Optimal Monetary Policy in Open vs Closed Economies: An Integrated Approach

Richard Clarida, Jordi Gali and Mark Gertler
Discussion by
Lars E.O. Svensson
www.iies.su.se/leosven

- 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

- 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?

- 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

$$r_t = rr_t^0 + b\mathrm{E}_t\pi_{t+1}, \quad b > 1$$

    - Equilibrium condition, not operational
    - Operational reaction function: respond to predetermined variables
    - $\mathrm{E}_t\pi_{t+1} = \alpha_w q_w \mathrm{E}_t u_{t+1}$, exogenous
    - 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)