

Discussion on IMF, External Sector Report Exchange Rates and External Adjustment

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Agenda

1. Currency pricing and external adjustment
2. Comments
3. Global value chains

Currency pricing and external adjustment

1. First generation (or traditional approach, MF).

Only one domestic good (P in domestic currency) and one imported one (eP^* in d.c.). PCP

$$T = X - \frac{eP^*}{P}M = X - qM \quad (1)$$

a depreciation makes domestic goods cheaper, increases demand for exports, and imported more expensive, decline demand for imports. Expenditure switching improves T as long as ML conditions are satisfied. $Y = C + I + G + T$. ERPT to import prices is 1. There is PPP.

2. Second Generation

LCP: Local currency pricing (sticky prices in local currency, for exports sold at home PCP=LCP), no PPP.

$$T = \frac{eP^*}{P}X - M \quad (2)$$

No exchange rate adjustment?

- If imports prices in domestic currency do not change, no impact on imports. ERPT is zero.
- If export prices in foreign currency do not change, no changes in the demand for exports.
- Supply of exports? When SOEs face an infinitely elastic demand, supply determines exports (not demand as sticky price models). If price of exports in foreign currency do not change and the currency depreciates, ERPT is one so the price of exports in domestic currency increase, and hence profitability of exports rises (e.g., commodities). Change in relative producer prices.

3. Third Generation

Dominant Currency Paradigm (DCP). Invoicing versus pricing. The evidence on invoicing is overwhelming, and this casts doubts on the use of multilateral exchange rate vis-a-vis bilateral with US dollar exchange rate. For the remaining I will assume SOE facing a bilateral depreciation.

This is PCP for imports and LCP for exports, or FC pricing where the foreign currency is the US dollar.

$$PT = eP_X^{US} X - eP_M^{US} M \quad (3)$$

P_X^{US} and P_M^{US} are given.

- Depreciation raises domestic price of imports and, hence, M falls.
- Depreciation leaves constant price in dollar of exports and, hence, no demand effects.
- Still a supply effect. Price in domestic currency and profitability of exports increases.

- In all of the pricing models e helps external adjustment.
- In the DCP adjustment of imports is more important, in the LCP case adjustment should come through supply of X .
- DCP have different implications for USD vis-a-vis multilateral exchange rates.

Comments on DCP

- The models assume sticky prices. Volumes are demand determined. It does not hold for commodities, about 30% of world trade.
- The evidence is consistent with DCP. Greater effects on M than X , but in the short run X responds negatively to a depreciation with respect to the USD. Exporters would ask for an appreciation!!!
- DCP and the effect of a USD depreciation on import prices helps the adjustment.
- In addition to LCP or DCP, prices are assumed to be sticky. But optimal prices change since even when demand does not change, marginal revenues in local currency change with the exchange rate. Perhaps more needs to be done in terms of pricing dynamics and exchange rates.

- Is invoicing in FC the same as setting prices in FC? Not necessarily, even when settlement is in USD. Invoicing is done in a currency that can be used for financial transactions. Pricing is more complicated. For example LCP with US dollar invoicing. Could it be assessed empirically?
- Three cases: an importer, an exporter and a commodity producer.

Global Value Chains

- Global value chains reduce the impact of changes in the exchange rate on trade volumes. And this effects depends on the degree of trade openness. The evidence is consistent with this.
- GVC is an importat determinant of DUS dollar invoicing. Should we attempt to do a join estimation of dollar invoicing (DCP) and GVC?