Discussion of:
Incomplete pass-through in import markets and permanent vs. transitory exchange rate shock
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Motivation and main goal of the paper

- **Motivation: pass-through depends on whether the exchange rate changes are regarded as permanent or temporary**

→ **Build(adopt) a theoretical model and an empirical measure of temporary exchange rate changes and estimate to 5 countries (US, Japan, Germany, France, Italy)**

Steps

➢ **Static model of Dornbusch (1987 AER)**

➢ **Extend it to the case of intertemporal profit maximization (based on Kasa 1992 JIE) and arrive to a single equation specification**

➢ **Estimate it as benchmark (Engle-Granger)**

➢ **Perform a simulation exercise studying the effect of neglected temporary e.r. movements**

➢ **Adopt a measure of temporary exchange rate movements (based on Lee-Chinn 2002 IMF WP)**

➢ **In the cointegrating equation replace the actual RER with the permanent component and add the temporary component to the ECM-equation**

Outline of the Discussion

- **Theoretical part: more questions than comments (1 slide)**

- **Simulation: praise (1 slide)**

- **Empirical part: more comments than questions (5+1 slides)**

- **A check using the simple Hodrick-Prescott filter for permanent/temporary decomposition (4 slides)**

Theory

- **How was the results derived?**

- **What is the contribution of the paper?**

- **Why weak exogeneity of the exchange rate?**

- **My reading: the theoretical part is needed just to arrive to**

**DL(PM/PCPI) = -α(L(PM/CPI)-βL(RER))+D(something)**

Simulation

→ **Assume a true data generating process (only the permanent change matters for pricing)**

→ **Assume the processes of permanent/temporary ER**

→ **Simulate the model**

→ **Estimate the equation with the simulated total ER to study the bias of the estimator due to omitted temporary changes**

- **Very useful**

- **Could be extended especially to the final equation of the paper, i.e. to the problem of measurement error in the permanent/transitory component**

Empirics 1. - Data issues

- **The very basic issue: data**
- **The dependent variable, LOG(P(M))-LOG(CPI), is interpreted as the difference between the import price & domestic competitors' prices**
- → **Huge compositions differences**
- → **Product/industry specific data would be desirable**
- **Alternatively, simply view the equation, L(PM/CPI)=β*L(RER), as Import prices = β*foreign costs in domestic currency, and both sides normalized by the domestic price level?**
- → **E.g. Goldberg-Knetter (1997 JEL) in survey paper point pout that marginal cost should appear and available candidates are bad proxies**

US Data
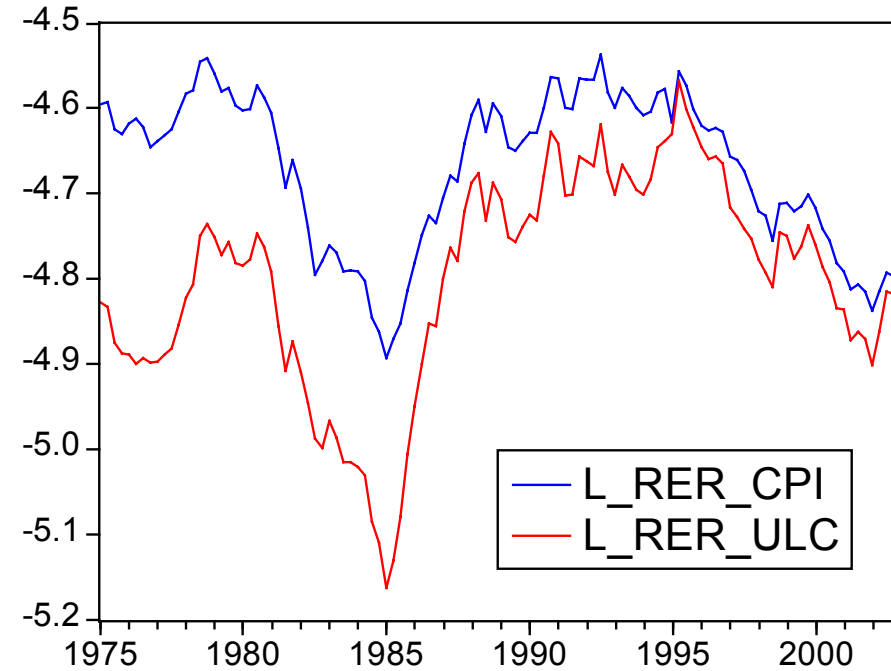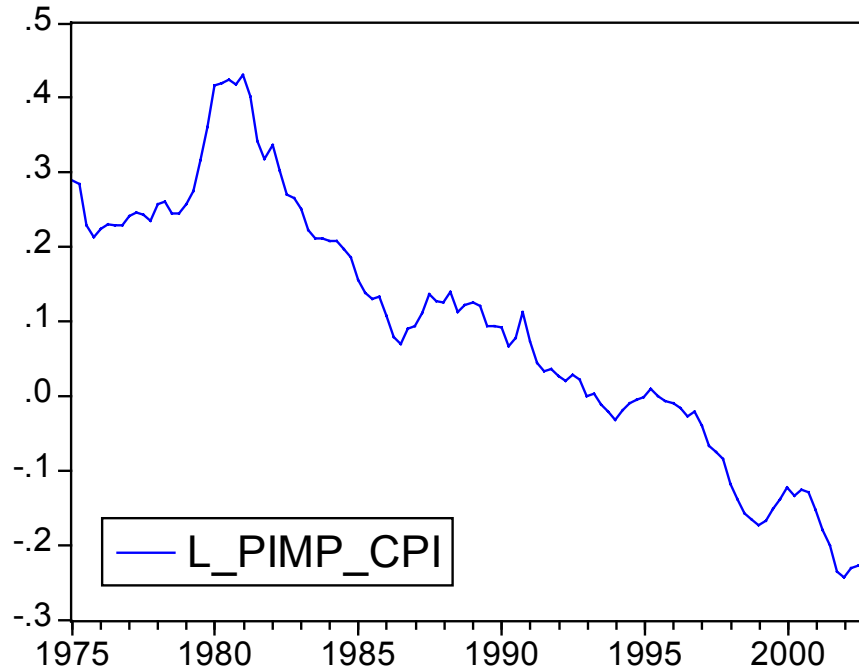
Trends? Unit roots?

Empirics 2. - General issues

- **Broken deterministic trends? Unit roots? Dummies?**

- **No attempts to estimate the deep theoretical parameters**

- **Estimation method (Engle-Granger)**

- **Errors in variables**

Empirics 3. - The BQ-decomposition

- **Bivariate Blanchard-Quah-type decomposition of the real exchange rate and the current account**

- **Results: "corner solutions" $\rightarrow$ Almost all ER movements are either transitory (US) or permanent (other 4 countries). Explanation?**

- **The real exchange rate of the world is 1 (for actual, permanent, and transitory as well) $\rightarrow$ US, Japan, and 3EU countries constitute a large part of the world**

- **Some of the VARs are very long: e.g. US $\rightarrow$ 9 lags, Japan $\rightarrow$ 10 lags**

- **Theory behind?**

Empirics 4. - The BQ/SVAR critiques

- **Faust-Leeper (1997 JBES)**
- > **Shock aggregation $\rightarrow$ too few identified shocks might be mixtures of the underlying ones**
- > **Long-run restrictions $\rightarrow$ from finite samples**
- > **Time aggregation $\rightarrow$ higher-frequency feedback**

- **Suggestions: sign restriction (e.g. Canova-De Nicoló 2002 JME, Peersman 2003 forthcoming in J.of Econometrics)**
- $\rightarrow$ **Notice that there are infinite number of possible decompositions, select those that have impulse response in line with theoretically expected signs**

Empirics 5. - Extended ECM-equations

- **Generated data/errors in variables**

$\rightarrow$ **Bias? Covariance?**

- **In any case, most of the included temporary ER movements are not significant according to standard distributional assumptions**

A quick check

- **How does the HP-filter?**
- ➢ **US data, 1975Q1-2002Q4 (from IFS)**

Real exchange rate: CPI based

Long-run:

LPM_CPI = 0.31*LRER   + 0.15*LPOIL + trend

LPM_CPI = 0.34*LRER_HP + 0.16*LPOIL + trend

Short-run:

DLPM_CPI = -0.13*ECM(-1) + 0.33*LAG + 0.23*DLRER + 0.07*DLPOIL

DLPM_CPI = -0.14*ECM(-1) + 0.27*LAG + 0.23*DLRER + 0.06*DLPOIL + 0.04*S + 0.08*S(-1)

A quick check 2.

- **How does the HP-filter?**
- ➤ **US data, 1975Q1-2002Q4 (from IFS)**

Real exchange rate: ULC based

Long-run:

LPM_CPI = 0.25*LRER   + 0.15*LPOIL + trend

LPM_CPI = 0.43*LRER_HP + 0.17*LPOIL + trend

Short-run:

DLPM_CPI = -0.15*ECM(-1) + 0.30*LAG + 0.16*DLRER
    + 0.06*DLPOIL

DLPM_CPI = -0.16*ECM(-1) + 0.24*LAG + 0.18*DLRER
    + 0.06*DLPOIL + 0.002*S + 0.09*S(-1)

A quick check 3.

- **How does the HP-filter?**
- ➤ **GERMAN data, 1975Q1-2002Q4 (from IFS)**

Real exchange rate: CPI based

Long-run:

LPM_CPI = 0.89*LRER   + 0.11*LPOIL + trend

LPM_CPI = 1.06*LRER_HP + 0.12*LPOIL + trend

Short-run:

DLPM_CPI = -0.14*ECM(-1) + 0.32*LAG + 0.54*DLRER + 0.05*DLPOIL

DLPM_CPI = -0.16*ECM(-1) + 0.34*LAG + 0.49*DLRER + 0.05*DLPOIL + 0.03*S

A quick check 4.

- **How does the HP-filter?**
- ➢ **GERMAN data, 1975Q1-2002Q4 (from IFS)**

Real exchange rate: ULC based

Long-run:

LPM_CPI = 0.24*LRER   + 0.12*LPOIL + trend

LPM_CPI = 0.32*LRER_HP + 0.11*LPOIL + trend

Short-run:

DLPM_CPI = -0.11*ECM(-1) + 0.37*LAG + 0.04*DLRER + 0.06*DLPOIL

DLPM_CPI = -0.14*ECM(-1) + 0.38*LAG + 0.01*DLRER + 0.06*DLPOIL + 0.02*S

The End