General Discussion*

One theme that arose during the discussion concerned the implications of real rigidities, such as distribution costs, limited participation, and cross-border shipping for exchange rate determination and the design of optimal monetary policy. Allen Head remarked that one of the challenges facing the developers of empirically satisfactory open-economy models is relaxing the tight relationship they generally predict between relative consumptions and real exchange rates. He then asked whether new approaches emphasizing distribution costs or limited participation may have implications for monetary policy analysis in a small open economy, or whether they are more likely to contribute to understanding exchange rate determination. In response to this, Brian Doyle suggested that the introduction of distribution costs into New Keynesian open-economy models may have implications for monetary policy by explaining the disconnect of exchange rate pass-through, which refers to the observed phenomenon whereby import prices respond considerably to exchange rate changes, while consumer prices respond minimally. Frank Smets added that recent research suggests that the incorporation of real rigidities associated with cross-border shipping of intermediate goods into small open-economy models can partially explain observed inflation and output persistence, a better understanding of which has obvious implications for the design of monetary policy.

The second principal theme that arose during the discussion concerned the implications of the persistence of shocks for the choice of pricing mechanism. Lawrence Schembri suggested that while New Keynesian open-economy models are derived from microeconomic foundations, they do not

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feature microeconomic foundations underlying the choice between local currency pricing and producer currency pricing. He added that the literature on New Keynesian open-economy models originally emphasized the distinction between temporary and permanent shocks, and concluded that local currency pricing was probably optimal if all shocks were temporary, while if all shocks were permanent, then producer currency pricing would obtain in long-run equilibrium. In response to the suggestion that the recent literature has overlooked the persistence of shocks and their implications for the optimal pricing mechanism, Doyle noted that a number of recent papers have modelled the choice between local currency pricing and producer currency pricing as endogenous, and suggested that the literature is evolving in this direction.