International Transmission of Shocks, Money Illusion and the Velocity of Money

The paper considers a benchmark New Open-Economy Macroeconomics (NOEM) model modified to allow for partial money illusion, and studies how this departure from full rationality modifies the design of optimal monetary policy in response to macroeconomic shocks to productivity. Next, it introduces shocks to money velocity and characterizes optimal monetary policy in a global Nash equilibrium.

The introductory section provides a good survey of developments in the NOEM literature over the last decade, but does little to build a case for the paper’s reliance on money illusion or the relevance of velocity shocks in the transmission mechanism. Section 2 restates the benchmark NOEM model with no value added in terms of original contributions. It would be useful to streamline these sections to give more weight to the original part of the paper that starts in Section 3.

Section 3 should be expanded, building on and moving beyond Shafir, Diamond and Tversky QJE 1997. For instance, I’d like to see a discussion of similarities and differences between money illusion and the notion of rational inattention popularized by Chris Sims in a series of recent contributions. Can we rationalize the tendency to think in nominal rather than real terms as a constrained optimum behavior in the presence of limits on agents’ ability to process information? Is this tendency affected by the historical (observed) track record of price stability, generating complacency and psychological inertia?

A more technical issue is why is money illusion introduced under the assumption that nominal demand \( W_H \) is systematically misperceived as \( (W_H)^{1/\xi} \). This seems a rather mechanical and arbitrary way of generating a departure from the full-rationality setup, with the specific log-linear parameterization adding an additional unwarranted restriction. The result that optimal monetary policy over-reacts to the shock (eq.27) is a direct implication of his restriction, but may not be robust to alternative parametric specifications of money illusion.

The paper never makes clear the relation between real balances entering the utility function in eq.1 and the money stance \( \mu \) on page 7. This is important for the discussion of velocity shocks in Section 4. In the context of the model, the monetary stance is literally the domestic supply of money, and given the way velocity shocks are introduced in the paper, they should be related to perturbations of the elasticity of utility to real balances \( \chi \) in eq.1 (thus considered as shocks to agents’ preference for liquidity). Alternatively, the equation on p.12 can be thought of as a statement that the money stance itself is subject to supply
shocks, thus the optimal monetary policy on page 13 would offset this policy “noise” as well as react to real shocks. The latter interpretation would be even more obvious in a variant of the canonical NOEM model without money in utility function, in which the money stance $\mu$ is defined in terms of current and future nominal short-term interest rates, assumed to be controlled by the monetary authority. No matter which interpretation one prefers, the welfare analysis of these money market shocks is rather trivial and adds little of substance to the literature.