Discussion of "Capital Flows and Exchange Rates: A Quantitative Assessment of the Dilemma Hypothesis" by Cesa-Bianchi, Ferrero, and Li

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Motivation: Trilemma-Dilemma Debate

Question: Does a flexible exchange rate insulate countries from international spillovers of US monetary shocks?

- **Trilemma** (Friedman, 1953; Mundel, 1957; Fleming, 1962)
  - Expenditure switching: depreciation increases exports (expansionary)
- **Dilemma** (Rey, 2015; Miranda-Agrippino/Rey, 2020)
  - Global financial cycle (GFC): depreciation increases foreign currency liabilities (contractionary)
  - Trade-off between monetary independence vs capital flow mobility
- **Dominant currency pricing** (Gopinath et al., 2020)
  - Incomplete exchange rate pass-through to import prices limits the expenditure switching channel

Summary

- Panel vector autoregression (PVAR)
  - US monetary tightening depreciates the exchange rate but reduces exports and real GDP
  - Flexible ER does not insulate countries from GFC
- Model based on Akinci and Queralto (2024)
  - Financial friction drives the UIP wedge
  - Dominant currency pricing limits the expenditure switching
  - Estimate the model parameters to match the VAR
- Policy counterfactuals
  - A currency peg increases the GDP volatility
  - Countercyclical tax on domestic credit or foreign borrowing reduces the GDP volatility, but the inflation volatility remains high

Discussion

- A combination of rich theoretical and empirical framework
- Very Interesting and important policy implications

- Two main suggestions:
  1. Cross-country heterogeneity
  2. Empirical validation of the mechanism generating the UIP wedge

Comment 1: Cross-Country Heteorgeneity

- The baseline sample consists of 15 countries.
  - **11 Advanced:** Australia, Canada, Germany, Japan, Korea, New Zealand, Norway, Singapore, Sweden, Switzerland, United Kingdom
  - **4 Emerging:** Chile, Mexico, South Africa, Thailand
- The currency share in international trade and finance is heterogeneous across countries.

(1) UIP Wedge in Advanced vs Emerging Economies

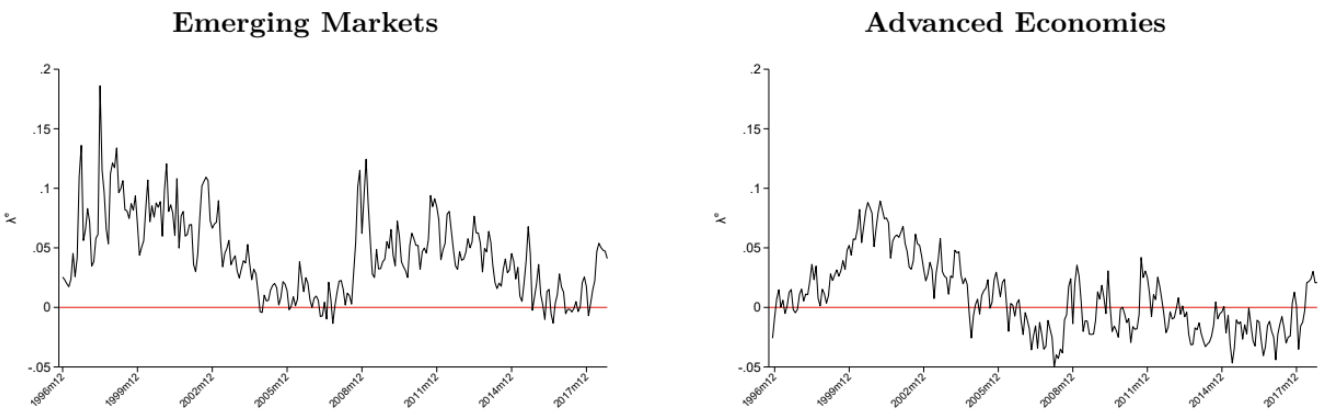


Figure 5. UIP Premium

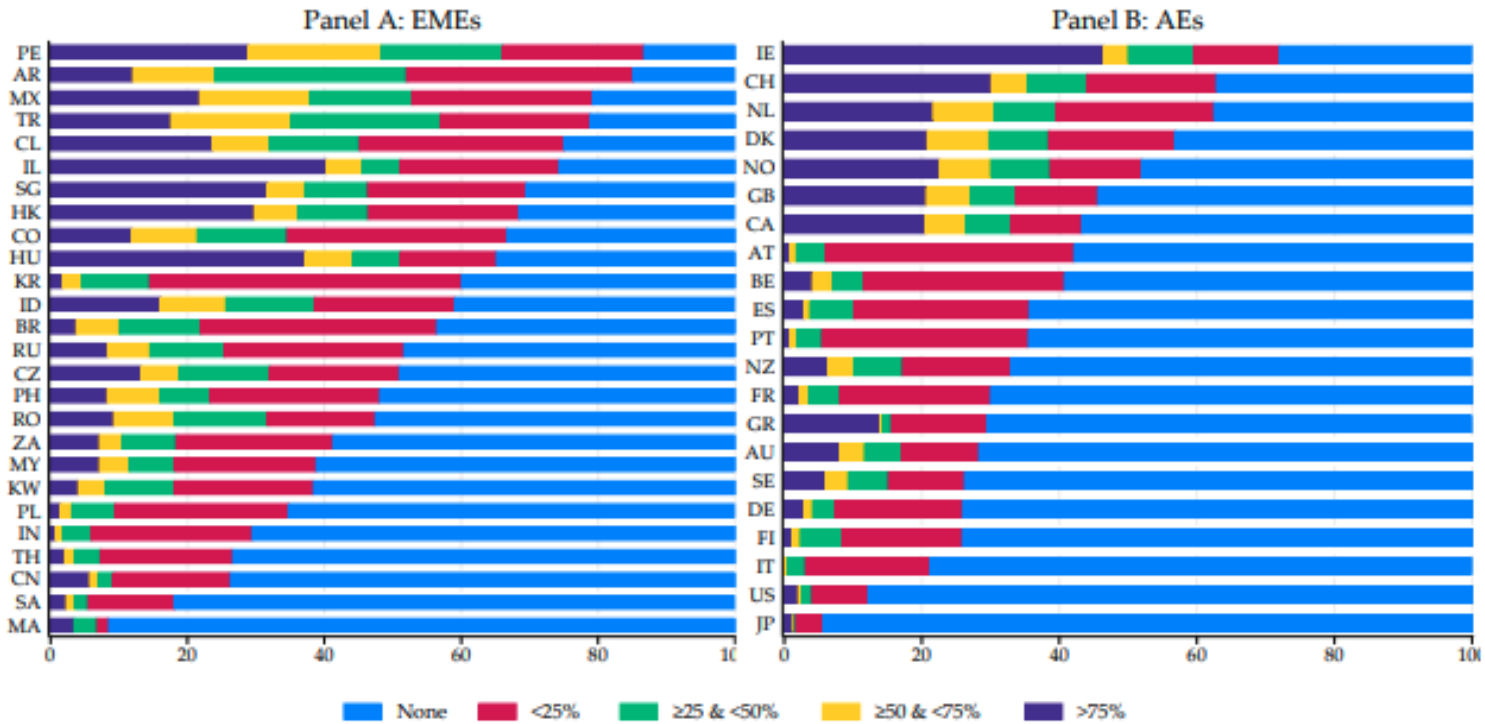
UIP premium at 12 month horizon for 21 EMs and 12 AEs, over 1996m11:2018m10, measured using deposit and money market interest rates from Bloomberg and expectations of exchange rates.

Source: Kalemli-Özkan and Varela (2024)

- EMEs have a larger UIP wedge than AEs.

(2) Heterogeneity in Foreign Currency Debt

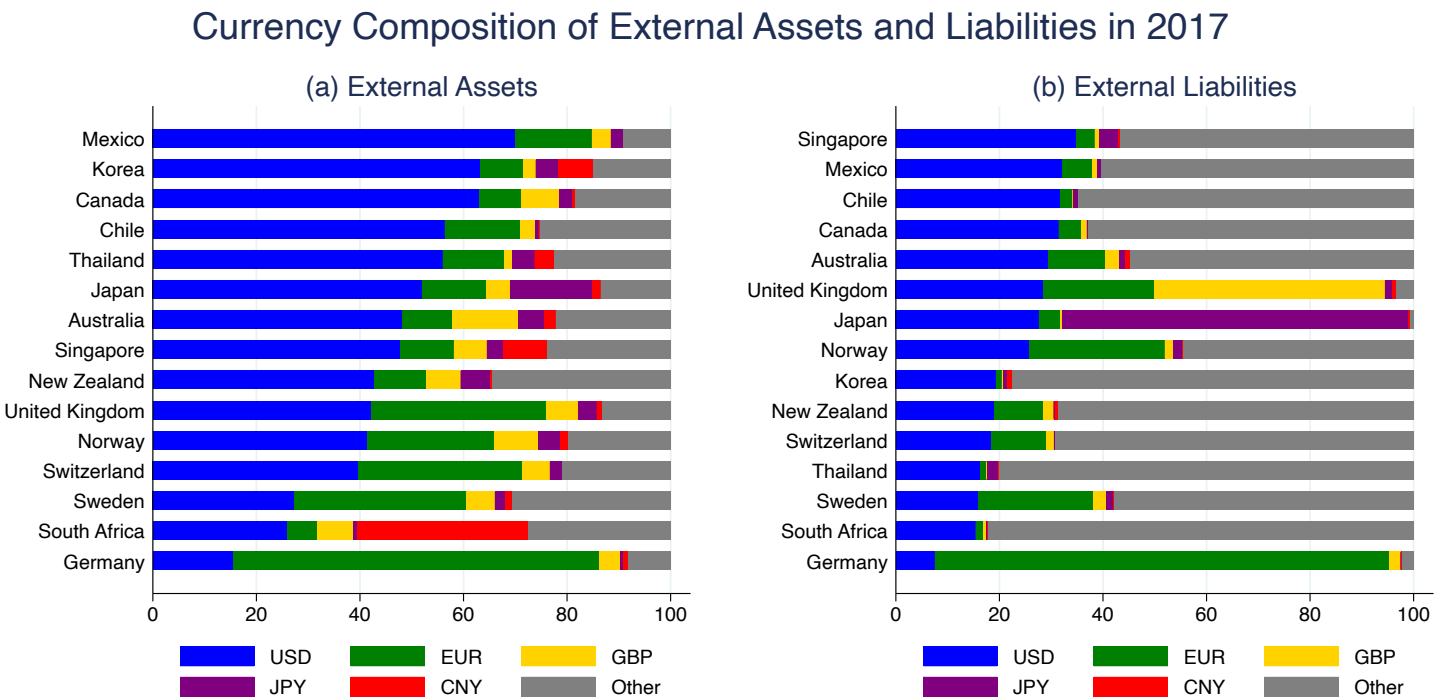
Figure 1: Share of firms reporting foreign-currency debt at some point (2005-2023)



Source: Alfaro, Caballero, and Hardy (2025)

- The FX debt usage is different within and across AE and EME groups.

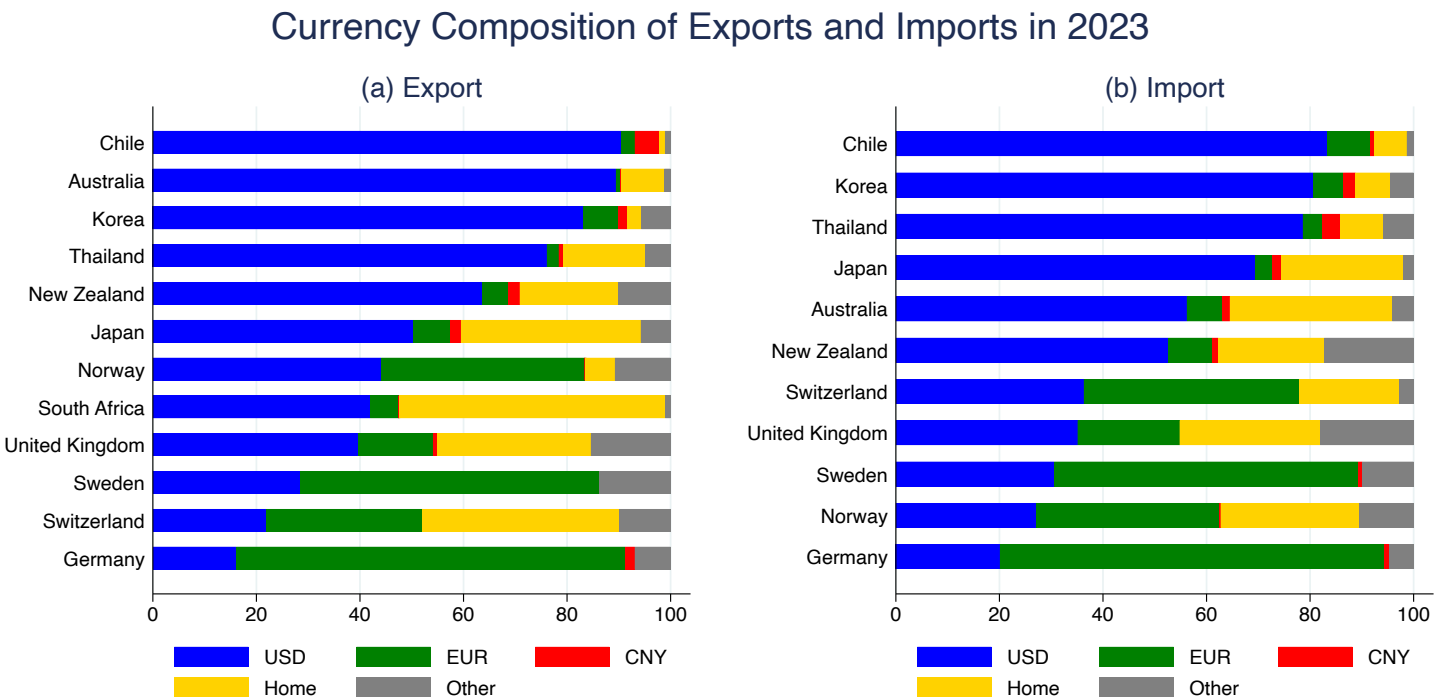
Currency Composition of External Assets and Liabilities



Source: Bénétrix, Gautam, Juvenal, and Schmitz (2019)

- The currency composition of external assets and liabilities varies across AEs and EMEs.

(3) Heterogeneity in Trade Invoicing Currencies



Data Source: Boz/Brüggen/Casas/Georgiadis/Gopinath/Mehl (2025). Figure plotted by the author.

- Currency invoicing in trade also varies across countries.

Heterogeneity affects the US Monetary Transmission

Suggestion: Compare the magnitudes of expenditure switching and balance sheet channels across different groups

1. Positive expenditure switching channel: Depreciation boosts exports (Mundell-Fleming)
2. Negative demand channel: Tighter monetary policy reduces demand and imports (Gourinchas, 2018)
3. Negative balance-sheet channel: Depreciation increases the repayment of dollar debt in the domestic currency (Rey, 2015)

- Whether countries should stabilize the exchange rate or not depends on the relative size of different channels, which depend on the currency share in international trade and finance in each country.

Suggestions

Suggestion: Compare the magnitudes of expenditure switching and balance sheet channels across different groups

- Calibrate the friction on the foreign currency borrowing constraint (γ) to match the foreign currency borrowing share (Bénétrix et al., 2019)
- Calibrate the shares of firms exporting in the Home and Foreign currencies to match the invoicing shares in trade (Boz et al., 2025)
- Advanced vs emerging (Argentina, Brazil, etc.)

Comment 2: Drivers of the UIP Wedge

Literature studies different possible drivers for the UIP wedge.

- Balance sheet constraint on foreign currency borrowing (Akinci and Queralto, 2024; Aoki, Benigno, and Kiyotaki, 2021)
- Currency market segmentation
  - Global financial intermediaries with limited risk-bearing capacity (Gabaix and Maggiori, 2015; Itskhoki and Mukhin, 2021)
  - Position limits or capital controls (Fanelli and Straub, 2021)
- Global investors' demand for safe assets during crisis times (Kekre and Lenel, 2023; Jiang, Krishnamurthy, and Lustig, 2024)

Suggestion: Verify the empirical link between borrowers' balance sheet risk and the UIP wedge

(1) Fama Regression

- Test the average UIP wedge in countries with/without dollar debt
- Fama regression:

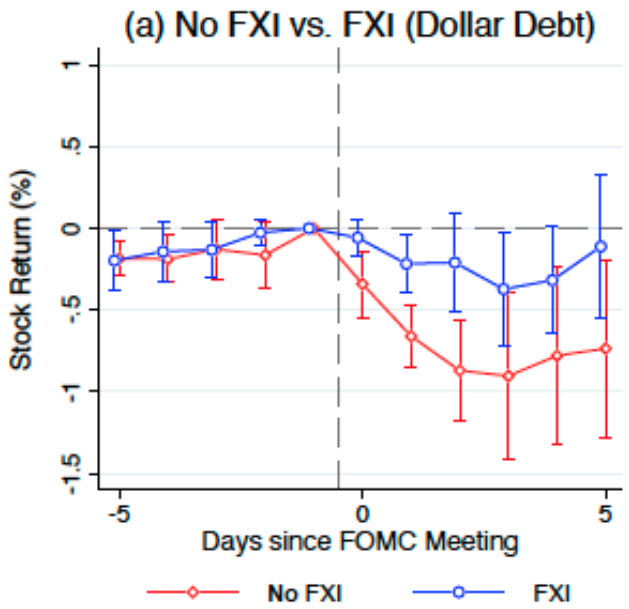
$$E(e_{t+1}) - e_t = \alpha + \beta(i_t - i_t^{US}) + \varepsilon_t$$

- Test the null hypothesis $H_0: \ \alpha = 0, \ \beta = 1$
- The estimated β tends to be negative and close to -1: the high-interest rate currency is expected to appreciate over time (Positive UIP wedge)
- How does the estimate of β differ across countries with large and small dollar debt?

(2) Panel VAR

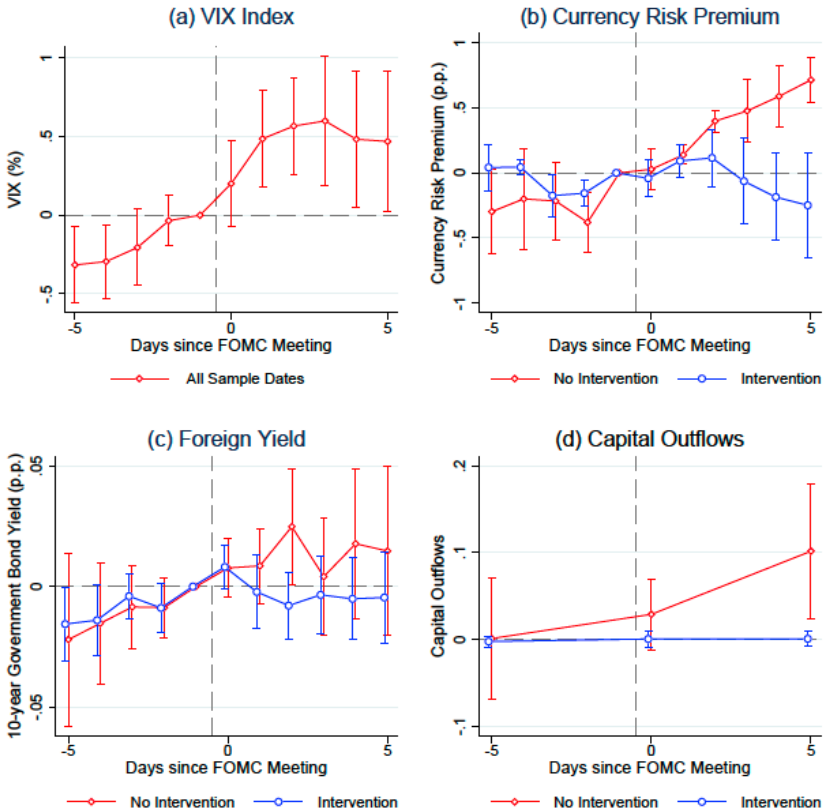
- Estimate the panel VAR and study the response of the UIP wedge to US monetary shocks in countries with large and small dollar debt

- Control for US monetary transmission channels other than the balance sheet contraction
  - VIX index captures the global investors' risk aversions (Miranda-Agrippino and Rey, 2020)
  - Portfolio rebalancing: EPFR equity/bond flows (Converse and Mallucci, 2023)
  - Capital controls (Chinn and Ito, 2006; Lane and Milesi-Ferretti, 2018)



Source: Rodnyansky, Timmer, and Yago (2025)

- Combine high-frequency US monetary shock (Nakamura and Steinsson, 2018) with daily FX interventions, firm-level stock returns, and balance sheet currency (S&P Capital IQ)
- No interventions: US monetary tightening $\Rightarrow$ stock prices $\Downarrow$
- Interventions: stock prices are stable for firms with dollar debt



Source: Rodnyansky, Timmer, and Yago (2025)

- MP and FXI can affect investors' risk aversion, currency risk premium, and portfolio rebalancing
- The balance sheet channel is robust after controlling for these channels

Other Comments

- Additional dimensions of heterogeneity:
  - Flexible vs fixed (Hong Kong) or managed (China, Singapore) exchange rates
  - Macroprudential policy
  - FX reserves (Laser, Mihailov, and Weidner, 2024)
  - FX interventions (Fratzscher et al., 2019; Adler, Chang, Mano, and Shao, 2024; Rodnyansky, Timmer, and Yago (2025))

Summary

- The paper quantifies the trilemma/dilemma hypothesis of the exchange rate
- Theoretical model with rich nominal and financial frictions + Careful matching with the empirical VAR
- Very interesting and important policy implications

- Future work could study:
  - Cross-country heterogeneity
  - Different drivers of the UIP wedge