Discussion on "Alternative Monetary Policy Instruments and Limited Credibility in a Small and Open Economies", by J. Garcia-Cicco

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Disclaimer: **The views expressed are mine and do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System**

Summary

- Interesting paper on the design of monetary policy in an environment of imperfectly anchored expectation (econometric model)
- Comparison among Taylor-type interest rule, money growth rule, fixed exchange rate under alternative specification in terms of how expectations are formed (RE and LC)
- Analysis in terms of trade-off by examining impulse responses following domestic and external shocks to the interest rate.

Summary: details and results

- Forecasting model is a VAR with a time-varying mean with two key aspects:
  - inflation is persistent as inflation expectations are shaped by past inflation and limit central bank policy action;
  - exchange rate volatility influences long-run inflation expectation.
- Results:
  - with RE, trade-off emerges between money targeting and interest rate targeting with peg performs poorly relatively poor
  - with LC, key role of exchange rate in determining how different rules perform.

Discussion

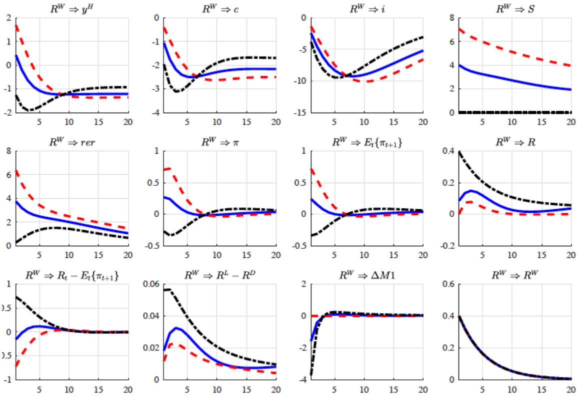
- Model and its features; What is needed? What is a good model for emerging market economies?
- Limited credibility and policy implications: key aspect is the dependence of expectation formation from exchange rate component.

Discussion

- Rich SOE-DSGE model:
  - Household: money and deposits in the utility function and choose also home and foreign currency bonds
  - Wage rigidity and price rigidity
  - Banking sector: perfect competitive sector with cost function associated with loans and deposits along with reserve requirement.
  - Working capital constraint at the level of capital producer generates demand of loans.
- What is the role of the banking sector? Borrowing and lending in the same currency. How do we characterize a non-advanced economy?

Discussion

Figure 3: External-Interest-Rate Shock with Alternative Instruments. Rational Expectations

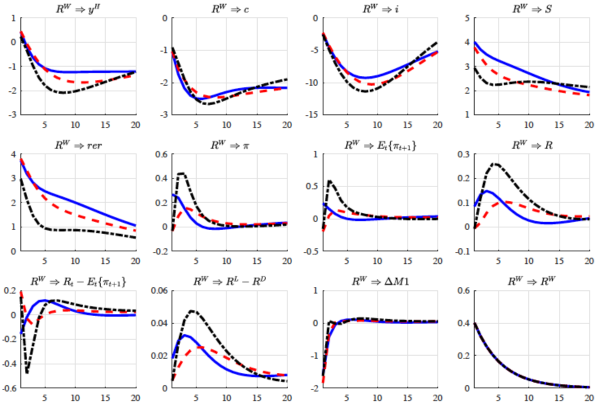


Notes: The solid-blue line is the version with an interest-rate rule, the dashed-red line uses an money growth rule, and dashed-dotted-black line corresponds to the exchange-rate peg. See the description in Figure 2 for variables' definitions.

Discussion: RE case

Expenditure Switching is important

Figure 5: External-Interest-Rate Shock under Interest-Rate Rule. Rational Expectations vs. Imperfect Credibility



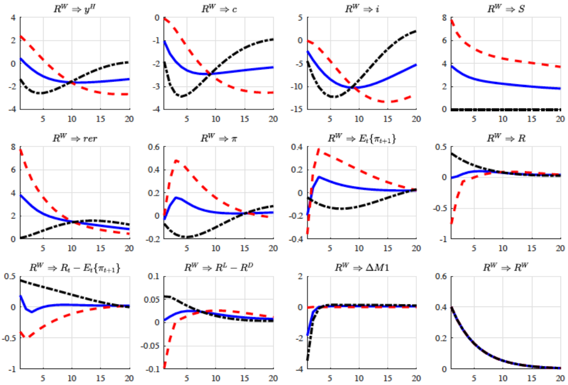
Notes: The solid-blue line is the version under rational expectations, and the dashed-red line is under imperfect credibility. See the description in Figure 2 for variables' definitions.

Discussion: LC case

- Limited Credibility Case: Agents use econometric model to forecast expected wage and price inflation.
- Key aspect is the dependence on exchange rate component.
- Econometric model is estimated using data from Argentina and Chile. Possibility of non-linearity in terms of exchange rate role.

Discussion: LC case

Figure 6: External-Interest-Rate Shock with Alternative Instruments. Imperfect Credibility with $K_{\pi s} = 0$.

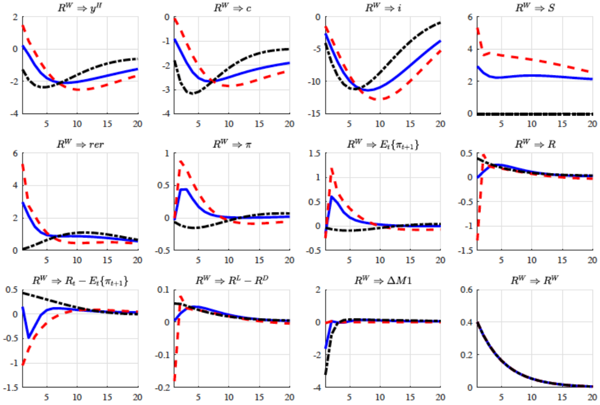


Notes: All responses correspond to the learning model with $K_{\pi s} = 0$, The solid-blue lines is the version with an interest-rate rule, the dashed-red lines uses an money growth rule, and dashed-dotted-black lines corresponds to the exchange-rate peg. See the description in Figure 2 for variables' definitions.

Discussion

- Expenditure Switching is mitigated under Taylor rule (?)

Figure 7: External-Interest-Rate Shock with Alternative Instruments. Imperfect Credibility with $K_{\pi^S} = 0.2$.



Notes: All responses correspond to the learning model with $K_{\pi^S} = 0.2$, The solid-blue lines is the version with an interest-rate rule, the dashed-red lines uses an money growth rule, and dashed-dotted-black lines corresponds to the exchange-rate peg. See the description in Figure 2 for variables' definitions.

Conclusion

- Interesting work;
- Two avenues;
  - role of limited credibility in small open economy
  - role of limited credibility in emerging market economy
- Analysis: trade-offs should be examined in the context of welfare metric.