

Financial Shocks and Optimal Monetary  
Policy in  
Small Open Economies  
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# Introduction

- This paper analyzes the optimal monetary policy response to an increase in interest rate spread between market and policy rates in small open economies framework.
- Optimal response is considered in relation to: 1.the degree of correlation between the financial shock and foreign financial conditions (risk premium); 2. for which rate, market or policy, UIP condition holds.

# The Setup

- Small open economy DSGE model
- Prices and wages are sticky (to allow for trade-off between inflation and output fluctuations)
- Domestic consumption basket contains: Home goods, Foreign goods and fuel. All goods are imperfect substitutes.
- Optimal monetary policy set interest rate to minimize a welfare loss function

# The Setup

- Imperfect passthrough from exchange rate movement to import prices
- Financial friction in the form of an exogenous spread between the market and the policy interest rates
- UIP condition with risk premium can hold for market or policy interest rates. Risk premium is endogenous to the net asset position.

# Simulation exercise

- 4 cases is considered depending on existence of correlation between financial shocks and foreign financial conditions, and for which rate, market or policy, UIP condition holds.

# Results

- If the financial shock is correlated with foreign financial conditions and if the UIP holds for the policy interest rate, then the policy trade-off will increase.
- If the financial shock is not correlated with foreign financial conditions and UIP holds for the market interest rate, then, there is no policy trade-off and the policy rate fall.

# Comments

- Does correlation between financial shock and foreign financial conditions is mainly determined by exchange rate (risk premium is function of exchange rate)? Perhaps, more convenient way is to consider directly correlation between financial shock and exchange rate

# Comments

- Not clear what set of parameters used in simulation. It is impossible to replicate the results. How robust are results to changing parameters?
- Does financial shock correlate with foreign financial conditions in data?



# Comments

- Difficult to read the paper. Reference to other papers (Medina and Soto, 2007). Some notation is not explained. Some statements is not strict enough (case i: is financial shock perfectly or highly correlated with foreign financial conditions?)

# Conclusions

- Very nice result with important policy implications. Result is obtained after simple assumptions.
- Something should be done to make paper more readable