

# The Exchange Rate Insulation Puzzle by Corsetti, Kuester, Müller and Schmidt

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The logo for Unil, featuring the word "Unil" in a white, elegant, cursive script font.

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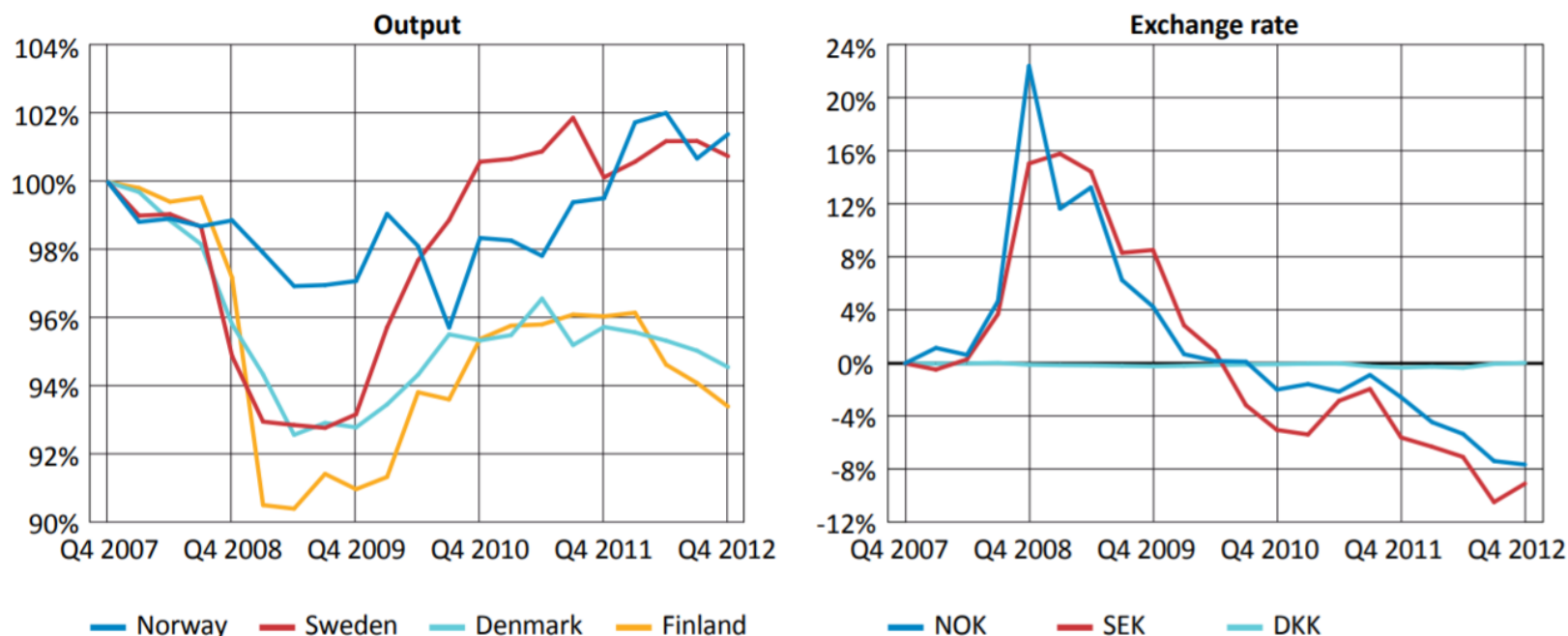
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# The paper

- Fascinating empirical finding
- Against common wisdom
- Is it a fact?
  - Would like to see more robustness
- Is it a puzzle?
  - *Many* explanations (you provide some)
  - Evidence of *strong* real or policy inefficiencies (a policy puzzle?)
  - Channels?

# Common wisdom

**Figure 1. Output and the exchange rate 2007–2012 in four Scandinavian countries**  
Real GDP (left) and change of exchange rate (end of quarter price euro, in local currency).



Note. The sample period is 2007Q4–2012Q4. GDP is normalized to 100 per cent in 2007Q4, and the exchange rate is expressed in percentage changes relative to 2007Q4. A positive value in the right-hand chart means a depreciation relative to 2007Q4.

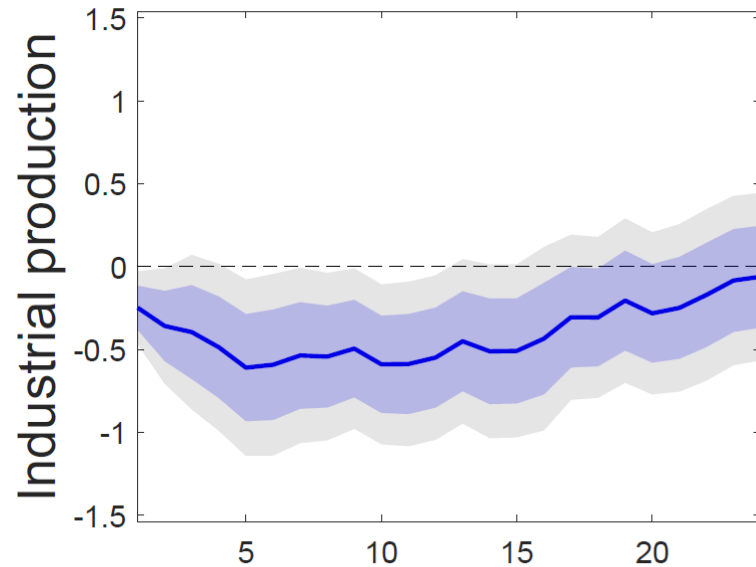
Sources: OECD Economic Outlook 98 and Bundesbank

Source: Corsetti, Kuester and Müller (2018)

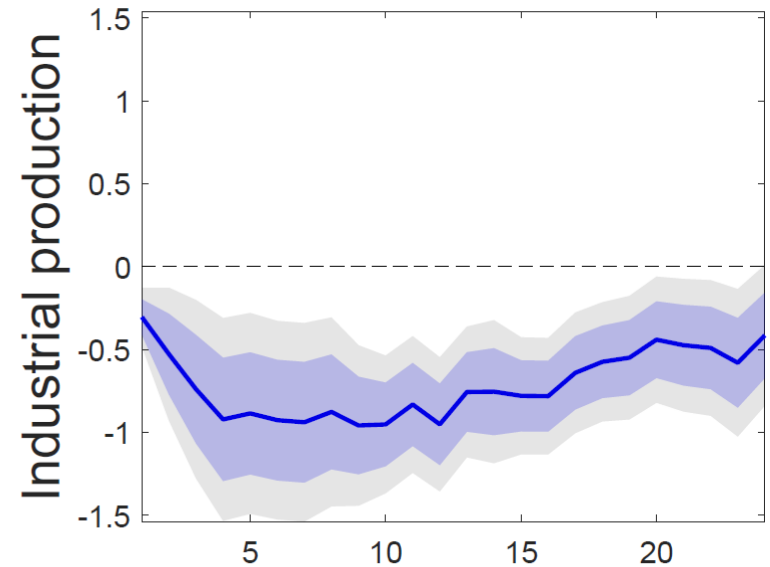
“We conclude that the classic case for flexible exchange rates appears to be alive and well.”

# Response to a Euro-area monetary policy shock

## Peg



## Float



“Exchange rate regime does not matter for spillovers”

# Empirics

- Local projection method using identified shocks

$$x_{i,t+h}$$

$$= \alpha_{i,h} + I_{i,t-1}\phi_{f,h}\epsilon_t + (1 - I_{i,t-1})\phi_{p,h}\epsilon_t + \gamma Z_{i,t}$$

$$+ u_{i,t+h}$$

- *Clean* identification
- *Conditional* response of output (so far: *unconditional* tests)
- Controls for financial conditions (VIX and VSTOXX):
  - not driven by the *global* financial cycle
- **Would like to see more robustness though**

# Empirics – Robustness

- Euro area counted as fixed exchange rate
  - Can we rule out that there are some stabilizing mechanisms within the Eurozone?
  - Implicit guarantees, QE, trade and financial integration...
- More and more pegs during the period
  - Are we capturing time-dependent responses?
  - Impact of the ZLB?
  - Impact of ECB communication?
- Commodity prices
- Role of country size?

# Empirics – Panel

- Add time fixed effects and keep interaction of shock with “float” dummy

$$x_{i,t+h} = \alpha_{i,h} + \beta_{t,h} + I_{i,t-1} \phi_{f,h} \epsilon_t + \gamma Z_{i,t} + u_{i,t+h}$$

- Time fixed effects will capture
  - Aggregate shocks: US monetary policy, global financial cycle,...
  - Common time-dependent responses to shocks
- **Test the lack of insulation:**
  - Weak  $\phi_{f,h} = 0$
  - Strong  $\phi_{f,h} < 0$

# Role of the “financial cycle”?

- You control for financial conditions
- Implicitly, the financial cycle is exogenous
- But it could be an endogenous response to “fundamental” demand and supply shocks (esp. to monetary policy)
- Look at the **response of spreads, UIP deviations, capital flows, leverage...**
- More generally, would like to see the **response of other variables** (trade balance, terms of trade...) to understand the channels



# Is it a puzzle?

- Argument: output can be decomposed into natural output and output gap

$$y = y^n + \tilde{y}$$

- The paper proposes 3 explanations:

- Comovement in  $y^n \rightarrow$  risk sharing

- $\rightarrow$  Efficient

- Comovement in  $\tilde{y}$  due to inflation output trade-off  $\rightarrow$  DCP (but also trade in intermediate goods, financial frictions, heterogeneity...)

- $\rightarrow$  Consistent with efficiency

- Comovement in  $\tilde{y}$  due to inefficient monetary policy  $\rightarrow$  CPI targeting

- $\rightarrow$  Inefficient

Policy  
puzzle

# A policy puzzle

- CPI inflation (or a close measure) is the typical target
- Why CPI targeting?
- Either a clear inefficiency
- Or for communication purposes?
- Or if it is indeed optimal, why?
  - Board of governors' website (*Why does the Federal Reserve aim for inflation of 2 percent over the longer run?*)

“It is understandable that higher prices for essential items, such as food, gasoline, and shelter, add to the burdens faced by many families, especially those struggling with lost jobs and incomes.”
  - **Nominal income rigidity**: CPI targeting dominates PPI targeting (Rhee and Turdaliev, 2013)
  - **LCP**: CPI targeting is optimal (Engel, 2011)

# Take out

- The empirical part is very intriguing and thought-provoking!
  - Establish the facts as robustly as possible
- Future version: More channels to explore in the data?