

Discussion of  
"Demand Imbalances, Exchange Rate Misalignment  
and Monetary Policy" by Corsetti, Dedola and Leduc

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# Thinking about Optimal Monetary Policy

- Economies with sticky prices as the only distortion

⇒ Flex price equilibrium is optimal ⇒ Price stability

- Economies with time-varying real distortions

Example #1: shocks to elasticity of substitution (exogenous)

Example #2: real wage rigidities (endogenous)

⇒ flex price equilibrium allocation is sub-optimal ( $y_t^n \neq y_t^e$ ).

- stabilization of  $y_t - y_t^n \Rightarrow$  price stability, inefficient activity
- stabilization of  $y_t - y_t^e \Rightarrow$  efficient activity, inflation
- optimal policy: "somewhere in between"

# The Present Paper

- Example of an "endogenous" real distortion: incomplete international financial markets in a two country model
  - Complete markets: unrealistic
  - Focus of recent closed economy analysis (Monacelli, Iacoviello)
- Comparison between:
  - Efficient allocation (flex price, complete markets)
  - Natural allocation (flex price, incomplete markets)
  - Allocation under the optimal monetary policy
  - Allocation under "price stability" policy (domestic or CPI)
- Welfare losses from price stability policies
  - role of "trade elasticity" and "exchange rate misalignments"

## Miscellaneous Questions and Comments

- Why focus on "news about future technology" shocks?
  - Generally "wrong" correlations under price stability:  $(C, L)$ ,  $(C, C^*)$ ,  $(L, L^*)$ , ...
    - cannot be a key source of fluctuations
  - Are the results robust to other shocks?
- Is the emphasis on "exchange rate misalignments" necessary?
  - Real exchange rate is another endogenous variable...
  - Why not "real interest rate misalignments" (given UIP) or "consumption misalignments"?
  - Implementation of optimal policy: Would a simple exchange rate-based interest rate rule do?
- Calibration of trade elasticity
  - Is  $\omega = 0.45$  too low? (check implications for trade balance).

# Issues related to the assumption of incomplete markets

- Which assets?
- Too much incompleteness? (no risk sharing)
- But no borrowing constraints!  $\rightarrow$  large imbalances
- Is the flexible price allocation invariant to monetary policy rule? (nominal assets)
- Optimal monetary policy (under sticky prices) can improve over the flexible price allocation  $\rightarrow$  desirability of nominal rigidities!
- Gains from optimal policy  $\longleftrightarrow$  internalization of the negative wealth effects on Foreign country. What if no cooperation?
- Orthogonal but interesting: Is there an advantage for Home consumers of having their bonds traded internationally? Or does it benefit Foreign consumers (hedging)?