

Discussion of Bianca de Paoli's " [Monetary Policy under Alternative Asset Market Structures: the Case of a Small Open Economy](#) "

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Contributions

The nature of financial market arrangements is shown to influence the choice of the welfare maximizing monetary policy in important ways.

This is an interesting paper that provides novel insights into the choice of flexible vs fixed exchange rates for small open economies

Model Structure

In the model each country produces one good. Each good is a composite of differentiated goods following the Dixit-Stiglitz setup with Calvo pricing.

Exports are priced in the currency of the producer.

The final consumption good in each country is given by a CES aggregator.

Purchasing power parity does not hold because of home bias.

To achieve a richer stochastic structure, the model allows for government spending financed through lump-sum taxation.

Model Structure (continued)

The paper considers three stark kinds of financial market arrangements:

1. Complete Markets across countries
2. One non-state contingent bond traded across countries
3. Financial autarky

What is the Basic Issue?

The home country might have an incentive to manipulate the real exchange rate through monetary policy. An artificially appreciated exchange rate can:

1. boost consumption by making foreign imports cheaper
2. reduce domestic income by lowering the demand for the domestic good
3. reduce domestic income by lowering the demand for domestic exports

The Basic Intuition

The degree of expenditure switching is primarily influenced by the elasticity of substitution across domestic and foreign goods.

As in Benigno and Benigno (2003), **with complete markets**, country-specific wealth effects are muted if the elasticity of substitution is sufficiently high.

Why experience the unpleasantness of producing at home, if the foreigners are just as good at it?

In response to positive technology shocks at home, policies that fight the exchange rate depreciation can be welfare enhancing.

The Basic Intuition (continued)

With incomplete markets, the wealth effects are more tightly linked to production.

With high substitution elasticities for traded goods, if monetary policy fights the depreciation implied by a positive technology shock, the resulting expenditure switching will reduce domestic output and wealth enough to offset the gain from production avoidance.

Instead, if the trade elasticity of substitution is low enough, the substitution effect dominates.

Lots of Painful Algebra

The paper provides a linear-quadratic approximation to the loss function of the representative agent in the economy.

Bianca also gives an analytical representation of the targeting rules.

You can never get enough of a good thing

While Bianca puts an impressive effort into the analytical derivations, I would have liked a little more guidance in differentiating the coefficients in the loss function and in the targeting rules across financial market arrangements.

I can tell the coefficients in the loss function and in the targeting rules vary with the financial market arrangements, but the expressions are complex enough functions of the fundamental parameters that it is hard to discern what might be interesting patterns.

Distortionary taxes

The optimal policy decision needs to balance two different distortions, 1) a distortion from monopolistic competition, 2) the terms of trade externality.

Much of the qualitative discussion in the paper focuses on 2).

Why not highlight the effects of the second distortion, by introducing taxes that can offset the monopolistic distortion?

Home bias

It seems to me that the terms of trade externality ought to be influenced by the degree of home bias in consumption.

In fact, Faia and Monacelli (2007) highlight how introducing home bias can lead to terms of trade externalities even with a unitary substitution elasticity between domestic and foreign goods.

The paper does not highlight the separate role of home bias, which merits some additional consideration

Substitution and Wealth Effects

The working of the terms trade externality is intimately related to the size of substitution and wealth effects on consumption and labor in response to shocks.

Showing the Baxter-King decomposition to quantify the substitution and wealth effects for a given shock under alternative rules, would be a straight-forward way to corroborate the intuition provided for the results.

Welfare losses

After the presentation of the optimal policy results, much of the discussion focuses on comparisons with simple suboptimal rules, including an exchange rate peg, CPI targeting and PPI targeting.

Given the prior discussion, the ranking is unsurprisingly affected by trade elasticities and financial market arrangements, confirming the intuition provided.

The tables in the paper show which simple rule in the set considered is superior, under different conditions. Why not also show the implied welfare differences with the optimal rule?

Is it the case that the alternative simple rules only imply a small consumption loss relative to the fully optimal rule?

Which box are we in?

Bianca suggests that the fully optimal targeting rules might be too difficult to implement.

How should we then choose among alternative rules?

The rankings depend on a growing number of factors.

The grids that are in the paper involve knowledge of the substitution elasticity and the degree of financial market completeness.

Add to these, other factors that were previously identified as important: the degree of local-currency pricing, the level of home bias, the importance of non-traded goods.

But these are pesky details to clear up.