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Journal of Economic Dynamics & Control 32 (2008) 2085–2117

JOURNAL OF Economic Dynamics & Control

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Gains from international monetary policy coordination: Does it pay to be different?

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Received 5 August 2006; accepted 9 August 2007
Available online 12 September 2007

Abstract

In a two country world where each country has a traded and a non-traded sector and each sector has sticky prices, optimal independent policy in general cannot replicate the natural-rate allocations. There are potential welfare gains from coordination since the planner under a cooperating regime internalizes a terms-of-trade externality that independent policymakers overlook. If the countries have symmetric trading structures, however, the gains from coordination are quantitatively small. With asymmetric trading structures, the gains can be sizable since, in addition to internalizing the terms-of-trade externality, the planner optimally engineers a terms-of-trade bias that favors the country with a larger traded sector.
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JEL classification: E52; F41; F42

Keywords: International policy coordination; Optimal monetary policy; Asymmetric structures; Terms-of-trade bias

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0165-1889/$ - see front matter © 2007 Elsevier B.V. All rights reserved.
doi:10.1016/j.jedc.2007.08.004

1. Introduction

As countries become more interdependent through international trade, should they conduct monetary policies independently or should they coordinate their policies? In other words, are there gains from international monetary policy coordination? This question lies at the heart of the intellectual discussions about optimal monetary policy in open economies.

The literature has produced a strong conclusion in favor of inward-looking policies and flexible exchange-rate regimes. This conclusion has been drawn not only in the traditional literature within the Mundell–Fleming framework that features ad hoc stabilizing policy goals, but also in the more recent New Open-Economy Macro (NOEM) literature that features optimizing individuals, monopolistic competition, and nominal rigidities, with the representative household's utility function serving as a natural welfare metric for optimal policy. In the traditional literature, many have argued that the gains from coordination are likely to be small because a flexible exchange-rate system would effectively insulate impacts of foreign disturbances on domestic employment and output (e.g., Mundell, 1961; McKibbin, 1997). In the NOEM literature pioneered by Obstfeld and Rogoff (1995), it has been shown that, although gains from coordination are theoretically possible, they are quantitatively small (e.g., Obstfeld and Rogoff, 2002; Corsetti and Pesenti, 2001).

The remarkably strong conclusion about the lack of gains from coordination has stimulated a lively debate and a growing strand of literature in search of sources of coordination gains by enriching the simple framework built by Obstfeld and Rogoff (2002). Several potential sources have been identified. For instance, the gains from coordination can be related to the degree of exchange-rate pass-through (e.g., Devereux and Engel, 2003; Duarte, 2003; Corsetti and Pesenti, 2005).[1] Even with perfect exchange-rate pass-through, inward-looking monetary policy can be suboptimal and be improved upon by coordination, depending on the values of the intertemporal elasticity and the elasticity of substitution between goods produced in different countries (e.g., Clarida et al., 2002; Benigno and Benigno, 2003; Pappa, 2004). Policy coordination may also produce welfare gains if the international financial markets are incomplete (e.g., Sutherland, 2002), policymakers have imperfect information (e.g., Dellas, 2006), or domestic shocks are imperfectly correlated across sectors (e.g., Canzoneri et al., 2005).

Most of the studies on international policy coordination focus on countries with *similar* characteristics. The theoretical framework used in these studies typically features two countries that are identical except that they might be buffeted by different shocks. Such a framework is not suitable, and indeed, is not designed to address issues on policy coordination between countries at different stages of development or countries with different institutional structures that render their production and trading structures asymmetric. Recent events such as the rise of

[1] Corsetti and Dedola (2005) show that, if the distribution of traded goods requires local inputs, then international markets would be endogenously segmented, rendering exchange-rate pass-through incomplete. This feature also provides a scope for international monetary policy cooperation.

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