Discussion on Della Corte, Riddiough & Sarno:

Currency Premia and Global Imbalances

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The paper

- Empirical test of the main intuitions in Gabaix & Maggiori (2014), who establish a link between exchange rate fluctuations and fundamentals:
  - Debtor countries offer a currency risk premium to compensate (risk-averse) investors for financing negative external balances.
  - Risk premia are related to the evolution of net foreign asset positions (and their currency of denomination).
  - When global risk aversion spikes, debtor countries experience a sharp currency depreciation.

My discussion

- Contribution
- Portfolios
- Imbalances
- Risk-aversion shocks
- Samples

The paper's contribution

- The authors produce evidence that external imbalances (a fundamental!) have an effect on exchange rates.

- For those of us socialized in open macro under the (rather pessimistic) sign of Meese and Rogoff (1983), this is comforting news.

- Do the paper's results suggest we can forecast exchange rate fluctuations much better?

- The reliance on (unpredictable?) "risk-aversion-shocks" suggests not.

Portfolios

- The empirical evidence is based on the comparison of portfolios with different currency compositions, constructed by the authors.

- These are not necessarily the portfolios that investors hold.

- Why would investors make portfolios out of currencies only? Isn’t the risk of these currency-only portfolios too large in comparison with the risk of the portfolios investors actually hold? Aren't there any assets out there with which to (at least partly) hedge the currency risk?

Imbalances

- The only thing that seems to matter in the analysis regarding imbalances is the foreign net asset position.

- What is the borrowing country doing with all that funding? Are they investing in non-tradables (e.g., housing market bubble), are they consuming it (debt-financed private or public consumption), or are they investing it in export industries (oil)?

- Why should these things not make a difference?

Risk-aversion shocks

- Gabaix & Maggiori (2014) suggest investors' risk aversion is subject to shocks.

- Shocks to preferences or perceptions of increased volatility/risk?

- Other variables can potentially proxy for these events (besides VIX): lack of liquidity in the money market, banking crises, housing market bubbles/ crashes?

- Are these really "global" shocks or are they country-specific shocks that become global via contagion? (Important distinction from a policy perspective.)

Samples

- Sample period: October 1983 – June 2014.

- Large sample of 55 (industrialized and developing) countries, many of them likely to be pegged or subject to capital restrictions.

- Smaller sample of 15 industrialized countries to address this issue: Australia, Belgium, Canada, Denmark, Euro Area, France, Germany, Italy, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom.

- But some of these countries' central banks are also likely to be active in the forex markets!