Discussion of Hamann, Julio, Restrepo, and Riascos: "Inflation Targeting in a Small Open Economy: the Colombian Case"

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Bottom Line of the Discussion

- This is serious work:
  1. It uses a relatively large scale DSGE model (capital accumulation, real and nominal frictions) . . .
  2. and takes the model to the data in an informative (and sophisticated) way, following Diebold, Ohanian, and Berkowitz (1998).
- But some more work is needed for the model to address important policy issues related to inflation targeting:
  1. Turn the economy into a *real* small open economy.
  2. Ask empirical questions – for this, you need to estimate, not calibrate.
  3. Changes in monetary policy regime?

The Model

- The model is pretty much at the frontier in terms of closed economy models (Christiano, Eichenbaum, and Evans):
  - Capital accumulation.
  - Real rigidities: investment adjustment costs.
  - Habit formation.
  - Nominal rigidities: retailers with Calvo price stickiness.
  - Three shocks: productivity, government, and preferences.
- . . . but the small open economy part is pretty much just "tagged on": The household can borrow and lend (but faces borrowing costs that increase in the amount of foreign borrowing).

The Model – continued

- Does the model contain all features that are important for a small *Latin American* economy?
  - Effect of changes in the terms of trade.
  - Dynamics of the real exchange rate.
  - No foreign shocks.
- What questions related to inflation targeting can we address with this model?
  - An issue for inflation targeters is the degree of vulnerability to exchange rate fluctuations . . .
  - but in this model exchange rate depreciation and inflation are the same $\rightarrow$ inflation targeting and exchange rate targeting are one and the same:

$$\textit{Fear of Floating} \;=\; \textit{Fear of Inflation}$$

- Add financial frictions (liability dollarization) to motivate why Central Bank should care about exchange rate fluctuations in addition to inflation.
- Once this is done, you can evaluate the implications of different monetary policy rules.

Taking Model To the Data

- Frequency Domain Strategy: Compare the model's spectrum with the data's (Diebold, Ohanian, and Berkowitz 1998).
  - Very informative approach! (If used on actual data . . .)
- Why HP -filter the data?
  - The empirical strategy already allows for "down-weighting" frequencies you are not interested about.
- Aguiar & Gopinath: "Emerging markets:

The cycle is the trend"

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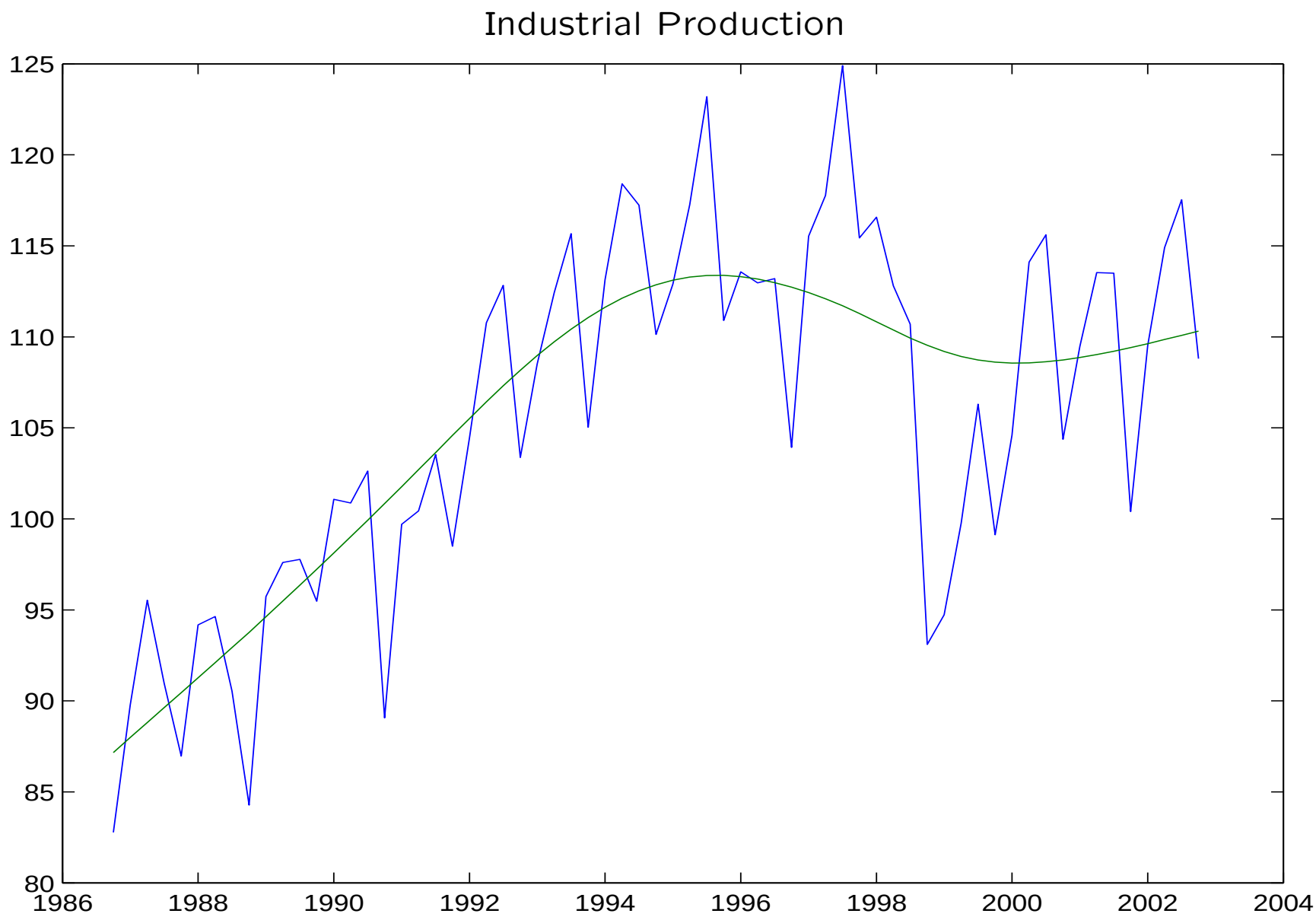
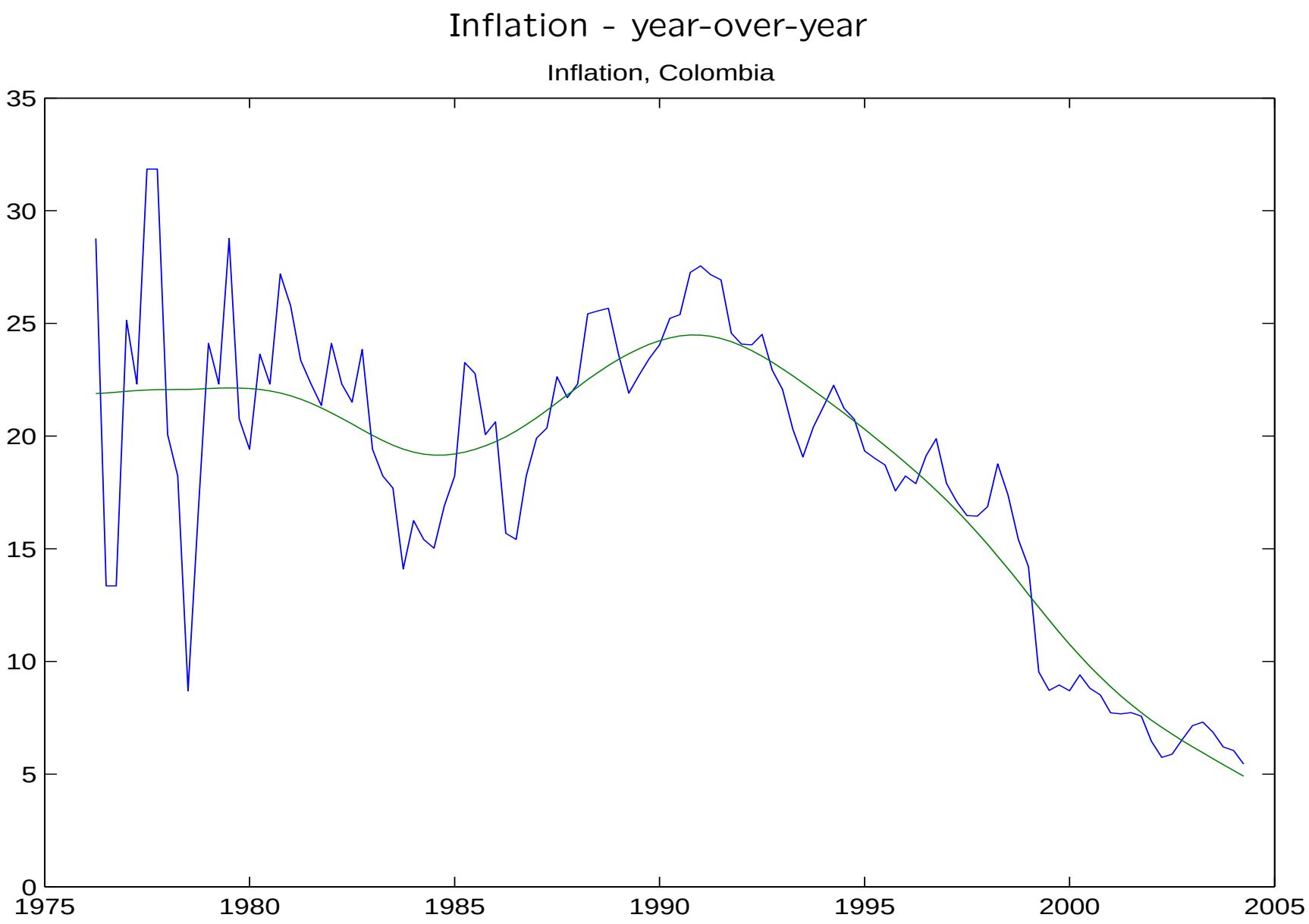

Industrial Production
125
120
115
110
105
100
95
90
85
80
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004


Inflation - year-over-year
Inflation, Colombia
35
30
25
20
15
10
5
0
1975
1980
1985
1990
1995
2000
2005

Estimation versus Calibration

- Ask empirical questions!
  - What monetary policy did Colombia actually follow in the recent past?
  - What were the weights on inflation, output, and possibly exchange rate depreciation in the Taylor rule?
  - What is the importance of the different shocks (including foreign shocks) for the Colombian economy?
  - . . .

Conclusions

Keep up the good work!