

Price Stability with Imperfect Financial Integration

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Abstract

This paper studies whether the international monetary system can be affected by asymmetries in the cross-country positions in the international financial markets, i.e., the fact that some countries are large debtors while others are creditors. An important channel that is explored is the interaction between international risk sharing and the stabilization role of monetary policy in each country. The main finding is that the welfare costs of incomplete markets and the gains of deviating from a policy of price stability are increasing with the cross-country asymmetries in the initial net international positions and in particular they become nonnegligible when the persistence of the shocks increases (1% of a permanent shift in steady-state consumption, for the welfare costs of incomplete markets, and 0.2%, for the gains of deviating from a policy of price stability). When global imbalances become larger, optimal monetary policy requires an increase in the volatilities of the real returns on assets and in particular of the nominal interest rates, which should happen to be more correlated across countries.

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