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International dimensions of optimal monetary policy[☆]

Giancarlo Corsetti^{a,b,c}, Paolo Pesenti^{c,d,e,*}

^a*European University Institute, 50133 Florence, Italy*

^b*University of Rome III, Rome, Italy*

^c*CEPR, London EC1V 7RR, UK*

^d*Federal Reserve Bank of New York, 33 Liberty Street, New York, NY 10045, USA*

^e*NBER, Cambridge, MA 02138, USA*

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Abstract

This paper provides a baseline general equilibrium model of optimal monetary policy among interdependent economies with monopolistic firms and nominal rigidities. An inward-looking policy of domestic price stabilization is not optimal when firms' markups are exposed to currency fluctuations. Such a policy raises exchange rate volatility, leading foreign exporters to charge higher prices vis-à-vis increased uncertainty in the export market. As higher import prices reduce the purchasing power of domestic consumers, optimal monetary rules trade off a

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*Corresponding author. International Research, Federal Reserve Bank of New York, 33 Liberty Street, New York, NY 10045, USA. Tel.: +212 720 5493; fax: +212 720 6831.

E-mail address: paolo.pesenti@ny.frb.org (P. Pesenti).

larger domestic output gap against lower consumer prices. Optimal rules in a world Nash equilibrium lead to less exchange rate volatility relative to both inward-looking rules and discretionary policies, even when the latter do not suffer from any inflationary (or deflationary) bias. Gains from international monetary cooperation are related in a non-monotonic way to the degree of exchange rate pass-through.

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1. Introduction

In the long-standing debate on optimal monetary policy, an open question is whether rules designed to fit the specific features of closed economies may be successfully adopted by open, interdependent, trade-oriented countries, or, rather, there exist policy trade-offs that have a specific international dimension. Some view exchange rate fluctuations as instrumental to the adjustment of relative prices. In this case, ‘inward-looking’ policies attempting to stabilize domestic prices and close the output gap are deemed to be desirable regardless of the degree of trade openness: no attempt should be made to offset currency movements and reduce the variability of import prices. But if terms of trade fluctuations are destabilizing sources of uncertainty, domestic monetary policy should be reactive to the exchange rate. A related set of questions concerns what welfare gains (if any) can be achieved through international monetary cooperation.

In this paper, we assess these issues by building a baseline general-equilibrium model of optimal monetary policy among interdependent economies with nominal rigidities, imperfect competition in production, and forward-looking price-setting.¹ The main conclusion of our analysis is that, in an open-economy context, policies exclusively focused on stabilizing internal prices and output gap may actually result, on average, in inefficiently high consumer prices of imports, and therefore suboptimal welfare levels for domestic consumers.

The intuition underlying this result is that monetary policies aimed at internal stabilization can raise the volatility of world demand and the exchange rate. Foreign firms whose export revenue is exposed to such volatility will attempt to reduce the sensitivity of their profits to exchange rate fluctuations. In our economy, they can do

¹This paper shares a unifying research agenda with a number of recent contributions on optimal monetary policy in closed and open economies. For an introduction to the literature see for instance Gali (2002); Goodfriend and King (1997) and especially Woodford (2003). A far from complete list of references on open-economy policy rules includes Ball (1999); Benigno and Benigno (2003), Carlstrom and Fuerst (1999), Clarida et al. (2001), Devereux and Engel (2003), Gali and Monacelli (2002); Ghironi and Rebucci (2002), Laxton and Pesenti (2003), McCallum and Nelson (1999), Obstfeld and Rogoff (2000, 2002), Parrado and Velasco (2002), Sutherland (2001), Svensson (2000), and Walsh (1999).

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