Optimal Monetary Policy in Open vs Closed Economies: An Integrated Approach
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- Simple work-horse model of monetary policy in small open economy
  - Skillful use of unrealistic assumptions
  - Elegant synthesis and simplification of previous work
  - Much easier to understand and use than the competition
  - Incorporates labor market, too
  - Should be very useful for teaching
  - Main result: Open-economy problem/model isomorphic to closed-economy problem/model

1 Preliminary, some details remain. Quite unrealistic assumptions
  - Complete markets, perfect international risk sharing
  - Complete pass-through, Law of One Price
  - No imported intermediate inputs
  - Optimal taxes cancel domestic distortions
  - Uncovered interest parity
    * Add exogenous risk premium?
    * Explicit derivation of welfare function?
  - Plausible value of weight on output-gap stabilization?
  - No lags, no inertia
    * Monetary policy immediate impact on inflation and output gap
    * Inflation, output forward-looking variables
    * Output gap and terms of trade (real exchange rate) highly correlated
  - Target (domestic) inflation in sticky prices, operational?

2 Optimal policy
  - First-order conditions: Targeting rules (Svensson, Svensson-Woodford “Implementing Optimal Policy Through Inflation-Forecast Targeting”)
    * Conditions for (forecasts of) target variables
  - Interest-rate feedback rule
    \[ r_t = r_{t-1} + bE_t\pi_{t+1}, \ b > 1 \]
    * Equilibrium condition, not operational
    * Operational reaction function: respond to predetermined variables
    * \[ E_t\pi_{t+1} = \alpha \pi_{t+1} \]
      * Possible indeterminacy problem with exogenous interest rates
        - Less problem with endogenous predetermined variables
      * One solution: Respond also to deviations from targeting rule (commitment to out-of-equilibrium behavior)