Inelastic Financial Markets and Foreign Exchange Interventions

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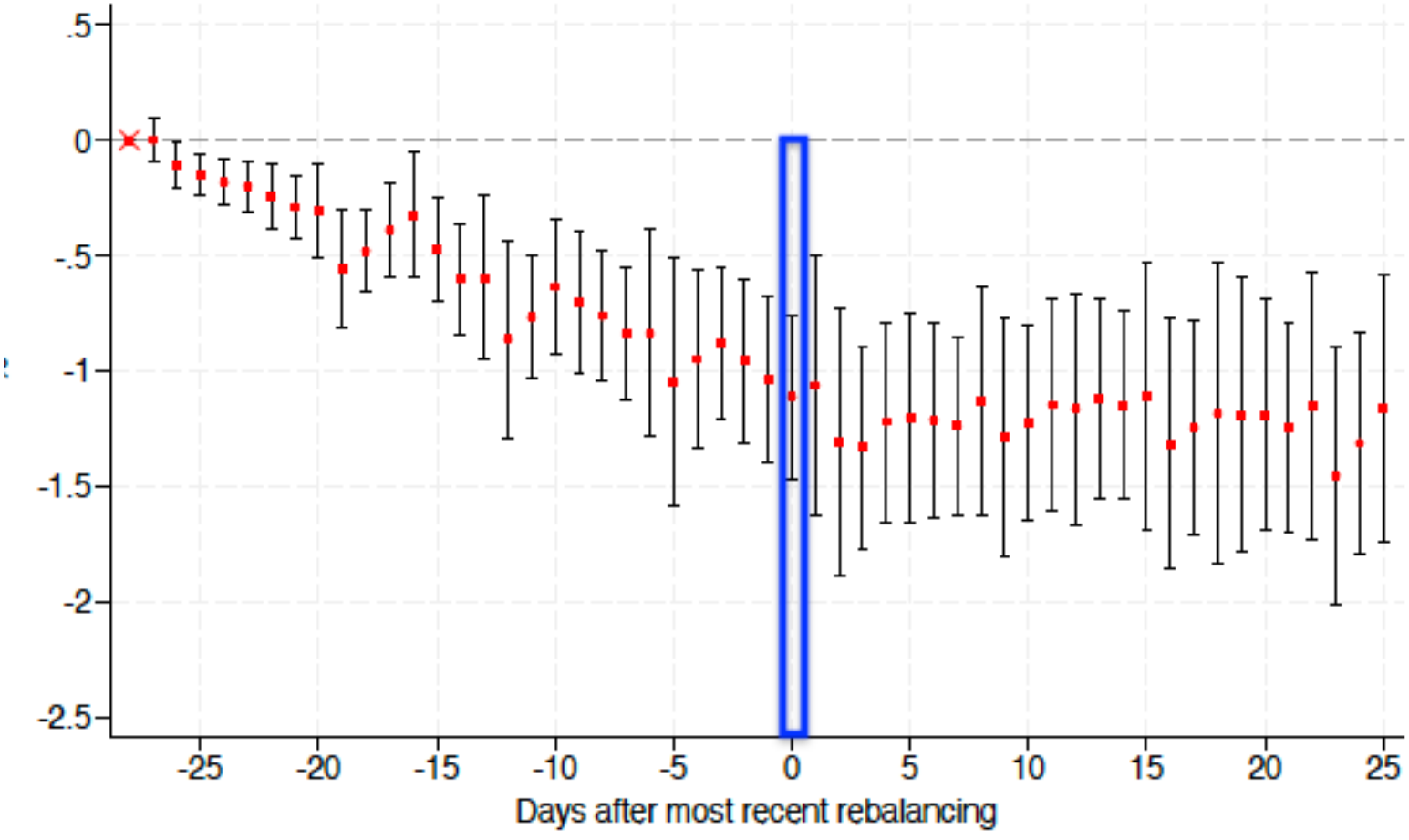
Paper's contribution

- Currency demand shocks that exploit the JPM-EM Global Diversified index rebalancing rules
- Paper quantifies EMs' FXs significant responses to these shocks
- Interprets this evidence through the lenses of the Inelastic Markets Hypothesis
  - Evidence is not consistent with UIP and Models in UIP deviations are exogenous
  - Evidence aligns with predictions of models with endogenous UIP deviations and limited risk-bearing capacity
- Quantitative statements about FX intervention
  - CBs do not systematically respond to FX demand shocks
  - But paper quantifies the counterfactual magnitude of interventions needed to stabilize FX

Three sets of comments

1. Well-executed idea on how to identify FX demand shocks exploiting index rebalancing—which are hard to come by
   - Some quibbles with the interpretation of the anticipated effects
2. Some statements in the paper seem redundant; other circular
   - e.g., UIP does not fit this evidence and, under UIP, the Trilemma holds
   - e.g., FXI is more effective under floating regimes than fixed exchange rate regimes
3. Broader questions raised by the paper's results
   - Why don't CBs stabilize FXs as theories of endogenous UIP deviation prescribe?
   - What more can we do with these shocks and their estimated price impacts?

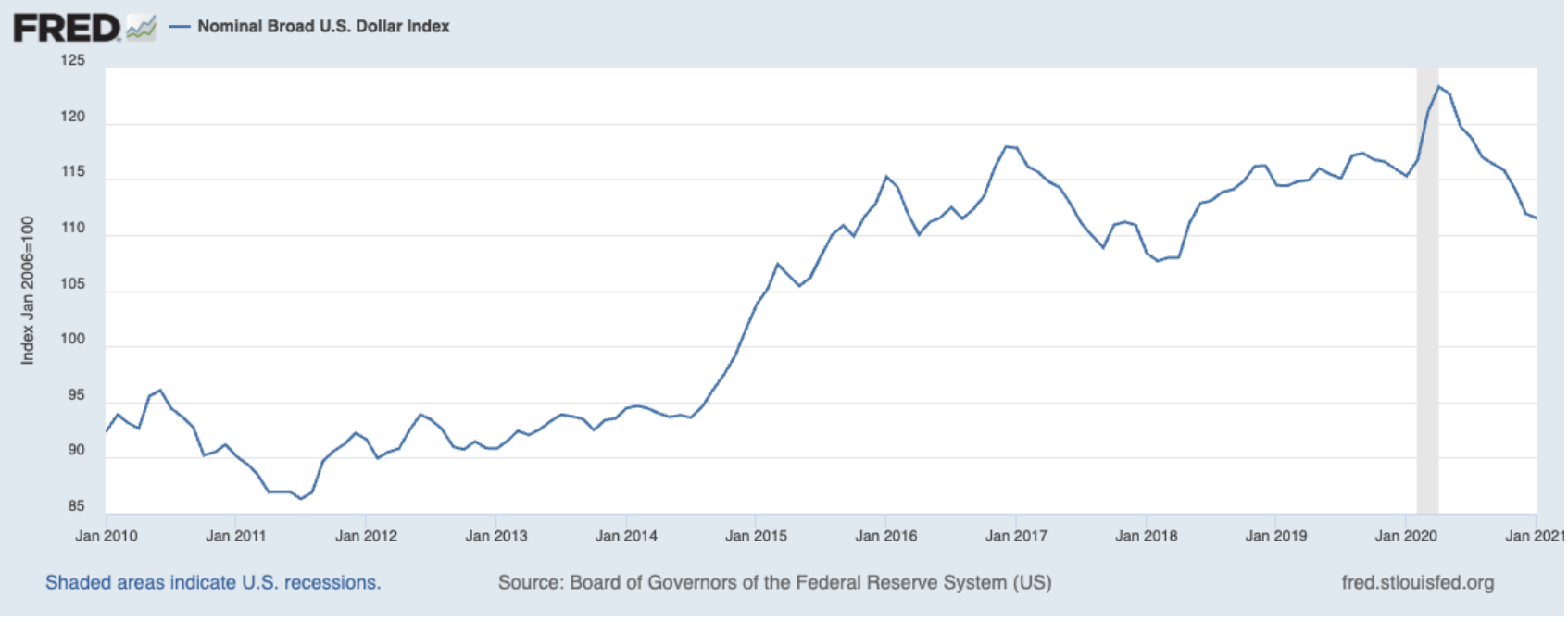
Comment 1: Price impact on rebalancing expectations



Requires additional robustness checks

- The expectation finding is valid and interesting as long as $\mu_{c,t}$ is also uncorrelated with common shocks in addition to domestic fundamentals
- The time-fixed effects cannot separate the effect of the **rebalancing shock** on the smaller countries from the impact of a **common shock (the US Dollar)** to both rebalancing and non-rebalancing countries before the rebalancing kicks in
  - In other words, **there are two treatments**: common shock pushing large EMs to the cap and rebalancing effect of the cap.
- Need additional controls and/or a Dif-in-Diff specification with the large countries included the regression

The Dollar is on steady trend between 2010 and 2021



Comment 2: Seemingly redundant statements

- Main points of Section 4 and 5 of the paper: (i) interpreting the results and (ii) evidence on FXI
  - Models with UIP or exogenous UIP deviations are inconsistent with the empirical findings
  - Evidence aligns with the Inelastic Market Hypothesis, Asset Market Segmentation, and Models of Endogenous UIP deviation
  - FXI can be effective in this setting **without other sources of asset market segmentation**
- The asset pricing framework proposed is useful to estimate FXI rules but is not suitable to quantitatively evaluate macro models
- What is the value added of the discussion of the Trilemma and the Relaxed Trilemma in Section 5.2?

Why are floaters more effective than peggers at stabilizing exchange rates?

- The risk bearing capacity $\lambda_{c,t} \equiv \omega\sigma^2_{e_{c,t}}$ governs the elasticity of the exchange rate to the demand shock.
- A managed FX implies lower $\left(\sigma^2_{e_{c,t}}\right)$, a more elastic market, and more FXI per unit change in the FX
- In the limit, FXs are immune to demand shocks, including from government
- **But low FX volatility came about with intervention** (BTW, real exchange rate volatility is often higher under a peg)
  - Fixed exchange regimes don't need to intervene further, but need other instruments (e.g., capital controls or other sources of market segmentation) to provide monetary independence.
  - FX flexibility provides monetary independence not FXI.

Comment 3: Broader questions

- Very interesting results, albeit underdeveloped, on the estimation of the intervention rules under the null hypothesis that CBs could respond to demand shocks (equation 11 and Table 5.1)

$$f_{c,t} = -\alpha_c^f n_{c,t} + \epsilon_{c,t}^f \tag{11}$$

- Why don't CB stabilize the FX as theories of endogenous UIP deviation suggest they should?
  - Theory ahead of practice or practice ahead of theory?
- What more can we do with these shocks and estimated elasticities?
  - Can the paper provide practical, quantitative guidance to CBs on how to intervene given their objectives

Conclusions

- A carefully executed empirical work with clear grounding on macro-finance theory
- Push identification a bit harder and dig more on what CBs do
- Think harder above the implications of your empirical evidence
  - What can and cannot be stated based on the facts documented?

Great paper! Thank You