BIS CCA-006-2011
May 2011

Discussant comments on

Understanding the impact of the global financial shock on the Chilean economy

Rodrigo Caputo, Juan Pablo Medina and Claudio Soto

Prepared for the 2nd BIS CCA Conference on

"Monetary policy, financial stability and the business cycle"

Ottawa, 12–13 May 2011

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[*] These comments reflect the views of the author and not necessarily those of the BIS or of central banks participating in the meeting.

Discussion of Caputo, Medina and Soto

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Bank of Canada-BIS conference on Monetary Policy, Financial Instability and the Business Cycle
May 13, 2011

Introduction

Structure of my discussion

- Overview of crisis in Chile
- Recession Accounting in a New Keynesian Model
- Monetary Policy

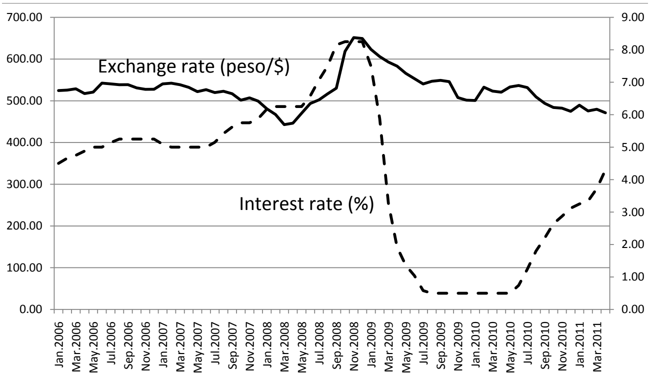
Overview of Crisis

Crisis viewed from Chile

- Recession, deflation in 2009
- Transmission of global shock
  - trade channel
  - financial channels
- Changes in selected macro aggregates (2009/2008, bn of 2003 peso)
  - Exports: -1,640
  - Investment: -3,040
  - Total consumption: +983
- Fiscal and monetary stimulus: swift exit (relative to advanced economies)

Overview of Crisis

Monetary policy and exchange rate



Recession Accounting

What this paper does

- Recession accounting in New Keynesian model
- Use small-scale New Keynesian model of small open economy
  - Demand is consumption of representative infinitely-lived consumer
- "Fit" the model to the data by estimating unobservable shocks
  - shocks to demand etc.
  - Bayesian estimation
- Decompose GDP growth

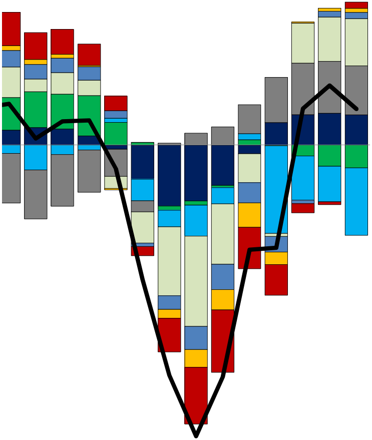
Recession Accounting

International Transmission in New Keynesian Model

- How can one explain observed fall in demand for home goods?
- Trade channel is weak in New Keynesian model
  - the impact of negative foreign demand shock can be smoothed through the financial account
- One needs an increase in the interest rate to decrease home demand
  - Euler equation for consumption
- But the Chilean monetary policy interest rate *fell* in 2009
- So one needs "financial shocks" that will depress demand
- The model has two interest rate spreads
  - domestic
  - external (EMBI spread)
  - domestic spread viewed as determined outside Chile (banking contagion?)
- Microfoundations?

Recession Accounting

One problem: the model does not have enough unoservable shocks and so "estimation" of observable variables.



Monetary Policy

- Policy experiment: the authors make monetary policy (i) responsive to spread; (ii) more responsive to output
- Activism would have paid off: this would have raised output and inflation in 2009
  - optimal since output *and* inflation were too low
- But how was this possible, given the zero-bound constraint?
- I do not understand the claim that the zero-bound constraint can be ignored because the optimal policy involves a higher nominal interest rate (once higher inflation is taken into account)
  - circular argument: one can ignore the zero-bound constraint if one ignores the zero-bound constraint
  - the higher inflation would not have materialized because of the zero bound-constraint

Conclusion

- Interesting paper: asks important questions, finds answers
- To make the answers even more convincing
    - estimate the model using all the observable variables (need to introduce more unobservable shocks)
    - incorporate the zero-bound constraint into the analysis