Discussion of :

"The Missing Internal Devaluation: Nominal and Real Adjustment to the Great Recession within the US"

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Internal devaluation

Theory: in an optimal currency area, movements in relative demand are associated with adjustments in relative prices.

- E.g. if the relative demand in country A falls with respect to country B, we should expect the $rer_{A,B}$ to depreciate in country A
- the mechanism goes through the relative adjustment of prices of tradable and non-tradable goods
- a fall in local demand hits harder non-tradable good producers, such that prices fall more in this sector than in the tradable sector and employment shifts towards tradable sector: internal devaluation

The case of housing price bust during GR: it may be considered as a quasi-natural experiment to study the effects of changes in relative demand across US regions

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Summary

This paper: it exploits MSA level data on changes in housing prices during the GR to explore the changes in *rer* across US regions

1. theory: define $rer_l = (1 - \alpha_S) \cdot (p_{l,j} - p_G) + \alpha_S \cdot (p_{l,S} - p_S)$
2. empirics:
   - explanatory variable: $\Delta log(hp)$
   - explained variables: $\Delta log(rer)$, $\Delta log(employment)$, $\Delta log(wages)$, $\Delta log(n.firms)$, $\Delta log(laborshares)$,
   - expected results: in regions where *hp* falls the more, $\Delta log(rer) \downarrow$, $\Delta log(employment) \downarrow$

OLS and IV – using the regional housing supply elasticity as instrument – as Δhp could be driven by unobservable variables

Key take away message

There is not evidence of internal devaluation in response to the heterogeneous fall in house prices across US regions

- In detail:
  - there seems to be no changes in relative prices for goods and services: the elasticity is even negative for services, as their price increased in regions where *hp* decreased more :(
  - as expected, employment fell more in services than in goods :)
  - wages: little response :[
  - mark-ups (inverse of labor shares): little response :[
  - number of firms: positive correlated, lower net entry in regions where *hp* fell more :[

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Main comments

At first, I thought this was a “forensic” paper:

1. remind a well-established adjustment mechanism from the theory on optimal currency area
2. show a puzzle in the data: empirical results do not match with the predictions from theory
3. solve the puzzle: where the missing internal devaluation come from? For the reader, this is the key question

Possible interpretation of the puzzle (to avoid a feeling of non-results):

- is there something wrong with the experiment/data?
- once we rule out any possible issue from data, should we use the experiment to reconsider the predictions from theory? E.g. highlight the channels in data that prevents a match with theory

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A few questions on the experiment and the data:

- is there any mechanical impact of *hp* on the relative price index of a specific region (I guess that controlling for the sectoral composition of regions gets rid of that)
- are there alternative measures of relative fall in demand?
- one possible explanation leaning against a decrease in price is that asymmetric information between lenders and borrowers may increase after a house price bust - because of the fall in the value of collateral - raising borrowing costs of firms: would it be possible to use regional-level measures of changes in financial constraints as a control?
- looking forward to see results using BLS CPI microdata on 69 MSAs from 1980s: has there been a rer appreciation associated with episodes of housing price booms prior to the GR?
- this will also rule out the potential impact of GR on the internal devaluation that cannot be addressed without looking at different periods

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Alternative approach: should we reconsider the predictions from theory? In that case, the experiment could provide new insights on the mechanisms behind the internal devaluation

- Results suggest that nominal rigidities seem to matter, as quantities move more than prices. Do authors want to push this reading of the results behind the missing internal devaluation?
- Should we discard the assumption of free mobility across sectors (T-NT)?
- Results go in the right direction for movements in employment and the number of firms, but the reallocation of workers is not enough to generate internal devaluation: is there a counteracting force at the intensive margin that offsets the possible increase in markups determined by the lower competition?

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Final remarks

- This paper contributes to the literature by :

  1. providing a neat measure of the fall in relative demand across US regions (MSAs) using the heterogeneous movements in house prices in a rich dataset
  2. it explores the consequences of the fall in relative demand on rer, employment, wages, number of firms and finds no evidence of internal devaluation: a key result also for the Euro Area policymakers

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