
Discussion of “The Predictive Information Content of External Imbalances for Exchange Rate Returns: How Much Is It Worth?”

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Summary of discussion

- Sketch of the key paper mechanism
 - Conceptual Issues
 - Data

 - Discussion focused on first part of the paper
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Key mechanism (I)

- Application of intertemporal budget constraint
- If net external liabilities are too large...
- A. the trade balance must be in surplus
- B. returns on external liabilities have to fall (relative to return on assets)

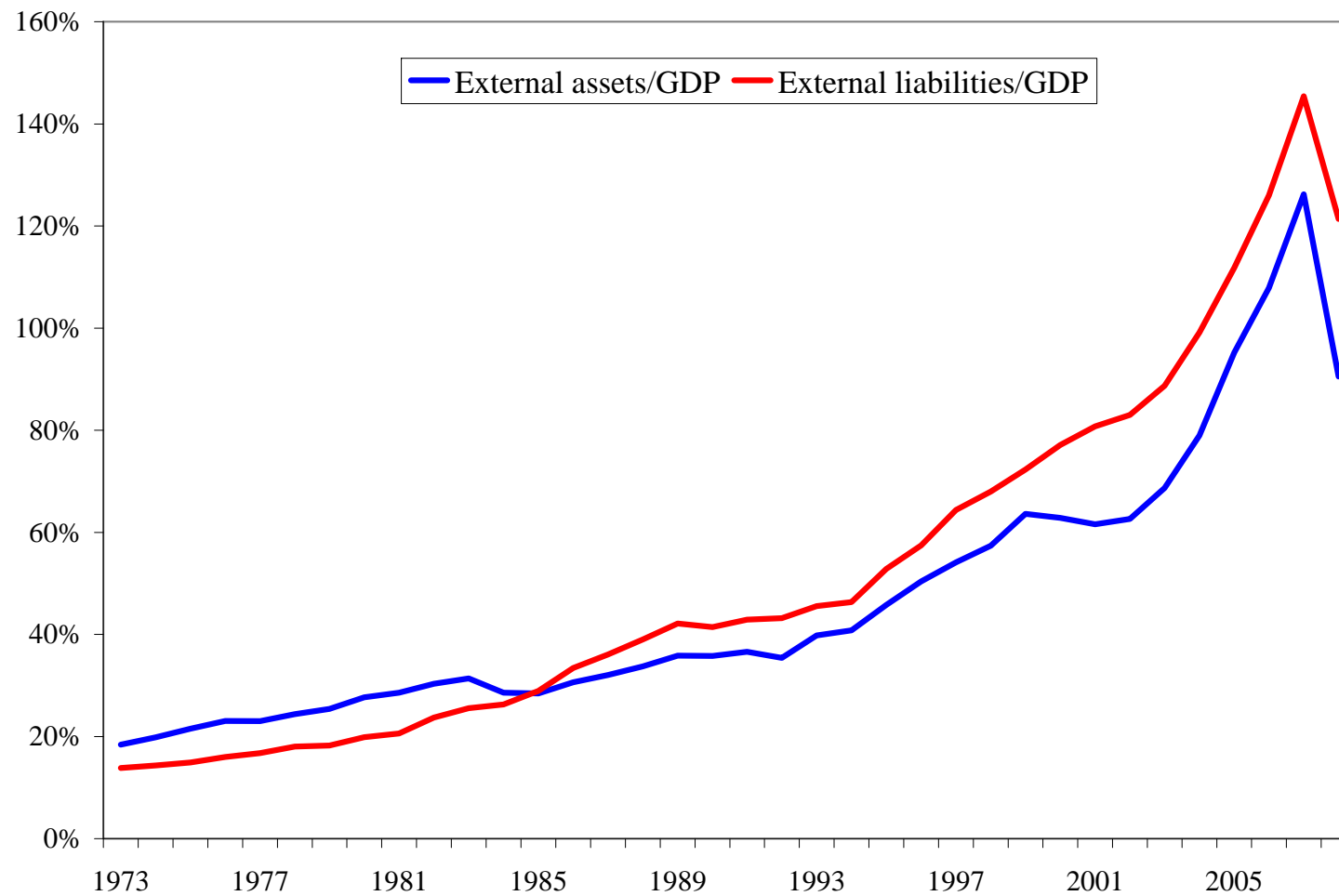
$$na_t - na_{t-1} \equiv tb_t + \frac{r_t^L - g_t}{1 + g_t} na_{t-1} + \frac{r_t^A - r_t^L}{1 + g_t} a_{t-1} + \varepsilon_t$$



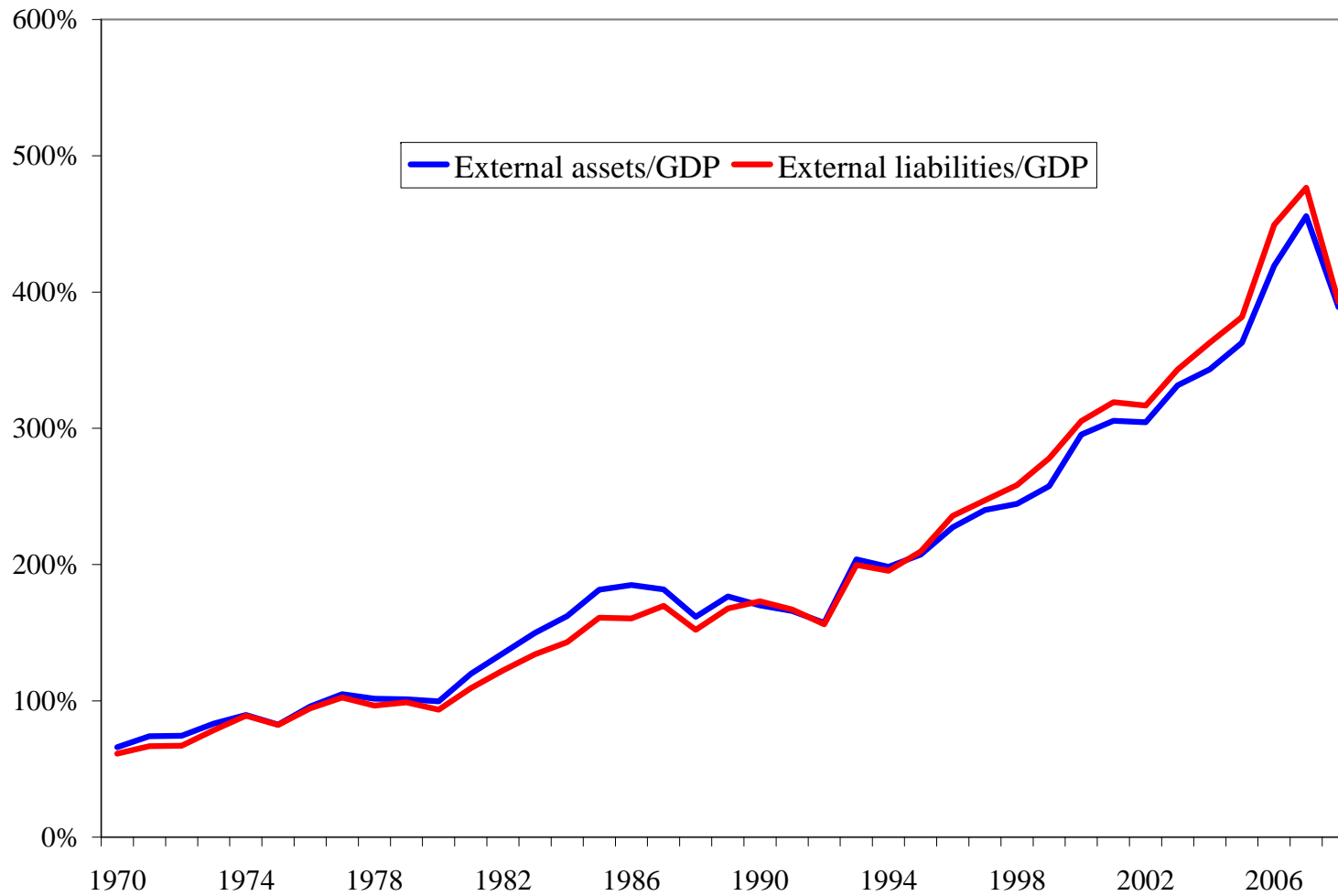
Key mechanism (II)

- If a country is “long” foreign currency, a depreciation will improve both the trade balance and the external position
 - Note that effect on rates of return is driven by exchange rate *change*, effect on trade from exchange rate *level*
 - How big can the “valuation” effect be? Much larger than before, thanks to increasing cross-border holdings
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United States: external assets and liabilities



United Kingdom: external assets and liabilities



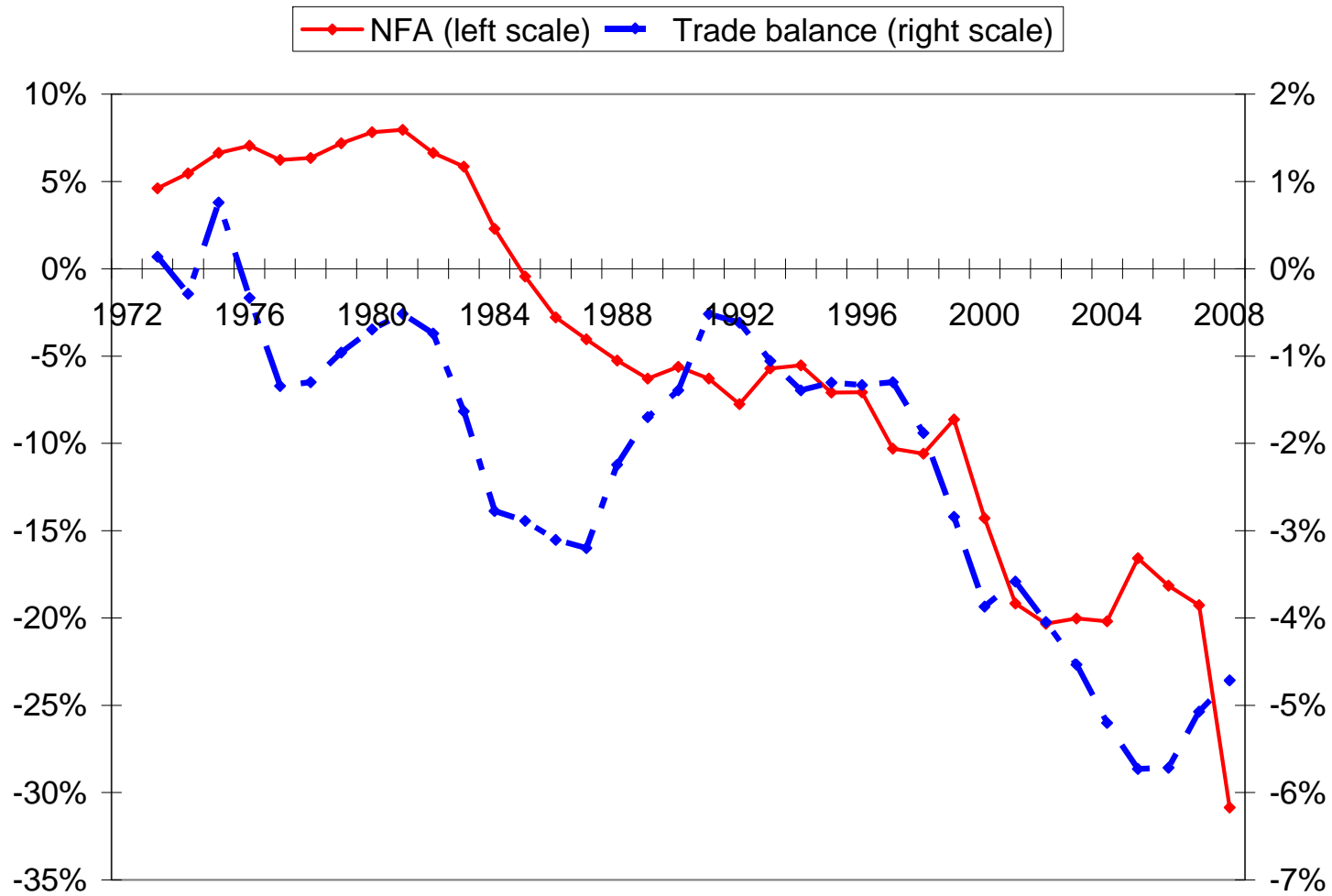
General issues

- Paper is remarkably simple and clear...
 - ...but underlying structure is quite complex
 - Some questions:
 - What exactly is “NXA”?
 - What are the key assumptions needed to derive the estimated relationships?
 - How to implement an analysis of bilateral exchange rates, given the multilateral nature of imbalances?
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The case of the United States

- Gourinchas and Rey remove trends in trade and external stock data (and so does this paper)
 - This implies focus on cyclical imbalances
 - In theory, there should be a long-run relation between the trade balance, relative returns, and the external position
 - In practice, however, little sign of cointegration
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The US external position and trade balance

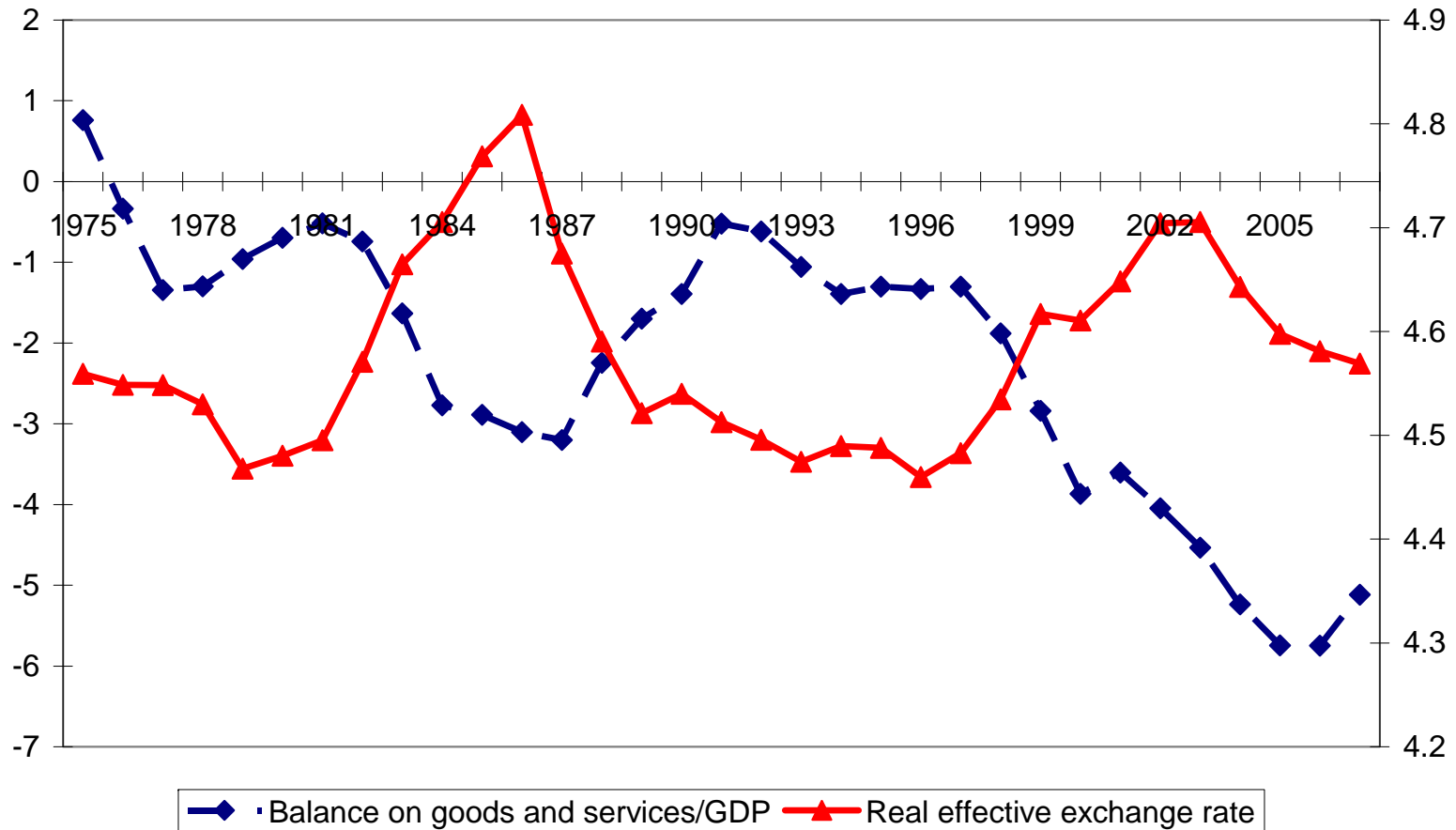


Conceptual issues

- NXA is a “peculiar” linear combination of external assets, external liabilities, exports, and imports (weights on assets and liabilities differ, weights on exports and imports differ)
 - Still, it seems to work empirically and be fairly robust (for example, to data problems in GR)
 - Where does the explanatory power come from?
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Trade balance and subsequent REER movements

United States: trade balance (1-year lag) and real effective exchange rate



Conceptual issues (continued)

- Some unease with the focus on bilateral balances
 - Paper could provide more detail on the first-stage IV regression designed to estimate $nxa(i)$:
 - How well does the first stage of the IV fit?
 - What is the sign on foreign “ nxa ”?
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Data—some suggestions and queries

- Extend sample to 2008 (many interesting things happening in recent years)
 - Make use of available information on bilateral positions (at least as cross-check)
 - Breakdown between “structural” and “cyclical” component of nxa: why are 1985 imbalances much worse than those in 2004?
 - A lot of recent US NFA deterioration was vis-à-vis emerging markets, but also Japan
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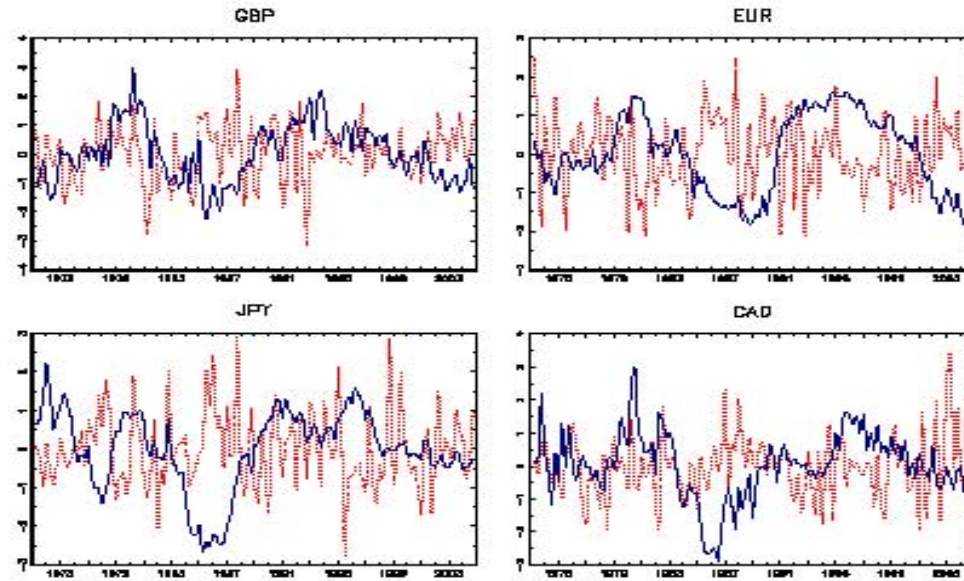


Figure 1. Exchange Rate Returns and Bilateral Cyclical Imbalances

The figure displays $\Delta s_{t+1}^{(k)}$ (dotted line) and $n\mathcal{Z}\alpha_t^{(k)}$ (solid line). $\Delta s_t^{(k)}$ is the bilateral nominal exchange rate return for the British pound (GBP), the Deutsche mark/Euro (EUR), the Japanese yen (JPY) and the Canadian dollar (CAD) with the US dollar (USD) as pricing currency; $n\mathcal{Z}\alpha_t^{(k)}$ is a bilateral measure of US cyclical imbalances relative to the UK, Germany, Japan and Canada, respectively. The data set comprises quarterly data ranging from March 1973 through December 2004. The time series are normalized to have zero mean and unit standard deviation.