Discussion of Ascari, Colciago and Rossi
“Limited Asset Market Participation and Optimal Monetary Policy”

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Quick summary

What does the paper do?

Studies optimal monetary policy in New Keynesian model with

1. Limited asset market participation (LAMP) as in Bilbiee (2008)
2. Nominal wage stickiness as in Erceg et. al. (2000)

Bilbiee (2008)

Sufficiently severe LAMP

- Aggregate demand increasing in real interest rate (IADL)
- Features of optimal monetary policy inverted

Strong response of wage to aggregate demand is key

Key insight of this paper

- Wage stickiness eliminates IADL
- Restores familiar optimal monetary policy

Discussion

Very nice paper

- Wage flexibility key in Bilbee's mechanism
- Very natural to revisit his analysis with wage stickiness

Plan for rest of discussion

- Simple two-period version of Bilbee (2008), not linearized
- Consider first flexible, then sticky wages
- Point out problem with IADL:
  - Arises only in unstable equilibrium
  - Stable equilibrium missed because of linearization
- Consequence of interaction LAMP & wage flexibility:
  - Not IADL (and the associated monetary policy implications)
  - Bad stable equilibrium with usual comparative statics
- Sticky wages stabilize, eliminate bad equilibrium

Model

Simple two-period model

- Nominal price level fixed in period 1
- Flexible price equilibrium in period 2
- Production function: $Y = N$
- Period utility: $\log(C + \gamma) + \log(1 - N)$

Consumption of Ricardian households

- Period 2: flexible price equilibrium C_S^*
- Period 1: Euler equation yields

$$C_S(r) = [\beta(1 + r)]^{-1}(C_S^* + \gamma) - \gamma.$$

Model

Labor supply

- Ricardian: $$N_S(w, C_S) = \max\left\{1 - \frac{C_S + \gamma}{w}, 0\right\}$$
- Non-Ricardian: $$N_H(w) = \max\left\{\frac{1}{2}\left[1 - \frac{\gamma}{w}\right], 0\right\}$$

Labor market clearing

- Condition: $Y = \lambda N_H(w) + (1 - \lambda) N_S(w, C_S)$
- Solve for $w(Y, C_S)$

Keynesian Cross

$$Y = \lambda \frac{1}{2}\left[w(Y, C_S(r)) - \gamma\right] + (1 - \lambda) C_S(r)$$

Illustration with $\lambda = 0.9$ and $\gamma = 0.1$

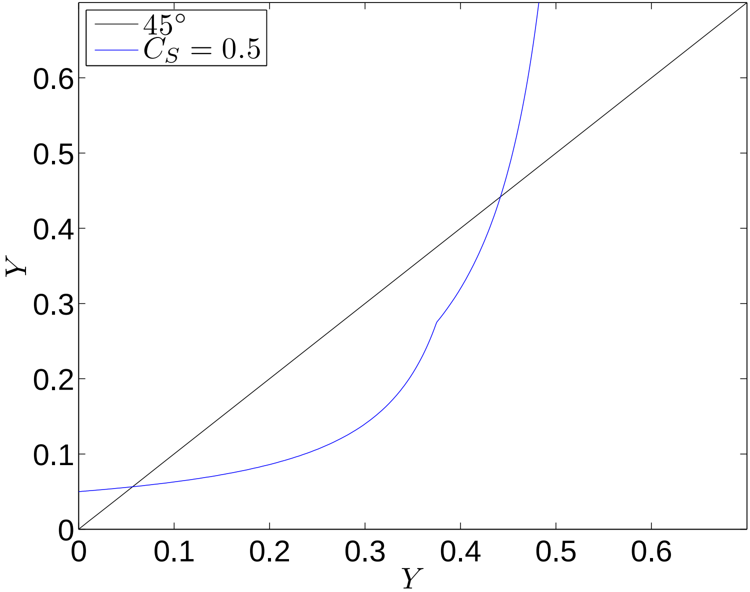
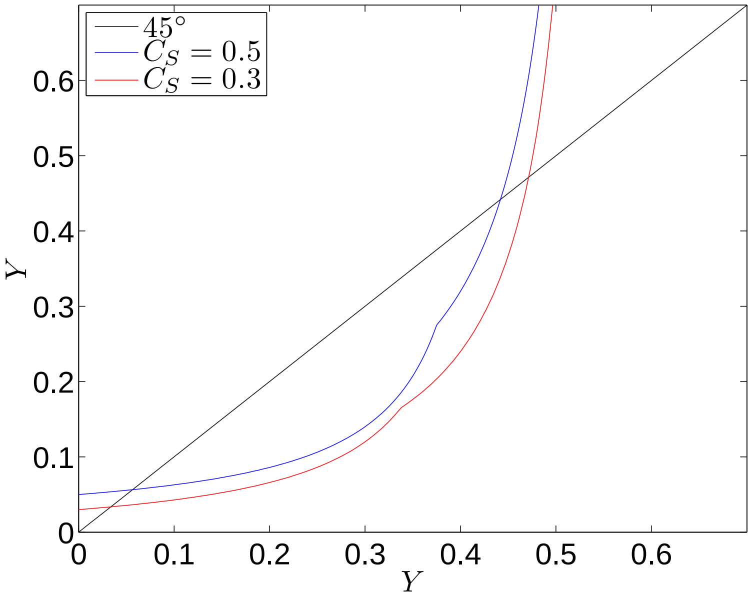


Illustration with $\lambda = 0.9$ and $\gamma = 0.1$



Fixed wage

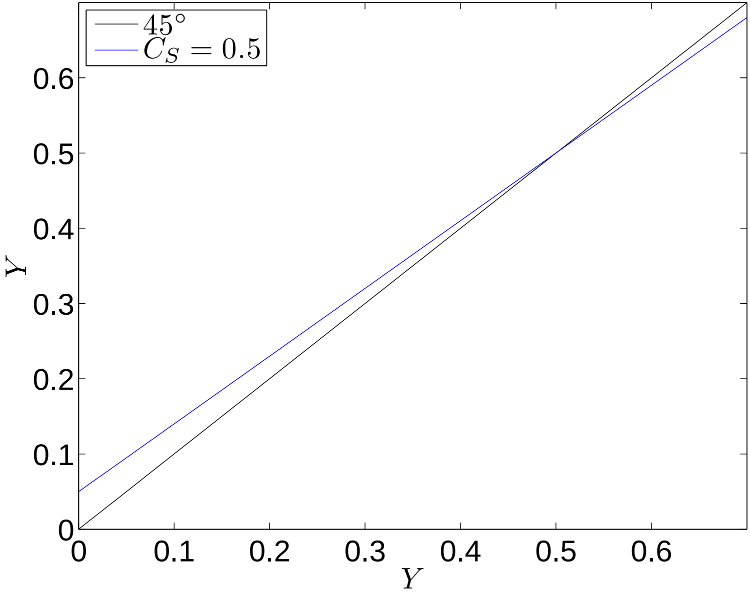
Labor rationing

Assume equal rationing $N_S = N_H = Y$

Keynesian cross

$$Y = \lambda w Y + (1 - \lambda) C_S$$

Illustration with $\lambda = 0.9$ and $w = 1$



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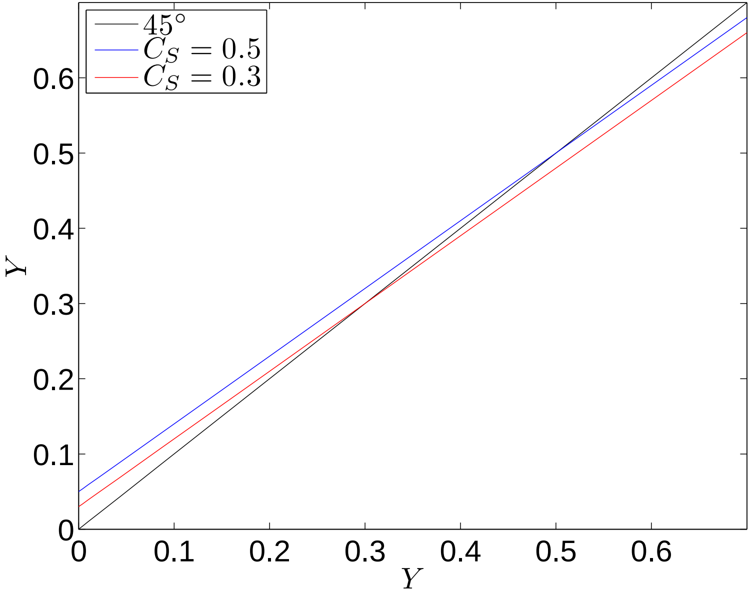

Punchline

- IADL may not be relevant even with wage flexibility
- Interaction LAMP with degree of wage flexibility important
- Model combining LAMP & wage stickiness very vauable