Ramsey Monetary Policy with Financial Distortions

Ester Faia

Discussion by Fabio Ghironi

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Premise

• Very nice.

• Challenges a “Holy Grail.”
The Holy Grails

• Two “Holy Grails” in recent monetary policy literature:

1. Taylor Principle ($i$ reaction to $\pi$ larger than 1)

2. Optimality of mimicking flex-price through price stability (Goodfriend-King-Wolman-Woodford).
• HG1 more robust than HG2:

* Equilibrium determinacy is main motive for HG1.

- Holds in multi-sector economies with different nominal rigidity across sectors, even if labor is immobile and reaction to only one sector (Carlstrom, Fuerst, and Ghironi).

- Holds in open economies under several scenarios.

(Depending on measure of $\pi$ if home bias in consumption baskets, De Fiore and Liu.)
• What about HG2?

* Suppose closed economy, monopolistic competition, and sticky prices (no $K$).

- Zero-$\pi$, steady-state markup $\Psi = \frac{\theta}{(\theta - 1)(1 - \tau)}$.

* Suppose policymaker chooses $\tau$ (taxation of revenues) so that $\Psi = 1$.

$\Rightarrow$ Sticky prices only distortion.

$\Rightarrow$ Flex-price business cycles are efficient.

$\Rightarrow$ Policymaker can reproduce them with price stability.

$\Rightarrow$ Price stability is optimal commitment.

* If $\Psi > 1$, monopoly power plus price stickiness $\Rightarrow \pi > 0$, but very small for plausible parameters.

$\Rightarrow$ HG2.
• BUT:

- Not true in multi-sector economies with different degrees of nominal rigidity (must target properly weighted avg of inflation rates, Benigno).

- Not true in open economies unless under (very) special assumptions (Benigno and Benigno, Corsetti and Pesenti).

(Relative price—terms of trade—distortions are at work, even if $\psi = 1$.)

- Capital.
• Also Ester challenges HG2.

* Closed economy with three distortions:

(A) Monopoly power.

(B) Sticky prices (quadratic adjustment cost, Rotemberg).

(C) Financial friction (costly state verification, external finance premium).

* (A) ⇒ markup ⇒ tax on labor demand.

(Tax on capital too.)

* IMPORTANT: (A) + (B) ⇒ time-varying markup!
* Ghironi (2000):

- Production: \( Y_t^i = Z_t \left( K_t^i \right)^\gamma \left( L_t^i \right)^{1-\gamma} \).

- Pricing: \( p_t(i) = \Psi_t^i P_t \lambda_t^i \).

- Markup:

\[
\Psi_t^i \equiv \theta Y_t^i \left\{ \left( \theta - 1 \right) Y_t^i + \phi \frac{P_t}{p_t(i)} \left[ K_t^i \frac{p_t(i)}{p_{t-1}(i)} \left( \frac{p_t(i)}{p_{t-1}(i)} - 1 \right) + K_t^i \frac{p_{t+1}(i)}{p_t(i)} \left( \frac{p_{t+1}(i)}{p_t(i)} - 1 \right) \right] \right\}^{-1}
\]
Labor demand: 

\[
\frac{W_t}{P_t} = \frac{p_t(i)}{P_t \Psi_t^i} \left(1 - \gamma\right) \frac{Y_t^i}{L_t^i}
\]

(Tax on labor demand: \(\Psi > 1 \Rightarrow\) real value of MPL is above real wage.)

Tobin’s \(q\):

\[
q_t^i = \left[\frac{V_t^i}{P_t} + \sum_{s=t+1}^{\infty} R_{t,s} \left(\frac{1}{\Psi_s^i} - 1\right) \frac{p_s(i)}{P_s} Y_s^i\right] / K_{t+1}^i
\]

(Tax on capital: \(\Psi > 1 \Rightarrow\) marginal \(q\) is lower than avg \(q\).)
* (C) in Ester’s paper acts as a tax on capital accumulation.

* If only (A) + (C) ⇒ monetary policy can do nothing: Y is suboptimally low because of both “taxes.”

* (A) + (B) + (C) ⇒ monetary policy can exploit markup movements to improve on the flex-price allocation by optimally trading off distortions.

* **Note:**

- With indexed loan contracts, monetary policy affects external finance premium only via AD channel.

- If non-indexed loans, monetary policy has also direct effect on premium ⇒ more scope for \( \pi > 0 \).
• Very cool!

* Reminiscent of open economy with incomplete markets (and no special assumptions) where world planner can improve on flex-price outcome (especially with non-zero steady-state net foreign assets, Benigno).

* Here, the relevant lending-borrowing relation is between workers and entrepreneurs (rather than home and foreign).

* Financial friction provides the source of the relevant market incompleteness.

* It amplifies the scope for departures from price stability relative to the combination (A) + (B).
• Some suggestions:

* Steady-state optimal policy (constrained—Golden Rule—vs. unconstrained): Can we see more comparison?

* Really like non-indexed loans case: Could be interesting to explore the consequences of different levels of steady-state debt.

* Not a paper on financial distress (exceptional situation); not a paper on reaction to asset prices.
• Fruitful directions for future research/challenges to HGs?

* Labor market frictions and involuntary unemployment (Quadrini, Trigari, Zanetti).

* More directly related: Imperfect competition in financial markets.

(Mandelman: Imperfect competition, entry, limit pricing—source of time-varying markups in financial sector.)