Discussion of

"Currency Risk Premia and Macro Fundamentals"

by

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The views expressed in this discussion are my own, and do not necessarily represent those of the Bank of Canada.

What does the paper do?

- Revisits the Meese-Rogoff puzzle: random walk provides best prediction of exchange rates
- Is there a link between macroeconomic fundamentals and exchange rates after all?
  - Yes!
  - Key: cross-sectional approach

Differences and similarities between the "traditional" approach and MS^3

- Model
  - Time-series models based on bilateral exchange rates
  - Multi-currency portfolio approach
- Forecast horizon
  - Short, medium, long run
  - Portfolio rebalancing after 1 year
- Predictors motivated from classical exchange rate theory
  - Univariate and multivariate
  - Sort portfolios based on lagged macro aggregates

- Evaluation criteria (loss function)
  - Statistical criteria for out-of-sample forecasting performance (e.g. MSPE, directional accuracy)
  - Economic metric: annual returns, Sharpe ratio

Bottomline

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- ☹ Sarno and Schmeling (2013): Exchange rates have strong and significant predictive power for nominal fundamentals. ⇨ What predicts what?

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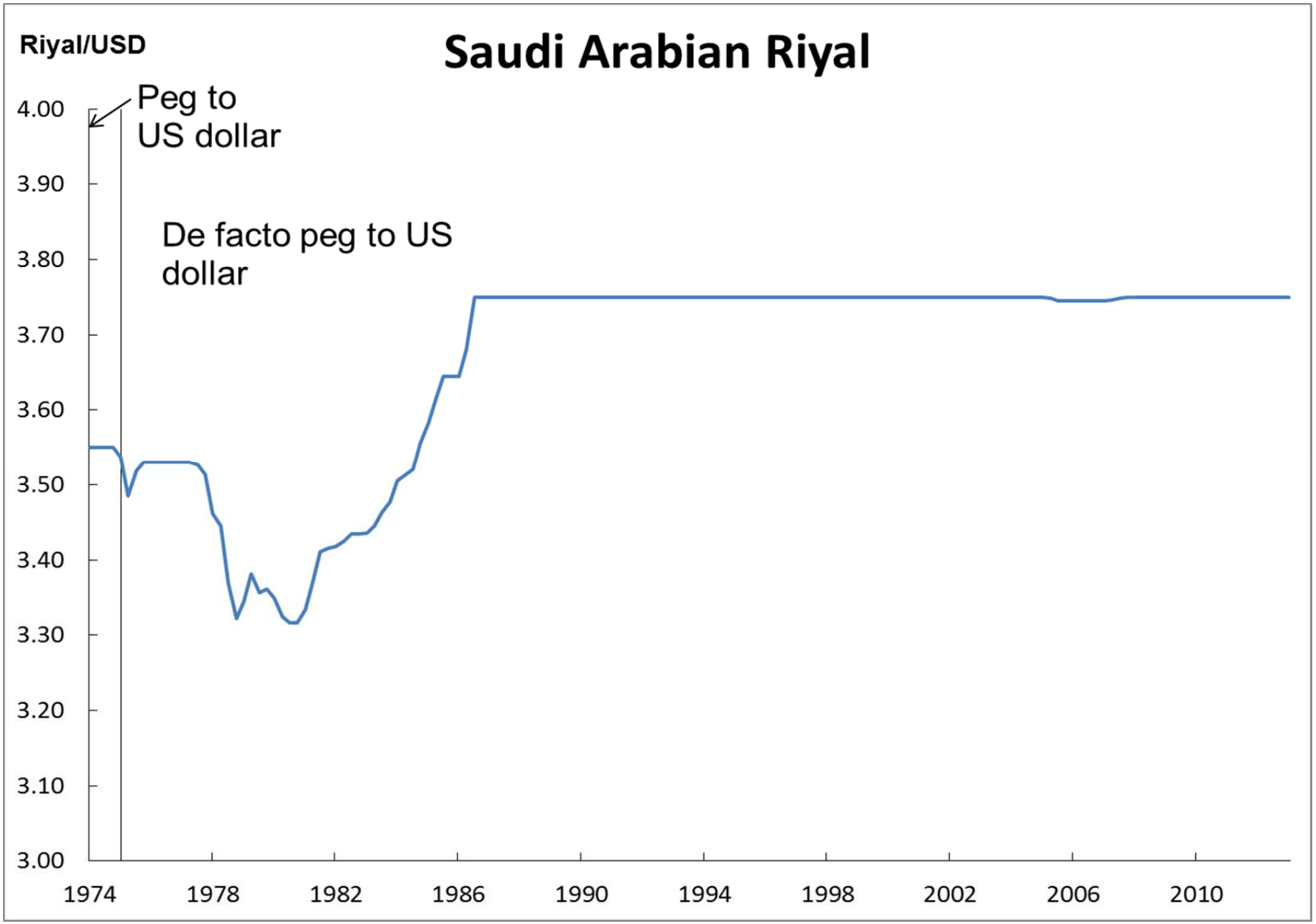
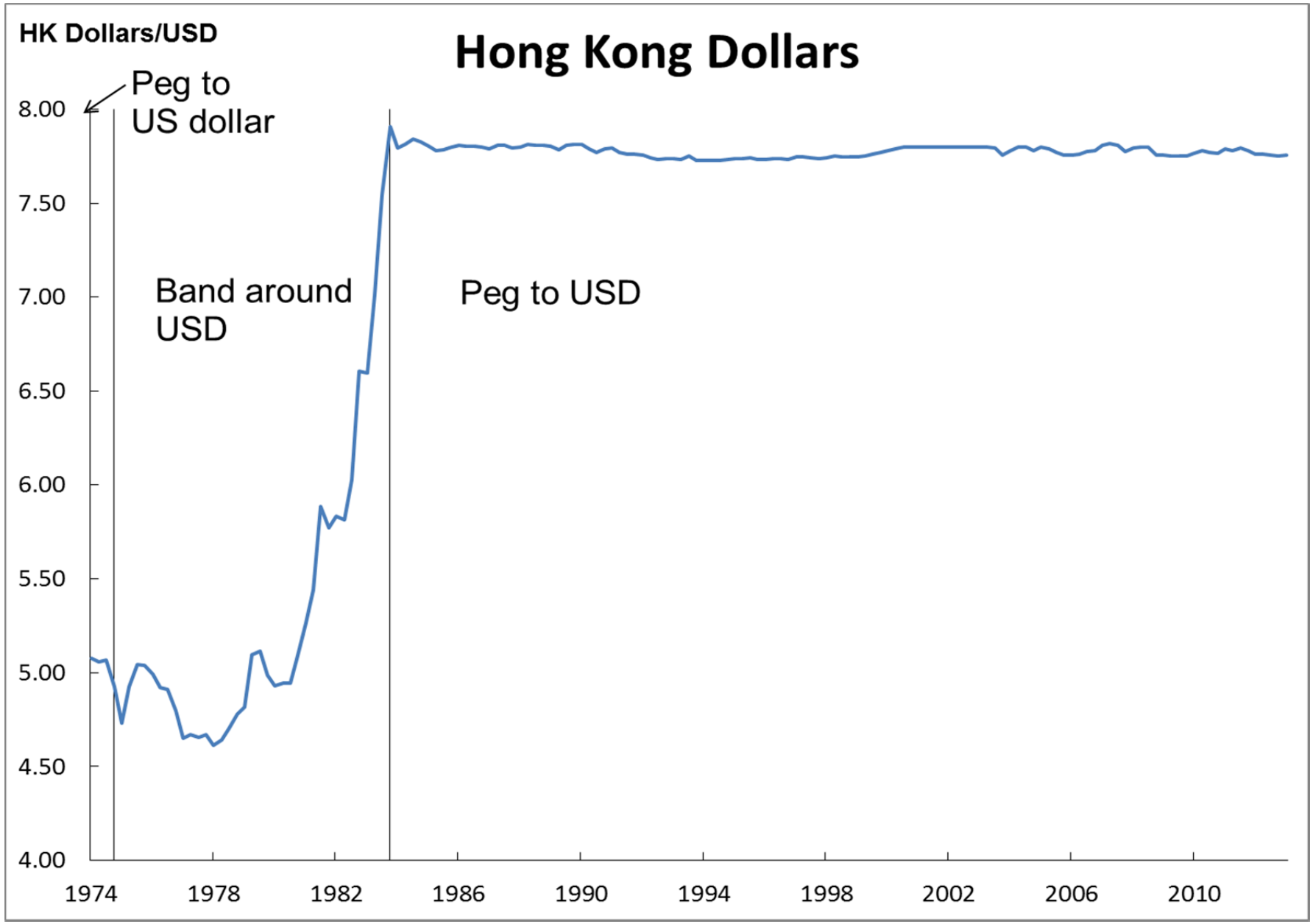
☹ Time-series dimension

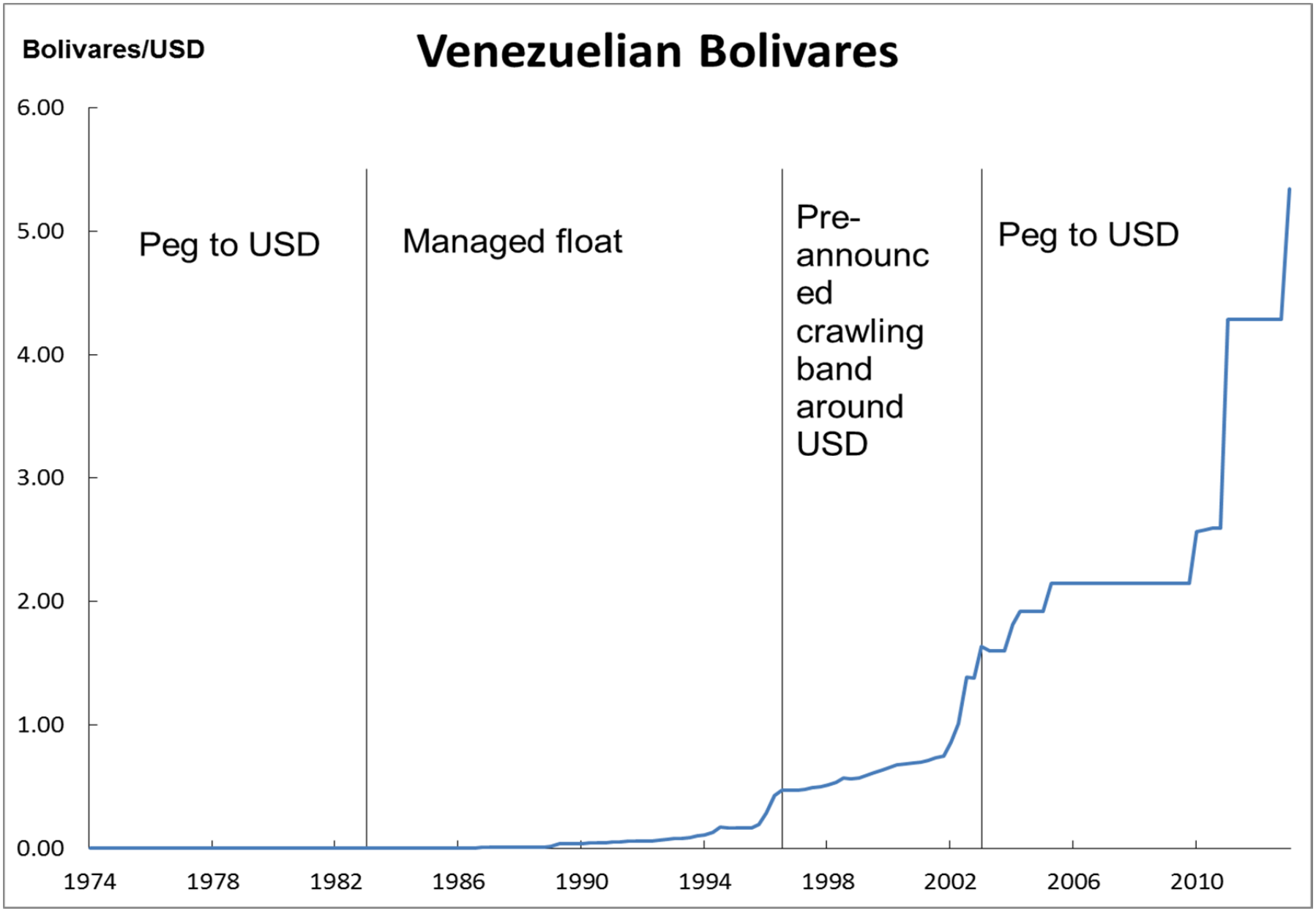
- Pooled approach: panel estimations
- Comparability

Data

- Large cross section of currencies: 35 exchange rates versus USD for the period 1974Q1 to 2010Q3
- Selection of countries:
  - Liquidity of currencies


Saudi Arabian Riyal
Riyal/USD
Peg to US dollar
De facto peg to US dollar
4.00
3.90
3.80
3.70
3.60
3.50
3.40
3.30
3.20
3.10
3.00
1974
1978
1982
1986
1990
1994
1998
2002
2006
2010


HK Dollars/USD
Hong Kong Dollars
Peg to
US dollar
Band around
USD
Peg to USD
8.00
7.50
7.00
6.50
6.00
5.50
5.00
4.50
4.00
1974
1978
1982
1986
1990
1994
1998
2002
2006
2010


Bolivares/USD
Venezuelian Bolivares
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Peg to USD
Managed float
Pre-announced crawling band around USD
Peg to USD
1974
1978
1982
1986
1990
1994
1998
2002
2006
2010

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  - Currencies pegged to USD: results robust to subset of only floating currencies?
  - Exclusion of European countries after adoption of Euro: why not replace by Euro and Euro area fundamentals?
  - Poor data quality: how important is measurement error?

- Real-time aspect: delay in data availability, but not data revisions

Taylor rule fundamentals

- Taylor rule calibrated on values suggested by Taylor (1993)
  - Knowledge not available to investors in real time prior to 1990s
  - Change in policymaker's preferences over time
  - Coefficients refer to U.S. economy: sensible to apply to all countries in the sample?
- Molodtsova and Papell (2009) amend Taylor rule to take into account 2 empirical facts:
  - In an open-economy setting, monetary policy might also depend on the real exchange rate.
  - Interest rate changes are sluggish (smoothing)
- Estimate rather than calibrate

Source of predictability

- *Persistent* differences in fundamentals across countries.
- Differences between countries in terms of growth rates, inflation differentials etc. do not change over time

  ⟹ How can this be reconciled with convergence of international business cycles over time?

Measures of business cycle risk

- Common macro-finance risk factors (e.g. US industrial production growth, US real GDP growth, US consumption growth) explain the spread in portfolio returns.
- Why are these measures all based on US indicators?
- Why not use global macro risk factors?

Conclusions

- Interesting paper
- Multilateral approach very promising
- Future challenge:
  - how to make cross-sectional dimension useful for policymakers
  - sort out the correct benchmark for evaluation