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Openness, imperfect exchange rate pass-through and monetary policy ☆

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Abstract

This paper analyses the implications of imperfect exchange rate pass-through for optimal monetary policy in a linearised open-economy dynamic general equilibrium model calibrated to euro area data. Imperfect exchange rate pass through is modelled by assuming sticky import price behaviour. The degree of domestic and import price stickiness is estimated by reproducing the empirical identified impulse response of a monetary policy and exchange rate shock conditional on the response of output, net trade and the exchange rate. It is shown that a central bank that wants to minimise the resource costs of staggered price setting will aim at minimising a weighted average of domestic and import price inflation.
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1. Introduction

Over the last 6 years a large literature (the so-called "New Open Economy Macroeconomics, NOEM") has developed examining the optimal conduct of

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monetary policy in a class of open-economy dynamic general equilibrium models that feature imperfect competition and nominal rigidities.[1] One of the models that has recently attracted a lot of attention is the one of Gali and Monacelli (2000). This model combines the open-economy features of the NOEM, with the elegance of the benchmark New-Keynesian closed economy model as, for example, analysed in Woodford (1999). One of the striking findings in Gali and Monacelli (2000) is that the welfare results obtained in the basic New-Keynesian model carry over to its open-economy counterpart. Welfare optimising monetary policy results in a complete stabilisation of the domestic price level. In particular, there is no trade-off between output gap stabilisation and domestic price stability and there is no need for an explicit consideration of the exchange rate.[2] This result has proven to be relatively robust with respect to certain extensions of the model. For example, in a two-country set-up Benigno and Benigno (2001) have shown that a policy pursuing domestic price stability can be considered as the optimal outcome in a Nash game between the monetary authorities in two countries. Similarly, Obstfeld and Rogoff (2002) have rejected the necessity of a new international compact on the basis of the argument that policies geared at domestic price stability deliver outcomes that are close to the first best. In another extension, Benigno (2001) shows that achieving domestic price stability continues to characterise the optimal monetary policy when international financial markets are incomplete.

One feature that characterises all the models discussed above is the assumption of perfect exchange rate pass-through. There is, however, a lot of empirical evidence that changes in nominal exchange rates affect import prices only gradually. Recently, Campa and Goldberg (2001) estimated pass-through equations for 25 OECD countries over the period 1975–1999. They find that they can reject the hypothesis of complete short-run pass-through in 22 of the 25 countries. In contrast, long-run elasiticities are generally closer to one; Campa and Goldberg (2001) reject long-run pass-through equal to one in only 9 of the 25 countries.[3] Based on an empirical analysis of international prices for two magazines, Ghosh and Wolf (2001) argue that sticky prices or menu costs are a better explanation for imperfect pass-through than strategic pricing or international product differentiation. Consistently with the findings of Campa and Goldberg (2001), they find complete long-run pass-through, which typically holds in theories based on sticky prices, but does not hold in theories of international product differentiation.

In this paper, we explore the implications of sticky import prices and imperfect exchange rate pass-through for optimal monetary policy. This is done in three steps.

[1] The seminal publications in the area are Obstfeld and Rogoff (1995, 1996). Other notable contributions include Betts and Devereux (1997, 1998), Svensson (2000), Kollmann (2000a, b), Gali and Monacelli (2000), Ghironi (2000a, b), Benigno and Benigno (2001), Chari et al. (2000), McCallum and Nelson (1999), Corsetti and Pesenti (2000, 2001). This literature parallels an abundant literature on optimal monetary policy in closed economy dynamic general equilibrium models. See, for example, the volume edited by Taylor (1999).

[2] See Woodford (1999) for a clear and thorough analysis of this result. The seminal papers are King and Wolman (1996), Goodfriend and King (1997) and Rotemberg and Woodford (1997).

[3] Other recent evidence on imperfect exchange rate pass-through can be found in McCarthy (1999).

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