Thirty years after Sims “Macroeconomics and Reality”,
Five years after CEE “Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy”

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)

	US dollars	Euro	Yen
Exports from Japan	54.7	12.5	30.3
Imports into Japan	70.4	3.0	24.6

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…)