Comment on Christiano, Trabandt and Walentin “Introducing Financial Frictions and Unemployment into a Small Open Economy Model”

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Quick summary

• Extend the standard NKM model along three dimensions.
  – OPEN ECONOMY dimension
  – FINANCIAL MARKET dimension
  – LABOR MARKET dimension
• Most of the extensions known to the literature.
• But the labor part new. Especially the endogenous separation part.
• Bayesian estimation.
Comments on the model: LABOR dimension

• As I already said, this is the most innovative part of the authors’ model.

• But the innovation seems to come with costs.

• Endogenous cut-off point for the worker determined by equation (4.21).
  – The cut-off point is determined by maximizing a weighted sum of the firm’s and the worker’s surpluses.
  – This assumption seems to lack a solid foundation (?).
Comments on the model: OPEN dimension

• Local currency pricing assumption: Traded goods are priced solely in the units of the buyer’s currency.
  – But invoicing currency choices are more complex in reality. See next page.
  – In Shioji, Vu and Takeuchi (2008):
    • Rotemberg style price adjustment costs.
    • Cost associated with changing prices in the seller’s currency units.
    • Cost associated with changing prices in the buyer’s currency units.
    • Total cost is a weighted average between the two.
Shares of major currencies in trade contracting (Dec 2008, source: Bank of Japan)

<table>
<thead>
<tr>
<th></th>
<th>US dollars</th>
<th>Euro</th>
<th>Yen</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports from Japan</td>
<td>54.7</td>
<td>12.5</td>
<td>30.3</td>
</tr>
<tr>
<td>Imports into Japan</td>
<td>70.4</td>
<td>3.0</td>
<td>24.6</td>
</tr>
</tbody>
</table>
More on OPEN dimension

• Assumption: Importers borrow working capital in foreign currencies.
  – Why make such an assumption?
  – Realistic?

• Need an ad hoc assumption on risk premium to get the impulse responses right.
Comments on the model: FIN dimension

• Financial friction only on investment finance. No friction on working capital finance.
  – Wise choice?
  – Japan’s lost decade: financial frictions believed to be important. But they worked mainly through lowering TFP (crudely estimated). Investment side = a side story.
  – Would the “capital maintenance cost” specification open a channel between fin. frictions and current output through capacity utilization?
On estimation

• Entrepreneur’s wealth = stock prices?
  – Why?
  – If this identification is justifiable, it seems trivial that the CBs should react to the stock market.
  – But are we ready to accept the above equivalence?

• Ignore risk shocks to entrepreneurs: an important omission?
More on estimation

• Use first differenced data, and demean them, series by series.
  – Ignore theoretical restrictions on trends implied by the model.
  – Ignore information from the levels of the variables.
  – Any better idea??

• MCMC convergence criteria?
On estimation results

• Monetary policy gains effectiveness through the debt channel (the fisher effect).
  – Interesting but
  – Supporting evidence?

• Entrepreneur wealth shock -> C down, I up
  – A familiar problem but
  – Any way to resolve it?
More on the results

• Foreign output shock leads to increases in EX, C, I but causes a deflation.
  – Realistic?
  – Current Japanese deflation?
Comment on the implication

• Crisis of 2008-9: caused by a combination of many shocks.
  – ???
  – It seems to me that, for Sweden, there was only one big source of shock at that time = the US!
Other comments

- Why complicate the goods market so much? State the objective.
- Roles of natural resources and intermediate inputs as imports?
- SD of estimates very small.
- Why stick to the log utility?
- All workers with different productivities work for the same hours --- ??
• Discuss empirical results more extensively.
• I do not understand those various “markup shocks”.
• What is the central message?
• Monetary tightening -> hours per person up. Realistic?
• Fisher effects affect the stability conditions?
• International financial frictions as a possible future course of extension? (i.e., Swedish banks lending to Baltic countries...)