EUROPEAN CENTRAL BANK

EUROSYSTEM

Exchange Rate Pass-Through

Discussion of Bakota et al.

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Disclaimer: The views expressed here are my own and not those of the ECB or Eurosystem. I thank Luca Dedola (ECB) for help in preparing my discussion.

The paper

- **Question:** What is the exchange rate pass-through in the euro area?

- **Method:** Counterfactual Bayesian SVAR approach that aims to isolate the exchange rate channel by shutting down other transmission channels. SVAR is structural model with feedback effects to capture response of prices to exogenous shock to exchange rate

- **Key finding:** Estimated exchange rate pass-through (ERPT) to inflation is on the lower end of prior estimates, and transmission of other shocks is markedly reduced when accounting for the exchange rate channel

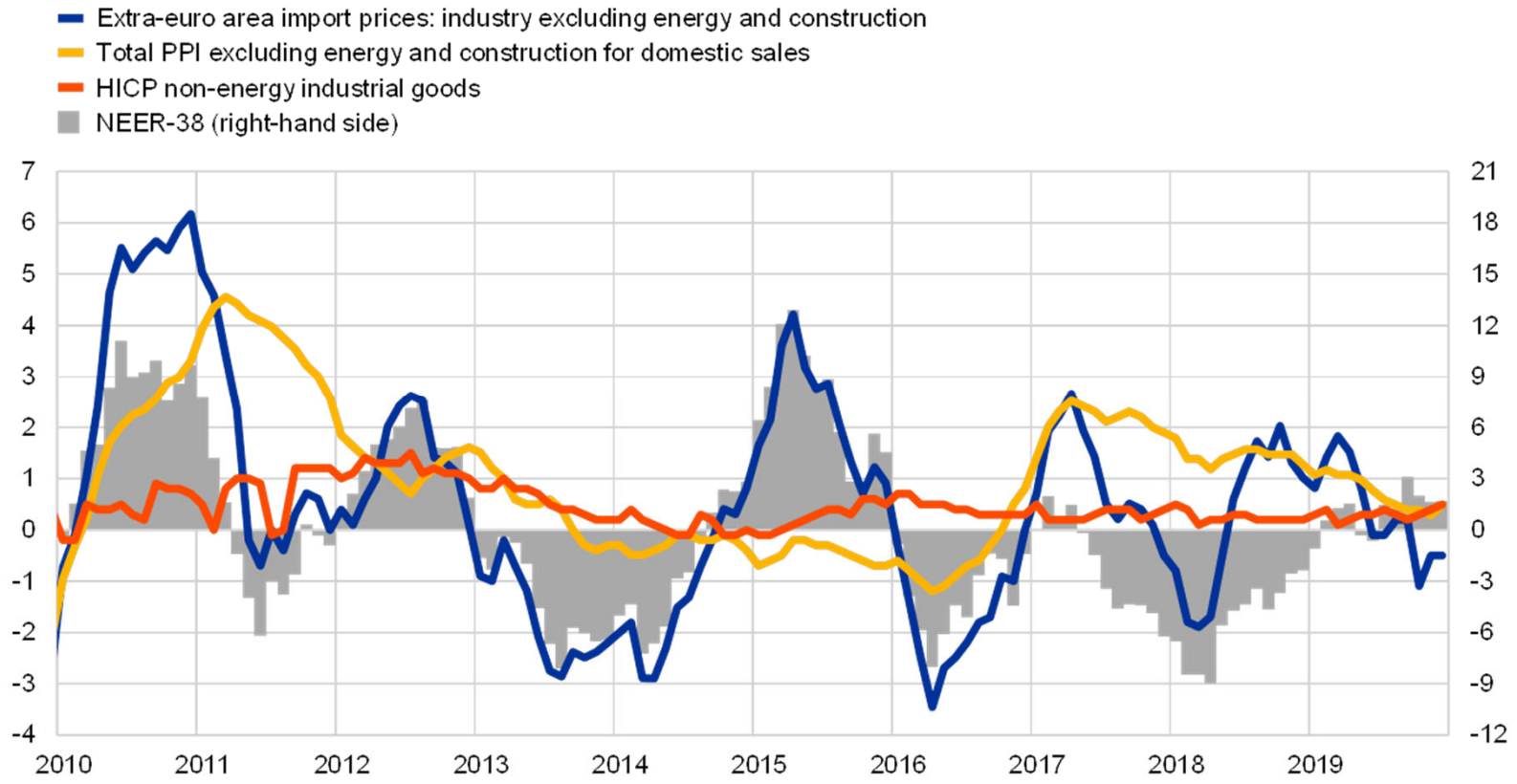
General comments

- Great topic—exchange rate channel is key for euro area but remains poorly understood
- Welcome the incorporation of import prices into the analysis, which allows to study the effects of exchange rate movements on import prices
- Ambitious paper in terms of objective. Some comments on underlying assumptions and implementation of the approach taken

ECB and exchange rate—a primer

- The ECB does **not** target/manage the exchange rate
- The ECB incorporates the exchange rate into its broad economic and monetary analysis to assess risks to price stability and overall euro area growth
  - For instance, weaker euro makes imports more expensive, driving up imported inflation
- Empirical evidence (e.g. ECB LIFT report, ECB Economic Bulletin, Issue 3/2020)
  - Exchange rate pass-through is partial and delayed
  - While import prices react quickly, effect on consumer prices is much smaller and slower
  - Pass-through depends on monetary policy reaction

Nominal effective exchange rate, import prices, PPI and consumer prices



Source: ECB Economic Bulletin, Issue 3/2020

Comment 1: Tension between theoretical and empirical concepts of ERPT

- Disconnect between theoretical concept of aggregate ERPT and the reduced-form micro-level elasticity that is estimated
- The exchange rate is an endogenous variable that simultaneously clears goods, asset and money markets and aggregates multiple underlying primitive mechanisms that cannot simply be “shut down” in a reduced-form estimation
- Consequently, the exclusion restrictions may be violated and the Lucas critique applies
- Provide a set of sufficient conditions under which your approach can isolate the theoretical ERPT or include caveats to the analysis

Comment 2: Conceptual challenge

- The literature on Bayesian frameworks for structural scenario analysis using SVAR models has moved on and can help in your context
- Use the approach of Antolin-Diaz, Petrella and Giannone (JME 2021) to assess plausibility of your scenario and choose between observationally equivalent scenarios
- Use the approach of McKay and Wolf (ECTA 2023) to develop counterfactuals from estimated IRFs that are invariant to the Lucas critique (instead of series of MIT shocks)
- And cite these papers and related recent work

Comment 3: Identification

- You identify 4 shocks with contemporaneous sign restrictions. The identification of the first three shocks (MP, demand and supply) is conventional. The identification of the sentiment shock is less compelling
  - The key assumption to distinguish sentiment shock from a (negative) demand shock is the opposite sign on the exchange rate response, but this does not rule out a foreign shock, such as an increase in US interest rates (from Fed tightening)
- Suggest to include foreign variables, such as the US interest rate

Takeaway

- Important policy-relevant question
- Promising approach
- Some suggestions to clarify the paper's objective, address conceptual weaknesses and solidify identification
- Looking forward to seeing the next version of the paper

Thank You !