Discussion on "CONSUMPTION HETEROGENEITY AND MONETARY POLICY IN AN OPEN ECONOMY" by Sihao Chen, Michael B. Devereux, Kang Shi and Jenny Xu

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Summary

- Limited asset market participation, captured by the size of Keynesian households, $1 > n > 0$.
- Monetary expansion$\rightarrow$lower nominal rate$\rightarrow$With the intertemporal substitution, higher current consumption for Ricardian households.
- But how does aggregate consumption change depend on the presence of Keynesian households.
- When n increases, aggregate consumption may fall. Specifically, under PCP,
- $$\hat{Y}_t = \underbrace{\frac{1}{\delta}\hat{C}_t^R}_{\text{Aggregate consumption effect}} + \underbrace{\frac{1}{2}\hat{q}_t}_{\text{The terms of trade effect}}$$
- So impact on output depend on the sign of $-\infty < \delta < 1$ in general equilibrium while the depreciation of the terms of trade followed by an expansionary monetary shock improves the output.

Con't

- Also international transmission depends on
- $$\hat{Y}_t^* = \frac{1}{\delta}\hat{C}_t^{R*} - \frac{1}{2}\hat{q}_t$$
- Asymmetric size of Keynesian households across countries ($n \neq n^*$) change the results
- Under LCP, the impact of monetary policy shock is fully determined by the aggregate consumption effect, thus leading the economy to the monetary trap.
- Derive the optimal monetary policy under PCP and LCP with or without symmetric size of Keynesian households across countries and find that PPI domestic inflation targeting is a good policy.
- The real distortion (limited asset market participation) can be cured by other policy instruments.

Comment 1: Risk sharing across and within countries via the terms of trade

- It is well known that the terms of trade work to restore the perfect consumption risk sharing (Colde and Obstefeld, 1991).
- For Ricardian households, this would be the case with Cobb-Douglas aggregator even without any state-contingent assets.
- Is this true also for Keynesian households?
- By looking at the solution under the flexible price, since $\hat{H}_t^{fb} = \hat{H}_t^{fb*} = 0$, this seems the case (no consumption heterogeneity)
- Put differently, even with the limited asset market participation, there is a perfect consumption risk sharing within countries (as well as across countries) under the flexible price.
- Further, can we claim that the allocation under the flexible price is the first best allocation? (Devereux, 2004 and Hamano and Pappada, 2021)
- I would like to see a clear discussion on the issue and the intuition behind.

Comment 2: Role played by the elasticity of labor supply, ω

- By setting $\omega = 0$, almost all the result seem to be collapsed since we see ω, with $n\omega$.
- W is the inverse of Frish elasticity of labor supply. By setting $\omega = 0$, labor supply becomes infinitely elastic.
- For instance, when this is the case, there is no monetary trap as the monetary trap takes place in the range of $\left(\frac{1}{1+\omega}, \frac{1}{1+\frac{\omega}{2}}\right)$.
- The elasticity of labor supply mitigates the problem related to the limited asset market participation?
- What is the intuition behind?

Comment 3: Variability of exchange rate?

- In the literature, under PCP, one's house keep in order is the optimal policy (PPI inflation targeting)
- Under LCP, the nominal distortion in the pricing in exporting market must be taken into account in conducting the optimal policy. As a result, the fixed exchange rate regime may dominates (Devereux and Engel, 2003).
- The same mechanism would at work in the current model even with $n > 0$.
- What is the implied exchange rate variability under the optimal policy change with respect to n?

Other comments

- Related to my first comment, does monetary policy shock increase or reduce the inequality in the economy?
- I would like to see the solution of, L^R, L^K, w and C^K explicitly (it not easy to understand)
- In the numerical example, I would like to see how each variable (including the above two) change with respect to n.
- DP?
- For the consumption neutrality result under the flexible price, I didn't understand very well the logic of why financial markets matter to have these results?

Conclusion

Very interesting and good paper. I would like to see further development and refinement in the future!