Balance Sheets, Exchange Rate Regimes, and Credible Monetary Policy*

Luis Felipe Céspedes   Roberto Chang
New York University   Rutgers University

Andrés Velasco
Harvard University and NBER

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Abstract

We consider optimal interest rate policies in an open economy model with balance sheet effects a la Bernanke-Gertler (1989) and overlapping wage contracts a la Calvo (1983). The optimal "flexible inflation targeting" policy under discretion involves a floating exchange rate, and partial reaction of home interest rates to external shocks. This policy yields higher welfare than a policy of strictly fixed nominal exchange rates. Other optimal inflation targeting policies under discretion also dominates fixing. These results hold in spite of the credibility advantage of fixing, and of the presence of dollar liabilities and balance sheet effects.

1. Introduction

The recent crises in emerging markets have caused the profession to reevaluate received wisdom about exchange rate regimes. In particular, analysis of the connection between imperfections in the financial sector and exchange rate policy has risen to the top of the research agenda.[1] There are strong reasons for this focus. Both casual observation and formal econometric analysis[2] suggest the existence of an empirical link between financial turmoil and currency crashes. Moreover, whether or not central banks should defend their currencies against a speculative attack has emerged as a key and controversial aspect of the policy response, and this choice is increasingly governed by possible effects on the financial sector. Some analysts, such as Furman and Stiglitz (1999) and Radelet and Sachs (1999) have called for monetary expansion and depreciation in response to adverse shocks, reaffirming the validity of prescriptions derived from the conventional Mundell-Fleming analysis. Others, such as Calvo (2000), Dornbusch (1999) and Stein et al (1999), have argued that in the presence of sizeable dollar debts a sudden and unexpected depreciation may do more harm than good.

In a previous paper (Céspedes, Chang, and Velasco 2000, henceforth CCV) we made an attempt to identify the role of financial imperfections in the analysis of exchange rate policy, in the context of a dynamic stochastic model with explicit microfoundations. CCV's model focuses on a small open economy that borrows in the world market to finance investment. Crucially, information frictions imply that the economy's borrowing, and hence aggregate demand, is constrained by its *net worth*, as emphasized by Bernanke and Gertler (1989). Exchange rate behavior may then exacerbate net worth effects because domestic residents borrow in foreign currency, while domestic income depends on the value of domestic money; or, in Calvo's (1999) parlance, the economy's liabilities are *dollarized*. In such a scenario, a devaluation exerts, in addition to its conventional effects, a contractionary effect hitherto ignored in conventional literature. By weakening the economy's balance sheet, a devaluation exacerbates the effect of financial frictions, pushing down aggregate demand, output, and employment.

CCV's analysis yields at least two suggestions for the theory of exchange rate regimes. First, under reasonable parameter values, the coexistence of a net worth channel and liability dollarization may well imply a potentially contractionary effect of devaluation. Second, and somewhat surprisingly, such a finding does *not*

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[1] See Chang and Velasco (2000) for a detailed discussion of recent developments on this front.
[2] The standard reference is Kaminsky and Reinhart (2000).

justify the defense of the exchange rate against exogenous shocks, in particular real shocks from abroad. The reason is that adjustment to an exogenous shock will typically require a *real* devaluation, which will take place regardless of nominal exchange rate behavior. But it is real, not nominal, devaluation which determines the net worth effect. Hence the contractionary effect of devaluation will take place one way or the other, and exchange rate policy can only affect the manner of the adjustment. In fact, under CCV's assumptions, fixed exchange rates turn out to be more contractionary than flexible rates, as the former imply that a real devaluation can only take place via price *deflation* which, if nominal wages are rigid, exacerbates the contraction in employment and output.

To make progress and obtain analytically tractable closed-form solutions, in CCV we imposed very strong and simple assumptions about monetary policy. CCV compared a completely fixed exchange rate regime against a flexible rate regime that kept the price level fixed. One question that leaves unanswered is, what is the *optimal* exchange rate regime in the presence of balance sheet effects and liability dollarization? That question can only be answered by somehow specifying a social loss function and computing the optimal policy function under alternative timing assumptions..

A related issue is that of *credibility* of policy –that is, ensuring the monetary authority will not want to renege on an ongoing date and state contingent plan for the setting of its instruments. Optimal policy is meaningless unless it is also credible; this means that, in the absence of commitment devices, the relevant optimal policy is that computed under discretion. Can one improve upon discretion? A common argument is that fixed exchange rates may have enjoy the advantage of serving as a commitment device. The relevant comparison then would be that of a fixed exchange rate regime against a credible (discretional) policy of flexible rates.

The purpose of the present paper is to shed light on exactly these questions. We study the determination of the optimal monetary and exchange rate policy without commitment, and compare its implications –including welfare implications– against those of fixed exchange rates. Since it is key to tackle these questions in the presence of financial imperfections, our framework is a version of CCV's model, extended to introduce money demand explicitly and to allow for staggered nominal wage-setting à la Calvo (1983).

To characterize optimal policy without commitment, we assume that the central bank minimizes social loss, which is taken to be a function of income, inflation, and possible exchange rates and interest rates. Importantly, the central bank is

free to choose current policy every period. Under rational expectations, market behavior must then be consistent with future central bank strategy, which itself responds to market behavior. The outcomes of this interaction are then given by the time consistent equilibria of the model, defined as in Oudiz and Sachs (1985) and Svensson (2000).

Under discretion, we consider three possibilities: "strict inflation targeting," in which social loss depends only on inflation; "flexible inflation targeting," in which output fluctuations also matter for social loss; and "flexible inflation-real exchange rate targeting," in which real exchange rate fluctuations are also present in the social loss function. We study the dynamic outcomes under the three discretionary regimes as well as under fixed exchange rates. Finally, we compare the social loss under each discretionary regime against the loss under fixed rates.

A main result is that fixed rates imply a larger loss than each of the three discretionary regimes. In fact, in the three cases with discretion monetary policy exploits forcefully the ability to change nominal exchange rates to deal with foreign shocks, a result that is similar to that obtained by Svensson (2000) in a very different model. Exchange rate flexibility appears to be effective in stabilizing output fluctuations in the model. This gain outweighs the losses that arise from higher inflation under discretionary floating than under fixing.

It also becomes apparent in our discussion that the interpretation of monetary policy under discretion must take into account the full dynamics of the economy. This becomes clear in interpreting the discretionary policy rules which in general[3] prescribe that the home interest rate be adjusted up in response to adverse foreign shocks. A short-sighted analysis would interpret this as a case of "fear of floating." However, optimal policy also adjusts the home interest rate down whenever investment is below its steady state level. Since investment falls persistently after a bad shock from abroad, the overall policy response is very small except for the initial impact period and, after correcting for expected inflation, reveals an expansionary, not deflationary, policy stance.

The paper is organized as follows. Section 2 describes the environment under study. Section 3 focuses on the different cases under discretion. The implications of fixed exchange rates and a comparison with the discretionary, flexible rate cases are discussed in Section 4. Section 5 concludes.

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[3]Except when inflation targeting is strict –see below.

2. The Model

As already mentioned, our basic environment is taken from CCV, extended to explicitly include money demand and to allow for overlapping wage contracts of the Calvo (1983) type. For the sake of brevity, here we only sketch the main aspects of the model and describe the two extensions just mentioned. For a more detailed exposition, the interested reader is referred to CCV.

We focus on a small open economy that produces a single good using domestic labor and domestic capital. These two factors of production are owned by distinct agents called workers and capitalists. Workers consume and capitalists invest an aggregate of the home good and a single imported good. For simplicity, capitalists are assumed to consume only imports.

A crucial aspect of the model is that capitalists can invest in excess of their own net worth by borrowing abroad but, because of informational asymmetries, the cost of borrowing exceeds the world interest rate and depends on the ratio of net worth to investment. Hence, as emphasized by Bernanke and Gertler (1989) and others, the model features "balance sheet effects" that may be quantitatively important.

2.1. Domestic Production

The home good is produced by competitive firms with a common Cobb Douglas technology which, in the neighborhood of the steady state, can be written as

$$y_t = \alpha k_t + (1 - \alpha)l_t, \ \ 0 < \alpha < 1 \tag{2.1}$$

Here and in the rest of the paper, lowercase letters denote (except when noted) percentage deviations of the corresponding uppercase variables from their non-stochastic steady state levels[4]; for instance, if Y_t denotes the level of output in period t and Y its steady state level, $y_t = (Y_t - Y)/Y$. Hence 2.1 is simply a log-linear version of the production function $Y_t = AK_t^a L_t^{1-\alpha}$, where K_t and L_t denote capital and labor inputs in period t.

As in Obstfeld and Rogoff (2000), workers are heterogenous. Correspondingly, L_t is assumed to be a CES aggregate of the services of the different home workers, and the market for labor exhibits monopolistic competition as in Dixit and Stiglitz (1977). The representative firm, however, takes all prices as given, and chooses

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[4]See CCV for a proof of the existence and uniqueness of the steady state.

output and factor demands to maximize profits in every period. The main implication is that, in equilibrium, factor prices must equal marginal productivities, which (in percentage deviations from steady state) can be expressed as:

$$r_t - p_t = y_t - k_t \tag{2.2}$$

$$w_t - p_t = y_t - l_t \tag{2.3}$$

where p_t denotes the price of the home good, r_t the rental rate of capital, and w_t the *aggregate* wage (that is, W_t is the minimum cost of obtaining a unit of L_t), all expressed in terms of the domestic currency (the *peso*).

The solution to the representative firm's problem also implies a downward sloping demand curve for each worker's labor. Such a demand schedule is described later, when we discuss workers and the maximization problem they face. Finally, firm profits are zero in equilibrium.

2.2. Capitalists

Capitalists finance investment with their own net worth and with foreign loans. However, because of informational asymmetries, foreign borrowing is subject to agency costs of the kind emphasized by Bernanke and Gertler (1989). This is the key ingredient for the model to feature balance sheet effects.

In every period, capitalists must invest for next period's capital, which is assumed to be a Cobb Douglas aggregate of home goods and imports. Imports have a fixed price in terms of a world currency, called the *dollar*. The Law of One Price holds and implies that the peso price of imports is equal to the nominal *exchange rate.* The implication is that the peso price of capital satisfies

$$q_t = \gamma p_t + (1 - \gamma)s_t \tag{2.4}$$

where γ is the share of home goods in the Cobb Douglas aggregator and s_t is the nominal exchange rate.

To finance investment capitalists use their net worth and also borrow from a world capital market where the *safe* interest rate for dollars between t and $t+1$ is random but known at t. However, the cost of borrowing abroad will be higher than the world interest rate because of informational problems. In particular, we follow Bernanke, Gertler and Gilchrist (1999) and assume that the yield on investment is subject to idiosyncratic shocks that can be monitored by lenders only at a positive cost. This results in a costly state verification problem as in

Townsend (1979) and Williamson (1986). The optimal contract to deal with this problem implies then that there will be a divergence between the expected return on investment and the world interest rate, which can be written as

$$\eta_{t+1} = [_t(r_{t+1} + k_{t+1} - s_{t+1}) - (q_t + k_{t+1} - s_t)] - \rho_t \tag{2.5}$$

For any variable z_{t+j}, the expression $_t z_{t+j}$ will denote the expectation of z_{t+j} conditional on period t information. In the RHS of 2.5, the term in square brackets is the expected *dollar* return on capital, given by the (log) difference between the dollar revenue from capital investment and the dollar cost of the investment. On the other hand, ρ_t is the world interest rate on dollars loans between t and $(t+1)$, expressed as a difference from its steady state value. Hence η_{t+1} represents the agency costs associated with external finance or, for short, a *risk premium*.

In turn, the optimal contract implies that

$$\eta_{t+1} = \mu(q_t + k_{t+1} - p_t - n_t) \tag{2.6}$$

where (close to the steady state) μ is a positive constant, and n_t is the capitalists net worth, expressed in terms of home goods. In words, 2.6 says that the risk premium is higher the larger the value of investment relative to net worth.

That investment is financed via foreign loans and net worth now implies that

$$q_t + k_{t+1} = \varphi(s_t + d_{t+1}) + (1 - \varphi)(p_t + n_t) \tag{2.7}$$

where d_{t+1} is the amount borrowed at t and due for repayment at $(t+1)$, and φ is the steady state ratio of foreign borrowing to the dollar value of investment.

Next we describe the evolution of net worth. At the beginning of each period, capitalists collect the income from capital and settle their foreign debts. Then, a fraction $(1-\delta)$ of the capitalist population dies and is replaced by new capitalists. The dying capitalists consume their wealth; to simplify, we assume that they only consume imports. Consequently, n_t is the aggregate net worth of the surviving capitalists, and its evolution is given by

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\begin{aligned}
n_t &= \varkappa(r_t + k_t - p_t) - (1 - \varkappa)(\rho_{t-1} + s_t - p_t + d_t) - \varsigma\eta_t \\
&= \varkappa y_t - (1 - \varkappa)(\rho_{t-1} + s_t - p_t + d_t) - \varsigma\eta_t
\end{aligned}
\tag{2.8}
$$

where $\varkappa$ and ς are positive constants that depend on the steady state. Intuitively, net worth increases with capital income and falls with debt repayments due at t. In addition, the term $\varsigma\eta_t$ captures the fact that agency costs increase the cost of servicing the debt due at t, and hence reduce net worth.

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The second line of equation 2.8 implies that, *ceteris paribus*, a *real* devaluation of the peso (an increase in $s_t - p_t$) reduces net worth by increasing the relative burden of debt due at t. This is the crucial aspect of the model in CCV and implies that, in contrast with conventional analysis, a devaluation may have contractionary effects.

2.3. Workers

As mentioned earlier, labor services provided by individual workers are imperfect substitutes of each other. Consequently, each worker enjoys some monopoly power over the services he provides and, as in CCV, the labor market is monopolistically competitive as in Dixit and Stiglitz (1977). We depart from CCV here, by assuming that, as in Calvo (1983) only a random subset of the workers can set a new nominal wage each period. Moreover, we model money demand explicitly, which is useful to allow for different specifications of monetary policy. Because of these changes, we will be more detailed in our discussion of workers than in the rest of the model.

Workers are indexed by $i \in [0, 1]$, and worker i's preferences are given by the expectation of

$$\sum_{t=0}^{\infty} \beta^t \left[\log C_{it} - \left(\frac{\sigma - 1}{\sigma} \right) \left(\frac{1}{\nu} \right) L_{it}^{\nu} + \left(\frac{\kappa}{1 - \gamma_m} \right) \left(\frac{M_{it}}{Q_t} \right)^{1 - \gamma_m} \right] \tag{2.9}$$

In this expression C_{it} is an aggregate of home goods and imports; note that for simplicity we assume the same Cobb Douglas aggregator as the one relevant for investment, which implies that the peso price of consumption is Q_t. The variable L_{it} denotes i's supply of labor and M_{it} his peso holdings at the end of period t. Hence 2.9 simply says that worker i enjoys consumption and money holdings, and dislikes working.

Worker i's choices include what to consume, how much to charge for the labor he supplies, and how many pesos to hold. In addition, each worker will hold a portfolio of securities, as will be described shortly. His constraints are of three types. First, he faces a downward demand curve for his labor services:

$$L_{it} = \left(\frac{W_{it}}{W_t} \right)^{-\sigma} L_t \tag{2.10}$$

where W_{it} is the peso price of i's labor services, that is, i's wage rate. As in Dixit and Stiglitz (1977), the worker is small enough so that he takes the evolution of W_t and L_t as given.

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The second constraint is that, as in Calvo (1983), worker i sets wages in pesos, and he can change his wage in period t only with some probability $(1-\theta)$. Hence, with probability θ, his nominal wage must be the same as in the previous period, and it is assumed that he must satisfy any demand forthcoming (as given by 2.10) at that wage.[5]

Third, worker i is restricted by his budget constraint. Note that, because different workers change wages at different times, workers are subject to idiosyncratic uncertainty. We assume that workers cannot borrow from abroad to smooth such uncertainty. However, and following Woodford (1996), we assume that workers can trade enough contingent securities among themselves so as to, in effect, insure completely against idiosyncratic shocks. This implies that the flow budget constraint of worker i can be written as

$$Q_t C_{it} + M_{it} + {}_t(\Delta_{t,t+1} H_{i,t+1}) = W_{it} L_{it} + M_{i,t-1} + H_{it} + T_t \qquad (2.11)$$

where T_t is a peso transfer from the government, H_{it} is the peso value, at t, of the portfolio of contingent securities chosen at $(t-1)$, and $\Delta_{t,s}$ is the *pricing kernel*, such that the value at t of a portfolio delivering the random payoff H_s in period $s \geq t$ is ${}_t(\Delta_{t,s} H_s)$.

As discussed by Woodford (1996), under our assumptions (together with a technical assumption to rule Ponzi games), the budget constraint can be written in present value form. Assuming, in addition, that workers have identical initial wealth, it follows that they will completely pool their idiosyncratic risk, and choose identical consumption plans and peso holdings.

One consequence is that the pricing kernel is given by the marginal rate of substitution between consumption at different dates and states:

$$\Delta_{t,s} = \beta^{s-t} \frac{Q_t C_t}{Q_s C_s}$$

where C_t denotes the consumption level common to all workers in period t. This implies, in particular, that the *nominal interest rate* at t, which we denote by i'_t, must satisfy:

$$\frac{1}{1+i'_t} = {}_t \Delta_{t,t+1} = \beta \; {}_t \left(\frac{Q_t C_t}{Q_{t+1} C_{t+1}} \right) \qquad (2.12)$$

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[5]More precisely, the worker will provide labor elastically as long as the real wage is no smaller than the marginal disutility of working; beyond that labor would be rationed. In what follows we assume that we are always in the non-rationing range. This can be ensured by considering exogenous shocks that are not "too large."

as the inverse of $(1 + i'_t)$ is the price at t of a sure peso at $t + 1$.

Another consequence is that peso demand is given by

$$\kappa \left(\frac{M_t}{Q_t} \right)^{-\gamma_m} = (\frac{1}{C_t}) \frac{i'_t}{1 + i'_t} \tag{2.13}$$

which has the familiar interpretation that the marginal rate of substitution between money balances and consumption must equal its relative cost.

We assume that pesos are held only by workers and that the lump sum transfer T_t is the only way in which pesos are introduced in the economy. Hence the supply of pesos satisfies $M_t = M_{t-1} + T_t$. Then, adding up 2.11 over i, and recognizing the fact that the net supply of contingent securities is zero, implies that

$$Q_t C_t = W_t L_t \tag{2.14}$$

In other words, the value of workers' consumption in every period must equal the aggregate wage bill.

Note that, log-linearizing 2.12 and 2.14 around the steady state, and using 2.3, the deviation of i'_t from its steady state level can be written as

$$i_t = {}_t y_{t+1} - y_t + ({}_t p_{t+1} - p_t) \tag{2.15}$$

which is an equation of the Fischer type.

Finally, worker i must decide what wage to set in period t, assuming he is allowed to. This is a tedious problem discussed at length by Woodford (1996). The upshot is that the evolution of the aggregate wage is given by:

$$w_t - w_{t-1} = \left[\frac{1 - \beta\theta}{1 + \sigma(\nu - 1)} \right] \left[\frac{\nu(1 - \theta)}{\theta} \right] l_t + \beta {}_t (w_{t+1} - w_t) \tag{2.16}$$

This is a wage Phillips curve: wage inflation increases with expected future wage inflation as well as with labor employment. Intuitively, the reaction of the current aggregate wage to labor demand pressure is faster if nominal wages are less rigid, as given by a smaller θ.

2.4. Competitive Equilibrium

To define equilibrium it remains to impose market clearing for home goods. Under our assumptions, domestic expenditure in home goods is a fixed fraction of final home expenditures. In addition, the home good can be sold to foreigners. As in

Krugman (1999) and CCV, we assume that the value of home exports in dollars is exogenous and given by an AR(1) process:

$$x_t = a_x x_{t-1} + \varepsilon_t^x \tag{2.17}$$

where a_x is between zero and one, and ε_t^x is white noise. The clearing of the market for home goods then implies

$$p_t + y_t = \lambda(q_t + k_{t+1}) + (1 - \lambda)(s_t + x_t) \tag{2.18}$$

Finally, we assume that the world interest rate follows an AR(1) process

$$\rho_t = a_\rho \rho_{t-1} + \varepsilon_t^\rho \tag{2.19}$$

This completes the description of the economic environment. Once monetary policy is specified, the system of equations 2.1, 2.2, 2.3, 2.4, 2.5, 2.6, 2.7, 2.8, 2.15, 2.16, 2.17, 2.18, and 2.19 suffice to determine the dynamic behavior of y, k, l, r, p, w, s, q, η, n, d, x, i, and ρ. We can, therefore, turn to the study of monetary policy.

3. Optimal Policy Under Discretion

In this section we analyze the policy choices of a monetary authority whose objective is to minimize expected social loss. Social loss is, in turn, assumed to depend on the deviations of output and inflation from their steady state values, and possibly on other variables such as changes in interest rates or the real exchange rates. Our assumptions about the preferences of the policymaker are, we believe, realistic, and may in particular reflect the existence of an inflation targeting regime (as in Svensson, 2000). Alternatively, our assumptions on social loss may be seen as an approximation to (some aggregate of) the welfare of workers and capitalists.[6]

Under our assumptions, the monetary authority faces the problem of choosing a strategy for setting its policy instrument in order to minimize expected social loss, subject to the constraints imposed by the equilibrium behavior of the economy. As in much of the recent literature, we shall assume that the instrument of the monetary authority is the short nominal interest rate i_t. This implies that the behavior of monetary aggregates plays no essential role in the analysis: the money, in particular, adjusts passively as given by equation 2.13 and can be ignored.

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[6]Although such an interpretation may require some additional assumptions to be accurate. See Kim and Kim (1999) and Benigno and Benigno (2000).

In analyzing the policy problem, it turns out to be crucial to specify when the monetary authority can commit to a particular choice. Our assumption will be that the monetary authority sets i_t in period t, after observing shocks in that period. In other words, we shall be concerned with the case of *discretion.* One reason for our focus is that the discretionary case is arguably the most relevant in practice. But, perhaps more importantly in our context, much of the recent debate on fixed versus flexible rates is based on the view that fixed rates may improve upon discretion by serving as an imperfect commitment device. Hence evaluating such a view requires comparing outcomes under fixed rates against discretionary outcomes.

3.1. Identifying Discretionary Policy Outcomes

As in Svensson (2000), the monetary authority's loss function is the unconditional expectation of a period loss function[7] of the form

$$\lambda_\pi \pi_t^2 + \lambda_y y_t^2 + \lambda_e e_t^2$$

where e_t corresponds to the real exchange rate, or $s_t - p_t$. Hence, after taking expectations, the loss function becomes

$$\lambda_\pi Var(\pi_t) + \lambda_y Var(y_t) + \lambda_e Var(e_t) \tag{3.1}$$

In the previous expressions, π_t denotes the deviation of a measure of inflation from its steady state value. In our benchmark computations, such a measure is given by wage inflation.

Notice that under this specification, the policymaker attempts to minimize the deviations of output from its steady state or "natural rate" level, not from some higher threshold as in some of the literature. This means that the "inflation bias" problem familiar from Barro and Gordon (1983) and related work is absent here. But this does not mean that there is no time consistency problem: optimal policy computed under discretion and under commitment will in general not coincide. This is because, as shown in Gali et al (1999), to the extent that wage-setting depends on future economic conditions, a monetary policy that can commit to future actions may face an improved inflation-output tradeoff in the short-run.

The policymakers problem is to minimize social loss by choosing a strategy for setting i_t in every period t, after observing the state of the economy and all shocks

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[7]It is well known that such an objective is the limit, as the discount factor goes to zero, of a scaled discounted sum of expected losses in all periods.

up to period t. To formalize this problem, it is useful to note that the dynamical system that determines the economy's equilibrium has a convenient state space representation. Letting $b_t = d_t + \rho_t$ denote aggregate debt repayment in period t, and $\pi_t = w_t - w_{t-1}$ denote wage inflation, one can write the model in the form

$$\begin{pmatrix} Z_{t+1} \\ {}_t J_{t+1} \end{pmatrix} = A_1 \begin{pmatrix} Z_t \\ J_t \end{pmatrix} + A_2 i_t + \varepsilon_{t+1} \tag{3.2}$$

where $Z_t = (\rho_t, x_t, k_t, \eta_t, b_t, w_{t-1})'$ is a vector of predetermined variables at t, $J_t = (s_t, p_t, \pi_t)'$ is a vector of jumping variables, $\varepsilon_t = (\varepsilon_t^\rho, \varepsilon_t^x, 0, 0, .., 0)'$ is a vector of exogenous shocks, and A_1 and A_2 are matrices whose coefficients are determined by the equilibrium system.

Given the state space representation 3.2, the techniques of Oudiz and Sachs (1985) and Backus and Driffill (1986) can be used to compute a discretionary outcome summarized by two linear maps. First, market behavior is given by a map

$$J_t = J Z_t \tag{3.3}$$

where J is a matrix defining values for the jumping variables at t as a linear function of the predetermined ones.

Second, policy choices are given by

$$i_t = f Z_t \tag{3.4}$$

where f is a row vector defining the interest rate at t as a linear combination of the predetermined variables.

The two linear maps thus defined have the property that (i) given the policy map 3.4, the market behavior defined by 3.3 defines a rational expectations equilibrium of the economy given by 3.2, and (ii) given the system 3.2 and the market behavior 3.3, the policy given by 3.4 in fact minimizes social loss subject to 3.2 and 3.3.

Once the maps 3.3 and 3.4 are obtained, they can be used in 3.2 to arrive at the law of motion for the Z_t vector. Then it is straightforward to obtain variances and covariances for all the variables in the model, and therefore to compute the value of the social loss function.

3.2. Parametrization

We set the model parameters to ensure that the steady state is empirically plausible. Thus, we set the steady state world real interest rate to 4 percent in annual

terms. The share of the home good in the production of capital and in the consumption index, γ, is set at 0.75, which is consistent with observed shares of imported goods in total output. The capital share in the production of the home good, α, is assumed to be 0.35, in line with standard estimates.

We set the probability of non-adjustment in wages (θ) to be 0.75, which implies that on average wages are adjusted every four quarters. The elasticity of demand for worker services, σ, and the elasticity of labor supply, ν, are both set to be 2.

We choose the rest of the parameters in the model to generate a steady state risk premium of six hundred basis points, a ratio of investment expenditures to debt that equals to 1.8, and an annualized business failure rate of 8.8 percent. The monitoring costs are assumed to be 15 percent of the total assets of the firm in case of bankruptcy. Additionally, the capitalists' saving rate δ is set to 0.9615, while the idiosyncratic shock to the return of capital is assumed to be distributed log-normally with a standard deviation equal to 0.28. Finally, the persistence parameter of the world interest rate and the export demand shocks is assumed to be 0.9.

We analyze three different cases of monetary-policy targeting, defined by the weights in the loss function: flexible inflation targeting, strict inflation targeting, and flexible inflation-real exchange rate targeting.

3.3. Flexible Inflation Targeting

Our benchmark case for the loss function parameters is $\lambda_\pi = 1$, $\lambda_y = 0.5$, and $\lambda_e = 0$. Hence this case corresponds to what Svensson (2000) calls "flexible inflation targeting": social loss depends on inflation, but also on domestic output.[8]

The solution for the optimal policy rule turns out to be:

$$i_t = 0.79\rho_t - 0.20x_t + 0.53k_t + 0.02\eta_t + 0.07b_t - 0.0w_{t-1} \qquad (3.5)$$

Several aspects of this rule warrant attention. The first is that the exchange rate is *de facto* floating: because there is no foreign inflation, the term $\rho_t + \eta_t$ captures the relevant international nominal interest rate at which the economy can borrow abroad. Since the optimal rule does not prescribe full adjustment of the domestic nominal interest rate to movements in this international rate, by standard uncovered interest arbitrage the domestic nominal (and real) exchange rate will jump in reaction to shocks.

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[8]Notice that we follow Svensson's (2000) somewhat special terminology, which defines a regime not by the actions it takes, but by the loss function it minimizes.

At the same time, in response to an increase of one hundred basis points in the world interest rate, the monetary authority *increases* the nominal interest rate by almost eighty basis points. At first glance, one may conjecture that this reflects that the monetary authority is partially defending the exchange rate. But such an interpretation would be misleading for two reasons. First, i_t is a *nominal* rate, and hence an increase in i_t may just be compensating for an increase in expected domestic inflation (see 2.15). Indeed, we shall see that domestic inflation increases after a rise in ρ_t. Second, the response of i_t cannot be understood independently of the full dynamics of the model. This is because, when policy is given by 3.5, interest rates increase by more than fifty five basis points if domestic capital is one percent above its steady state value. Since an unexpected increase in the world interest rate will cause a fall in domestic investment and capital in subsequent periods, i_t will increase very little, except for the very first period.

In response to an unexpected one percent increase in the demand for exports, the discretionary policy implies that the interest rate must fall on impact. But again, this is only the very short run response and should not be taken as an indication of a pro-cyclical monetary policy. In particular, a rise in x_t will increase capital accumulation, which then will push interest rates up under the discretionary policy.

Table 3.1 shows the standard deviations of the variables of ultimate relevance for the policymaker's decisions. Under the discretionary policy 3.5, the standard deviation of the real exchange rate is 2.77, and the standard deviations of the nominal exchange rate and the price of the home goods are much higher. Hence the optimal discretionary policy actively takes advantage of the ability to change the exchange rate, a finding similar to that of Svensson (2000) in a very different model. The main payoff is that output is stabilized almost completely. The standard deviation of (wage) inflation is also low (0.44 percent), although is not negligible, and is consistent with the high variability of the exchange rate.

Some further intuition can be obtained by studying the impulse response functions associated with 3.5, the discretionary solution. Figure 1 displays the responses to a one percent increase in the world interest rate. As we saw above, on impact the interest rate increases by 0.79 basis points over its steady state value, but this increase is only temporary: after one period, the interest rate has fallen to only two and a half basis points over its steady state value, and from then on it converges slowly to the steady state.

Since capital depreciation is complete, the dynamic behavior of i_t mirrors the adjustment of capital, which in turn responds to the real interest rate on loans.

On impact, investment and capital fall almost one for one with the increase in the world interest rate. Investment then recovers gradually, as the real cost of loans falls. The latter reflects not only the return of the world interest rate to its steady state, but also a gradual *fall* in the risk premium after an initial increase. The risk premium falls, in turn, because the interest rate increase reduces investment and foreign borrowing, which is apparent from Figure 1. In fact, the reaction of foreign debt is quite strong, falling by almost two and a half percent in the first six periods and then recovering slowly.

Finally note that since capital adjusts towards the steady state only gradually, the discretionary rules limits the deviation of the home interest rate from its steady state. This confirms our previous observation that the rule 3.5 can only be interpreted in the context of the model's dynamic properties.

The impulse responses to a one percent *decrease* in export demand are given in Figure 4. The shape of the response is the same as in the case of a world interest rate shock, although the magnitudes are smaller. The shock leads to a depreciation of the real exchange rate and to a fall in investment of half a percent. As can be seen, monetary policy almost perfectly stabilizes output. The shock and the associated monetary policy leads also to an increase in wage inflation.

3.4. Strict Inflation Targeting

Our second case for the loss function is one of "strict" inflation targeting: the parameters of the loss function are $\lambda_\pi = 1$, $\lambda_y = 0$, and $\lambda_e = 0$. In other words, in this case the monetary authority's sole objective is to stabilize (wage) inflation.

It turns out that, under strict inflation targeting, the monetary authority finds it optimal to keep the interest rate unchanged in response to shocks. The intuition is that, given the wage Phillips curve 2.16, wages and wage inflation can be held to their steady state values if labor demand can also be held at its steady state value. The latter can be achieved, by 2.3, if home nominal output is constant. But 2.15 implies that home nominal output must be constant if the domestic short interest rate is constant.[9]

Table 3.1 confirms that, if inflation targeting is strict, the discretionary solution indeed manages to keep wage inflation constant. The change with respect to the flexible inflation targeting case is that output becomes more variable: the standard deviation of the output is almost 1 percent. But this is intuitive, as

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[9]Note that, in this sense, a policy of keeping i_t at its steady state value is equivalent to a policy of "nominal GDP targeting," as studied by Frenkel (1995).

output variability implies no loss under strict inflation targeting. The standard deviation of the real exchange rate turns out to be 2.29 percent, somewhat lower than under flexible inflation targeting.

Figure 2 shows the response of the economy to a one percent increase in the world interest rate for the case of "strict inflation targeting." As expected, output and investment exhibit a stronger and more persistent fall under strict inflation targeting than in the flexible targeting case. Interestingly, output has a hump-shaped response, which replicates some existing VAR evidence without relying on assumptions about the timing of investment. Even though the increase on impact of the real exchange rate under strict inflation targeting is similar to the flexible case, its persistence is lower. As noted, a regime of strict inflation targeting keeps wages constant.

Notably, the response of the risk premium is identical to that in the flexible targeting case. This may seem surprising, although not unexpected given our previous work. In the context of CCV we showed that, in equilibrium, the response of the risk premium was the same under fixed exchange rates and under a flexible rate, price-targeting policy. Our finding here is similar, although it refers to the response of the risk premium to different monetary rules with flexible exchange rates. Indeed, we will see below that the change in the risk premium is the same across regimes, contrary to the conjectures in much of the recent policy literature.

The explanation for this result is straightforward: it can be shown with a bit of algebra (the details are in CCV) that movements in the risk premium depend on the response of overall dollar output. This is natural, as the risk premium depends on net worth relative to the value of investment, both of which depend on dollar output. And it turns out that in response to shocks dollar output changes by the same amount independently of interest and exchange rate policy. What policy does is determine the split between movements in real output and movements in the real exchange rate.

The response of the economy to a one percent fall in export demand appears in Figure 5. Again, monetary policy completely stabilizes inflation. Compared to flexible inflation targeting, strict inflation targeting results in a deeper contraction in output and investment. While the reaction of the real exchange rate is rather similar in shape and magnitude, the depreciation (increase) of the nominal exchange rate (price of the home goods) is smaller under strict inflation targeting.

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3.5. Flexible Inflation - Real Exchange Rate Targeting

In a third and last case under discretion, we allow the variance of the real exchange rate to affect the monetary authority's loss function. This can be termed "flexible inflation-real exchange rate targeting." Assuming that the exchange rate objective is as important to the central bank as the output objective, we chose $\lambda_\pi = 1$, $\lambda_y = 0.5$, and $\lambda_e = 0.5$ to represent this case.

The solution for the policy rule is:

$$i_t = 0.93\rho_t - 0.21x_t + 0.53k_t + 0.02\eta_t + 0.08b_t - 0.0w_{t-1} \qquad (3.6)$$

Now, in response to an increase of one hundred basis points in the world interest rate the monetary authority increases the nominal domestic interest rate by more than ninety basis points. Naturally, this reaction is stronger than the flexible inflation targeting case. The rest of the coefficients are quite similar to the ones in the policy rule for flexible inflation targeting.

As can be seen from Table 3.1, flexible inflation-exchange rate targeting implies that inflation and output are more variable and the real exchange rate less variable than in the two previous cases. This is not surprising, as the monetary authority now prefers to reduce exchange rate volatility at the cost of more variable inflation and output. In fact, the standard deviation of output in this regime is almost 50 percent higher than strict inflation targeting and more than 35 times higher than under flexible inflation targeting. The standard deviation of the real exchange rate is half the standard deviation under flexible inflation targeting and 40 percent lower than under strict inflation targeting.

Figure 3 presents the impulse responses to a one percent increase in the world interest rate. The initial fall of output is stronger compared to the previous two cases. Investment is also lower. However, the initial response of the real exchange rate is reduced by almost 50 percent. Inflation is lower than in the flexible inflation targeting but higher than the strict inflation targeting. The response of the risk premium is identical to that in the two previous cases.

Finally, Figure 6 displays the response of the economy to a one percent decrease in export demand. Notice that after the first period, when the interest rate increases, monetary policy turns clearly expansionary. Additionally, output and investment exhibit a stronger fall compared to the previous cases. The real exchange rate reaction is less pronounced and inflation is in fact negative under flexible inflation-RER targeting.

Table 3.1: **Unconditional Standard Deviations**

Variables	π_t	y_t	e_t
Flexible Inflation Targeting	0.44	0.04	2.77
Strict Inflation Targeting	0.00	0.96	2.29
Flexible Inflation-RER targeting	0.49	1.39	1.42
Fixed Exchange Rate	0.27	2.07	1.33

3.6. Summary

The analysis of this section yields a number of interesting insights. Optimal policy under discretion involves a rather sophisticated management of the nominal interest rate. In particular, the analysis of monetary policy requires taking into account not only how policy behaves on impact, but more importantly how policy evolves over time in anticipation of the adjustment of the economy to exogenous shocks. In addition, the implementation of the optimal policy under discretion implies that the nominal exchange rate can be quite volatile. Differences in the objectives of monetary policy matter considerably for investment, debt, output, and inflation. However, they have no impact on the dynamic behavior of the risk premium. This suggests that financial frictions may be important for the dynamics of the model and, at the same time, may not be too important for the evaluation of alternative monetary policy under discretion. This is in contrast with recent conventional wisdom, which makes the behavior of balance sheets and the risk premium the central factors in the design of monetary policy.

4. Fixed Exchange Rates

In this section we analyze the outcome of the model under a fixed exchange rate regime. As discussed before, this is relevant if one allows that some simple rules, including fixed exchange rate regimes, may be feasible even if they are time inconsistent. In such a case, fixed exchange rates may in principle be superior to the discretionary outcome, reflecting the stronger commitment associated with fixed rates.

To analyze this possibility, we solve the model in section 2 under a fixed ex-

change rate. This is achieved by setting $s_t = 0$, all t, as an equilibrium condition. Note that the nominal interest rate then responds passively to the resulting dynamic equilibrium and follows 2.15.

Under this policy the standard deviation of wage inflation falls to 0.27 percent, which reduces social loss relative to the discretionary solution. However, this is achieved at the price of an increase in the standard deviation of output from virtually zero (in the flexible inflation targeting case) to 2.07 percent.

To aid intuition, Figure 7 shows the responses of the fixed rate regime to a one percent increase in the world interest rate. The nominal interest rate increases, on impact, by less than fifteen basis points. It is interesting to note here that this increase is much less than the discretionary impact response, but this observation says little about the stance of monetary policy. With fixed rates, the interest rate is endogenous, and the fact that the increase in the interest rate is relatively mild reflects the fact that, following the shock, there is strong price deflation and a fall in output.

Indeed, output falls by almost one half of one percent on impact, and by more than 0.85 percent in the second period, relative to its steady state value. The response of investment and capital is even stronger: the short run contraction is about one and a half percent, and the recovery is relatively slow. In this case, inflation is negative the first few periods and slightly positive in the medium run.

Finally, Figure 8 presents the impulse responses of the economy to a one percent decrease in export demand. Again, output and investment reactions are stronger and more persistent that in the discretionary policy cases.

From the impulse responses, the conjecture emerges that, once the analysis goes beyond impact effects, fixed exchange rates exacerbate rather than ameliorate the adverse effects of financial frictions. This conjecture clearly warrants more research, if only because it contradicts the current conventional wisdom, based on the existence of liability dollarization.

4.1. Welfare Comparisons

Table 4.2 compares the social loss associated with each discretionary case with the loss under fixed exchange rates. For each discretionary alternative, the loss under fixed rates is evaluated using the weights in the welfare function associated with that alternative.

Our results indicate that social loss is always larger under fixed rates than under the discretionary solutions. The disadvantages of fixed rates appear to be

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larger the more important is output in the social loss function. Conversely, the only case in which fixed rates seem almost as good as flexible rates is when in the latter case there is strict inflation targeting.

Table 4.1: **Loss Function**

Flexible Inflation Targeting vs Fixed Exchange Rate	0.20	2.21
Strict Inflation Targeting vs Fixed Exchange Rate	0.00	0.07
Flexible Inflation-RER targeting vs Fixed Exchange Rate	2.21	3.10

5. Final Remarks

We have found that, even if fixed exchange rates enjoy a credibility advantage, they do not yield higher welfare than does optimal floating under discretion. Fixing turns out to have adverse consequences for aggregate real variability, particularly of output. This outweighs the inflation gains associated with fixed rates. This conclusion does not depend on –instead, it seems reinforced by– the existence of financial imperfections that interact with net worth effects. Naturally, these findings have to be checked further for robustness, under alternative parameters and model specifications. However, it is notable that they are consistent with our previous theoretical analysis in CCV.

Of the many extensions suggested by the analysis, perhaps the most obvious one is to drop the *ad hoc* specification of the monetary authority's loss function in favor of a true social welfare function derived from microfoundations, as in Woodford (1997) and Rotemberg and Woodford (1998). This involves not only aggregating the interests of agents in the home population, but also finding a tractable way to do so. This task is not trivial, since the results of Kim and Kim (1999) and Benigno and Benigno (2000) suggest that in the open economy the Woodford method may not always yield the quadratic loss function we have relied on. On the other hand, the recent work of Chang (1998), Phelan and Stachetti (1999), and Sleet (2000) suggests that there may be computationally feasible ways to tackle directly the nonlinear discretionary policy problem, without relying of linear-quadratic approximations.

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Figure 1
Impulse Responses to a World Interest Rate Shock
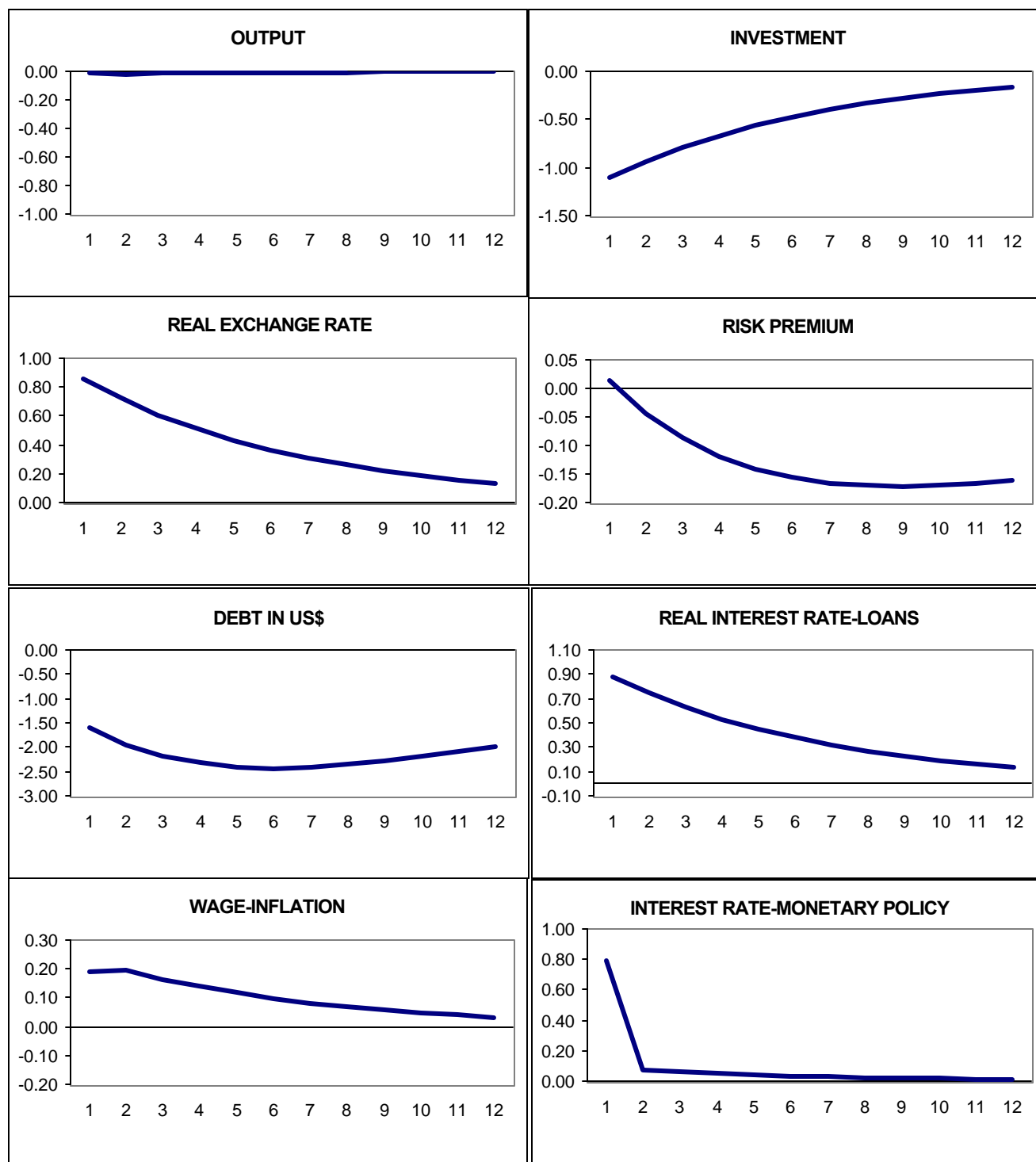**Flexible Wage-Inflation Targeting**

OUTPUT

INVESTMENT

REAL EXCHANGE RATE

RISK PREMIUM

DEBT IN US$

REAL INTEREST RATE-LOANS

WAGE-INFLATION

INTEREST RATE-MONETARY POLICY

Figure 2
Impulse Responses to a World Interest Rate Shock
Strict Wage-Inflation Targeting
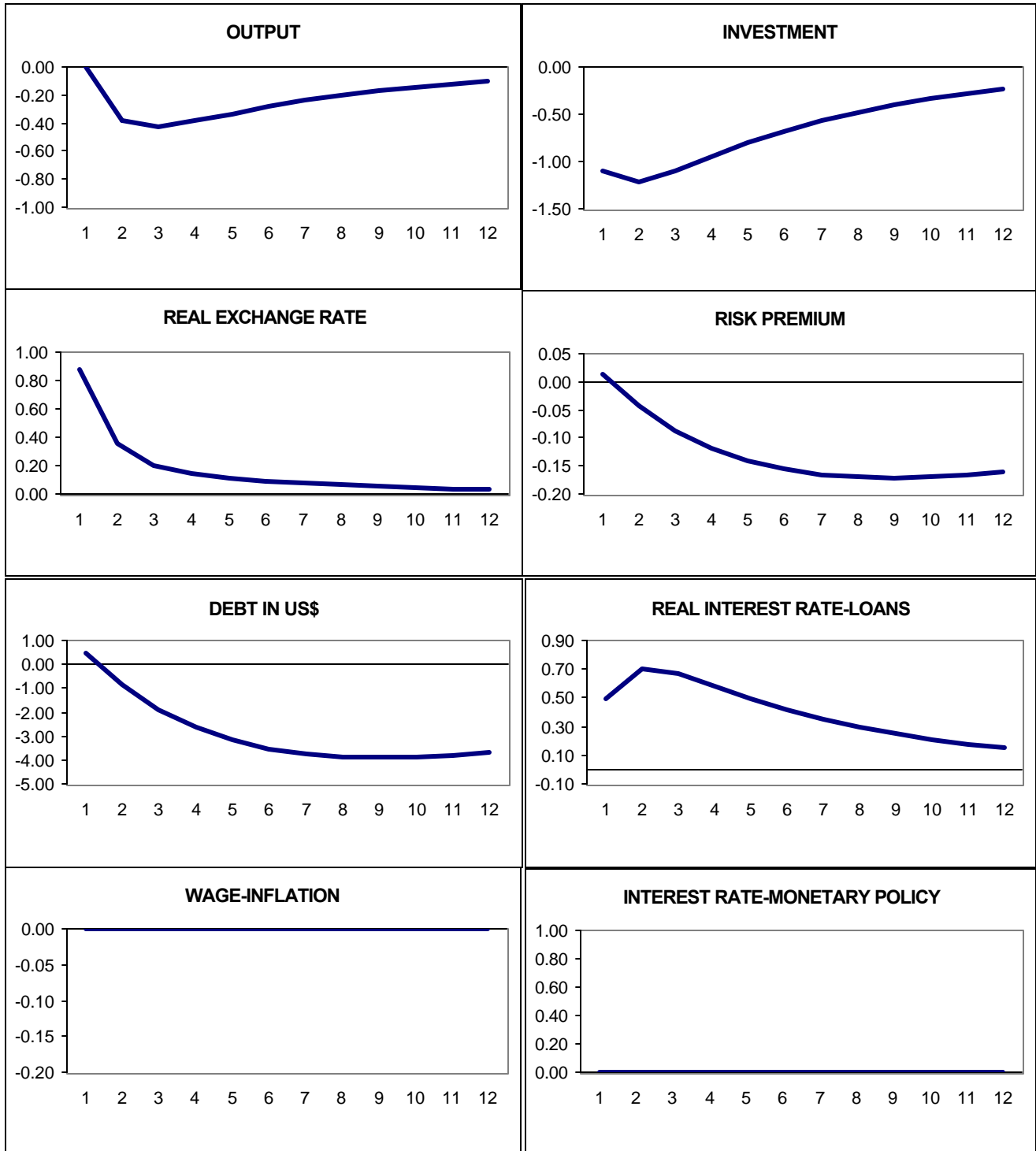
Figure 3
Impulse Responses to a World Interest Rate Shock
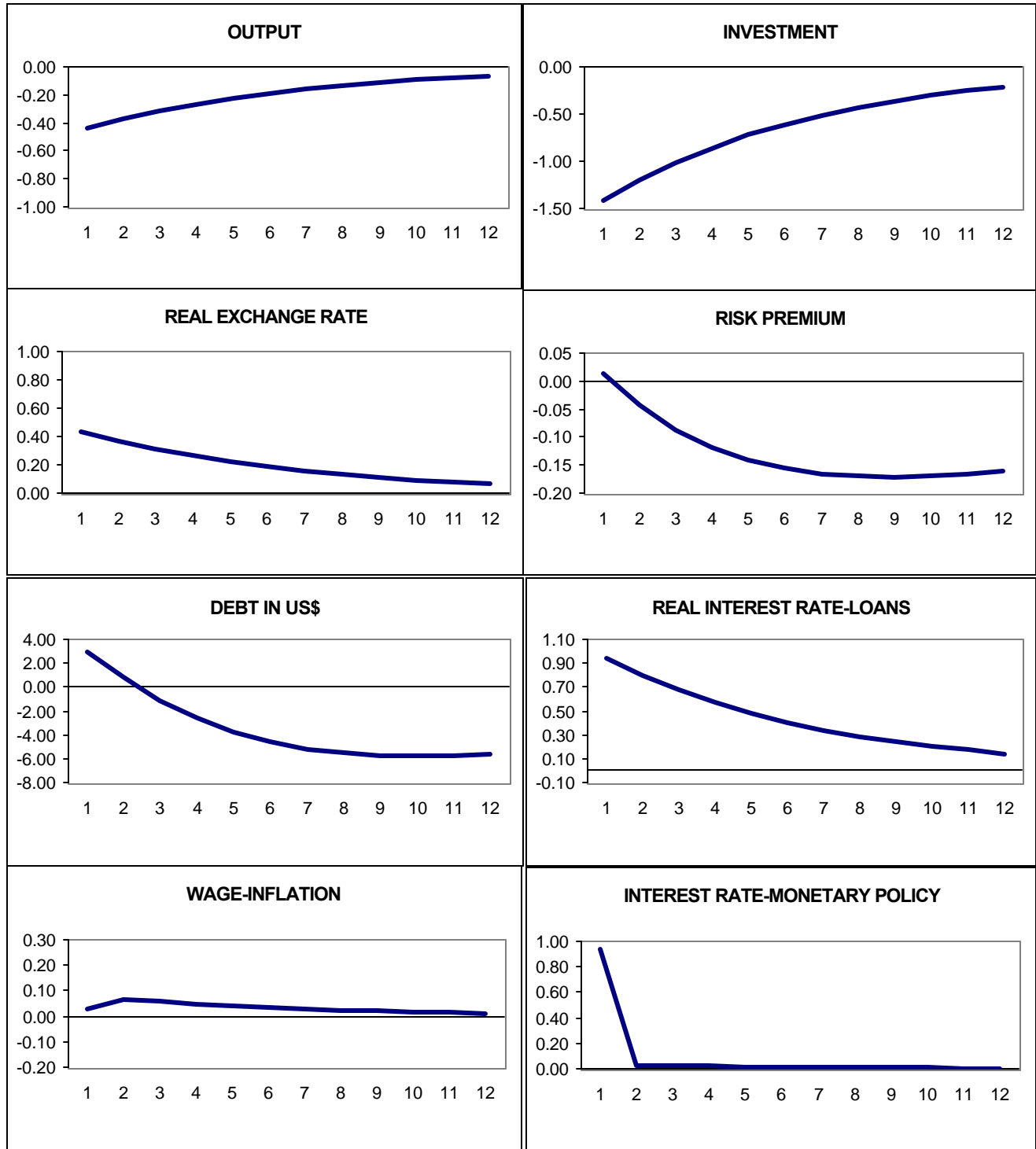**Flexible Wage-Inflation and Real Exchange Rate Targeting**

Figure 4
Impulse Responses to an Export Demand Shock
Flexible Wage-Inflation Targeting

Figure 5
Impulse Responses to an Export Demand Shock
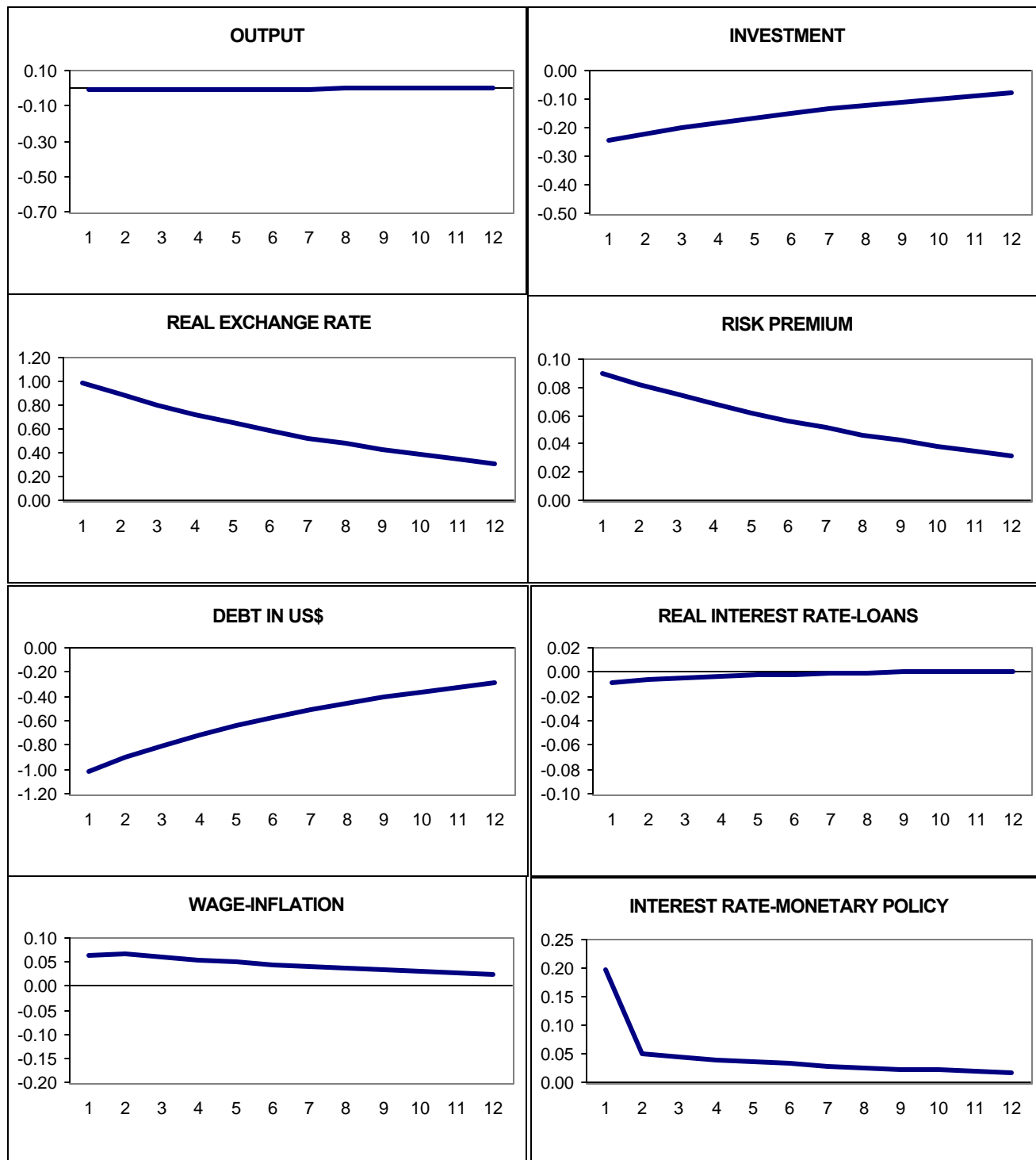**Strict Wage-Inflation Targeting**

Figure 6
Impulse Responses to an Export Demand Shock
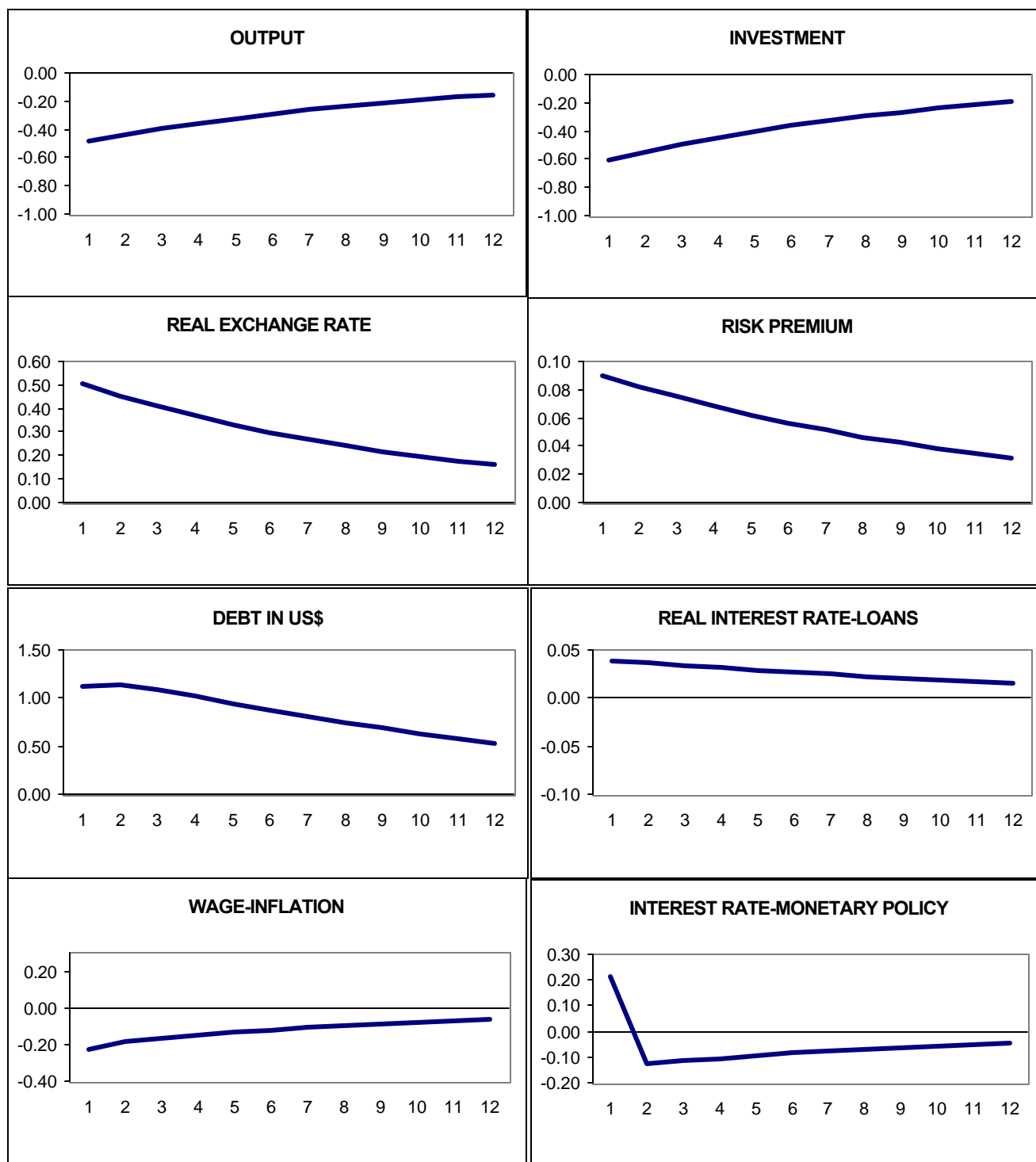**Flexible Wage-Inflation and Real Exchange Rate Targeting**

Figure 7
Impulse Responses to a World Interest Rate Shock
Fixed Exchange Rate

OUTPUT

INVESTMENT

REAL EXCHANGE RATE

RISK PREMIUM

DEBT IN US$

REAL INTEREST RATE-LOANS
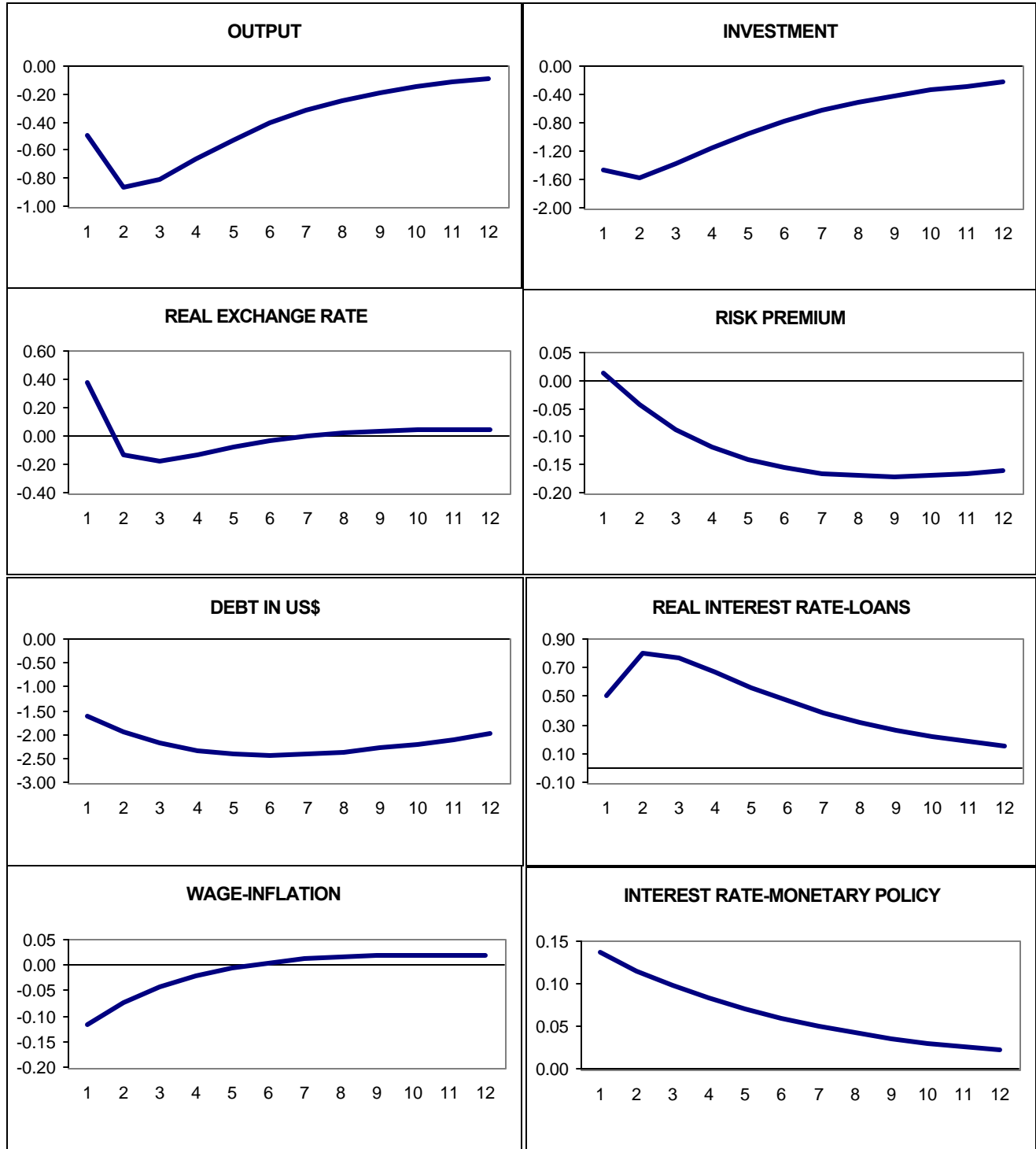
WAGE-INFLATION

INTEREST RATE-MONETARY POLICY

Figure 8
Impulse Responses to an Export Demand Shock
Fixed Exchange Rate

OUTPUT

INVESTMENT

REAL EXCHANGE RATE

RISK PREMIUM

DEBT IN US$

REAL INTEREST RATE-LOANS

WAGE-INFLATION

INTEREST RATE-MONETARY POLICY