Persistent Appreciations and Overshooting:
A Normative Analysis

Discussion by

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Presentation given at the 8th Jacques Polak Annual Research Conference
Hosted by the International Monetary Fund
Washington, DC—November 15-16, 2007

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Harvard and NBER

September, 2007
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• Do Persistent real exchange rate appreciations call for policy intervention?

• What should the intervention be?

• What causes the real exchange rate appreciation?
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- Do Persistent real exchange rate appreciations call for policy intervention?
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- What should the intervention be?
- Specific tax intervention, dynamic in nature
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What is this paper about?

- Do Persistent real exchange rate appreciations call for policy intervention?
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- What should the intervention be?
- Specific tax intervention, dynamic in nature

- What causes the real exchange rate appreciation?
- Not much to say about this
Previous Explanations for why Intervene?

  - Comparative Advantage via learning by doing. Temporary over-valuation can lead to permanent losses because these sectors lose their competitiveness. Growth from the tradable sector. Real ER appreciation makes you specialize in the less dynamic sector.

Mechanism

- Financially constrained Exporters: Can save, but cannot borrow. $a(s^t) \geq 0$.

- Irreversible Destruction: Cannot keep a factory idle. Need to hire one unit of labor to keep it running. Fixed cost of setting up unit.

- General Equilibrium Effect: Labor market clearing determines wages.

$$n(s^t) + c^s_N = 1 \quad (1)$$


- Pecuniary Externality
Figure 3: Constrained Economy

- Constrained Economy
- First Best
Figure 5: Optimal Policy

- Optimal Policy
- No Policy
Appealing Features

• Benevolent government, not trying to favor exporters will still want to intervene.

• Ex-ante versus Ex-post intervention. The duration of appreciations matter.
Some Questions

• Restrictions on policy instruments. These instruments cannot deliver the first best.

• If could transfer resources between the household and export sector then can arrive at the first best.

• Excluded policy instruments seem as plausible as the one of taxing consumption.

• Encourage FDI. Less financially constrained.
Some Questions

• Source of RER movement is important to understand. When will financial frictions be important.

• Capital Flows.

• Aid Flows: Rajan and Subramaniam. Traded sector which is the source of growth negatively effected.

• Resource Curse.

• Productivity Improvements.
To Conclude..

- Very interesting paper on an important question. Rich analysis

- More generally applicable to multi-sector models with asymmetric shocks and financially constrained sectors.

- Calls for more work on sources of RER appreciation, evaluate the importance of financial frictions.