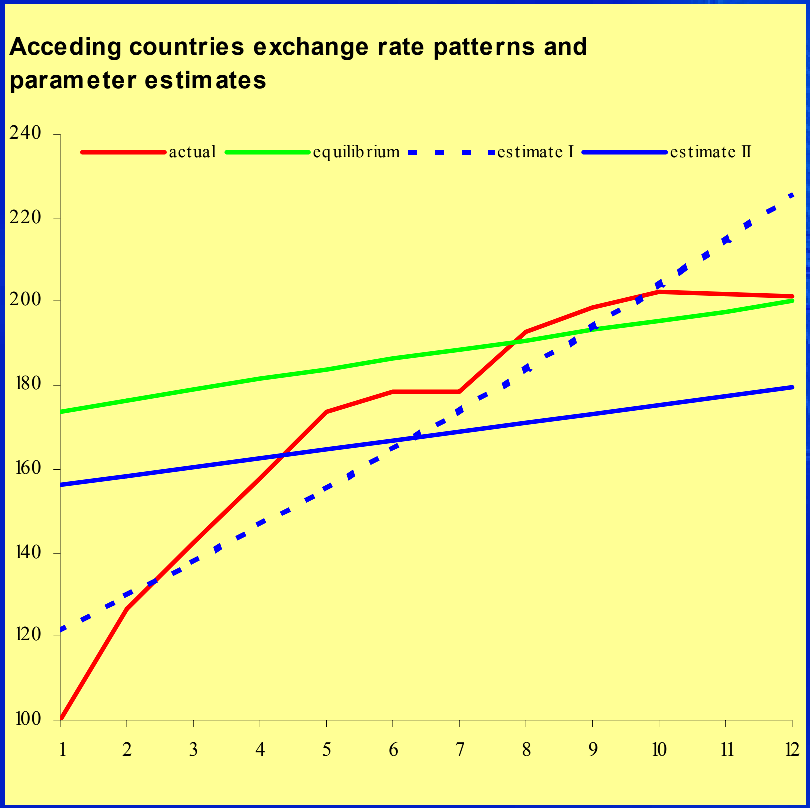
"Out-of-sample" approach

Includes only other countries (excludes acceding countries)

Applies relationships to acceding countries

→ no intercept estimated for AC

Problem I: Initial undervaluation



Stylised presentation:

- Typical exchange rate pattern for AC → red line
- Steady equilibrium real appreciation owing to BS effects

$$rer = \alpha + \beta\, prod$$

- Assumption of zero average misalignment
- Estimates for constant (and coefficient) are biased
  → draw wrong conclusions regarding "fair" valuation.
- Moreover:
  - Non-stationary data
  - Short sample range (N=32)

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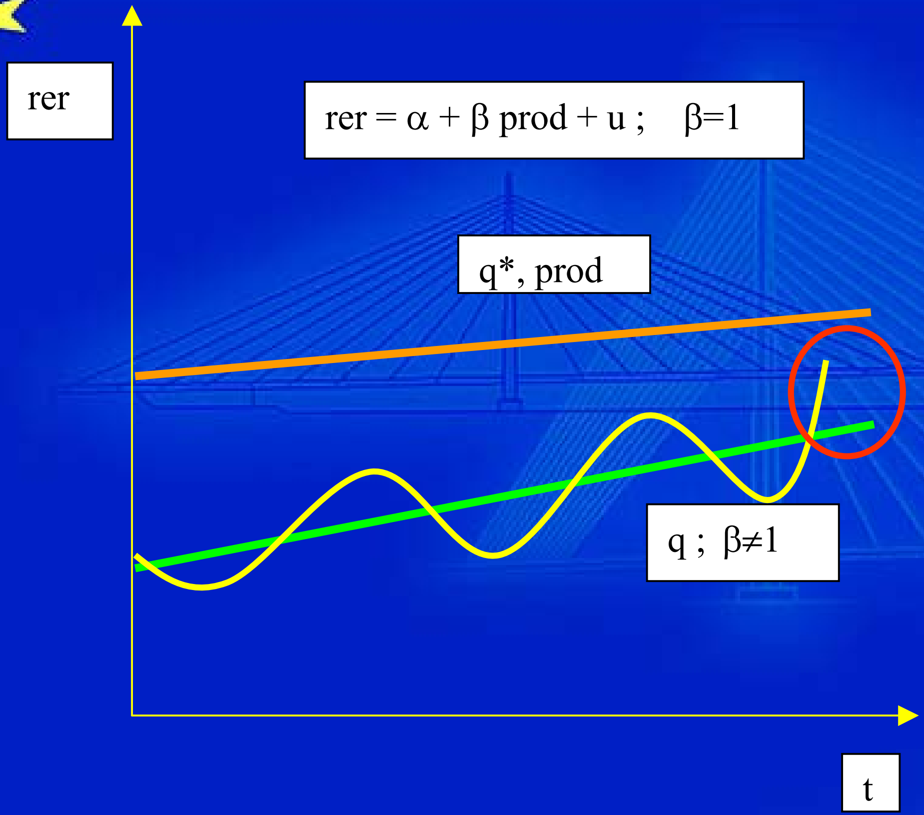
Problem II: Exchange rate regime



- Coefficient biased;
- No co-integration between RER and fundamental;
- Assumption of average zero misalignment critical!

Potential pitfalls in panel approach

- Cross-sectional contemporaneous correlation:
  - Take deviations from cross-sectional means.
  - Estimate time dummies (more demanding, more robust).

  → Inconsistent estimates

- "Poolability", i.e. homogenous long-run parameters:
  - Pooled estimators are consistent and efficient
    IF it is possible to pool.
  - If long-run parameters are heterogeneous:

  → Inconsistent estimates

Data issues and the EQER

Data issues

- All variables relative to Germany/euro area?
- Does it make sense to include real interest rate differential?
- Where is the PPI-based real exchange rate gone?
- Is all data indeed available at quarterly frequency ?

  → Provide a more elaborate discussion of the data

Equilibrium exchange rates

- choose a "base year … during which the exchange rate was in equilibrium."

→ set early transition period (1992-94)

→ is this key for magnitude of misalignment?

  → sceptical with regard to the results

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EQER: Are they suited for policy purposes?

- Is there an alternative?
- Major methodological issues need to be addressed
  - Country-by-country analysis
  - "In sample" panel analysis

  → very cautious interpretation of the results

  - Cross section analysis

    → simple but might give some initial insights
  - "Out-of-sample" panel analysis

    → promising avenue,
    but: extensive robustness checks necessary.

  → beware of the econometric pitfalls


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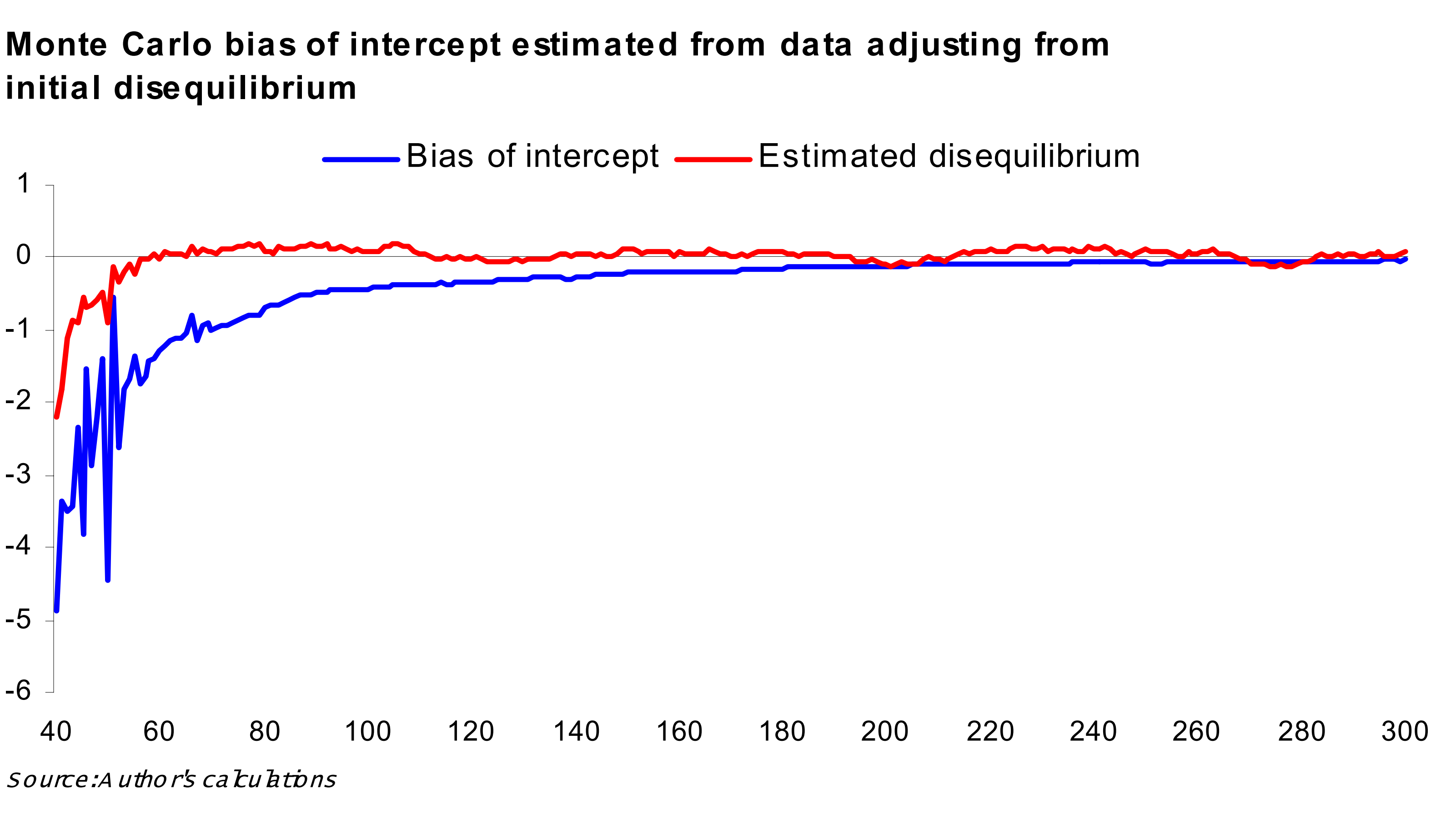
Background information



Calculated using 10000 Monte Carlo replications, alpha = -0.01

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