# EUROPEAN CENTRAL BANK

EXTERNAL DEVELOPMENTS DIVISION

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# Discussion of "Concepts of Equilibrium Exchange Rates" authored by R. Driver and P. Westaway at the Second Workshop on Macroeconomic Policy Research

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by

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# Outline of my intervention

Two issues will be addressed:

- Explain why the paper "Concepts of Equilibrium Exchange Rates" offers a perspective to the issues relating to the estimation of a "fair" value of a currency
- Point to some empirical particularities relevant when applying the various concepts of equilibrium to acceding and accession countries' currencies.

# Concepts of Equilibrium Exchange rates 1

The paper is a comprehensive, intuitive and innovative survey of the literature.

Why?

- Time horizon important
- Derivation of a taxonomy of available methodological approaches to equilibrium exchange rate determination

# Concepts of Equilibrium Exchange rates 2

Taxonomy allows for:

- a better understanding the interrelationships between the various methodological approaches
- highlights the relevance of each approach in answering different types of questions
- clarifies that policy implications of an estimated "misalignment" would differ depending on the concept of equilibrium employed.

# Empirical complications specific to ACs

Consider the most commonly used empirical approaches to equilibrium exchange rate determination

- Reduced form techniques (such as BEER)
- Normative Approaches (such as FEER)

Reliability of estimated relationship between exchange rate and fundamentals could be impaired.

Why?

- Small sample size
- Strong undervaluation at the start of transition
- Exchange rate policies

# Normative techniques

Reliability of estimated trade elasticities, output gaps and sustainable current (capital) accounts adversely affected by:

- Short history of ACs as market economies
- Ongoing structural change
- Inadequate consideration of Balassa-Samuelson effects

# What is the end result?

High probability of deriving unreliable estimates of the equilibrium exchange rate for ACs currencies.

# Conclusion

- Take proper account of AC specific stylised facts and particularities
- Adopt a multi-approach stand to the estimation of the equilibrium exchange rate
- Cross check findings in terms of size and direction of estimated deviation from equilibrium
- Interpret findings with caution

# The End


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