Financial frictions and optimal monetary policy in an open economy: Discussion

Kevin X.D. Huang

March 16, 2012

Central issue

- How shall CB respond to various types of shocks taking into account various types of distortions/frictions
- in a two-country economy?
- Oftentimes first best is not attainable
- Then key question is how CB should balance tradeoffs arising from the various distortions/frictions

Monopolistic competition

- Markup distortion even absent shocks (first order effect)
- May use fiscal policy to correct it (unrealistic?), but not in this paper
- One reason for why FER/MU regime more robust than IT/PLT option to inclusion of financial frictions (HL 2006)?

Unsynchronized price adjustment

- Cross-section effective-markup variation following various shocks--one source of relative price dispersion
- Consequence--misallocation of resources
- One incentive for IT/PLT (which target?)
- Paper shows PPI targeting outperforms CPI targeting in almost every scenario (what about optimal inflation index?)

Bankruptcy risk

- Variations in credit spreads cross section and over time (act as cost-push shocks)
- Variations in marginal cost--another source of relative price dispersion (even if synchronized/flexible price adjustment)
- First order effect--another reason for why MU may be more preferable than IT/PLT?
- Tension between IT/PLT (to stabilize EM) and EFP targeting (directly stabilize MC)--endogenous capital formation makes the latter quantitatively more important

Presence of non-traded goods intensifies the tension

- MP must balance tradeoffs between relative price dispersions both within and across sectors, as well as across countries
- Asymmetric effects of exchange rate movements on sectoral relative prices (tradable vs. non-tradable) give another reason for why FER/MU regime may be more robust than IT/PLT option to the inclusion of financial frictions

Under foreign-currency debt denomination, exchange rate movements act as an internal device

- To stabilize cross-country variations in EFC following a positive home productivity shock--this leads MP to give more weight on PPI targeting
- But to dis-stabilize cross-country moments in EFC following a positive foreign productivity shock--this makes fixed exchange rates more preferable

Extensions

- Frictions and shocks in banking sector
- Labor market frictions such as nominal wage rigidities (this adds another tension on the marginal-cost margin)
- More realistic modeling of fiscal policy (particularly relevant for EMU)
- Imperfect information--say, if CB does not know for sure the sources of shocks