Report on "Stock Prices and Monetary Policy: Re-examining the Issue in a New Keynesian Model with Endogenous Investment"

1 Short Summary of the Manuscript

The paper deals with a small scale New Keynesian model with endogenous investment. The authors envisage the possibility of bubble behavior to address two interesting questions: (i) first, should monetary authorities include financial indicators in their policy rule?; (ii) second, in response to which type of financial indicator should the policy rate be adjusted? In connection with the first question different views have been expressed in the literature and a clear consensus has not been reached so far. Bernanke and Gertler (1999, 2001) and Carlstrom and Fuerst (2007) conclude that there is no need for a direct response to asset prices. Conversely, Genberg, Lipsky, Cecchetti, and Wadhwani (2000), Di Giorgio and Nisticò (2007), and Pfajfar and Santoro (2012) show that there are conditions under which responding to asset prices misalignments may be beneficial for the sake of inducing dynamic stability. As to the second question, Pfajfar and Santoro (2011) have recently shown that whereas responding to asset prices misalignments from their frictionless level may represent a source of dynamic instability, adjusting the policy rate in response to asset prices growth does not harm dynamic stability and may promote determinacy by inducing interest-rate inertia.

2 Overall Assessment

I find the paper very well written. The research question is an interesting one and the model economy is competently designed. However, in my opinion some issues should be dealt with in the normative analysis to make sure that sound policy prescriptions are delivered.

3 Main Comments

1. A key result of the paper is that "the best performing rule of the traditional rules is output-aggressive instead of inflation-aggressive..." It is apparently surprising that the so-called 'output-aggressive rule' manages to stabilize inflation more than what is observed under an 'inflation-aggressive rule'. However, it should be noted that we face a model that does not feature any trade-off between output and inflation stabilization, as no supply shifter is at work. To generate a meaningful trade-off the New Keynesian Phillips curve could be augmented with a cost-push shock.

2. In my view the authors need to establish an appropriate metric to compare various rules, as the weights attached to the variables in the policy function are not optimally determined to minimize an overall criterion of welfare loss. For instance, it could well be the case that an optimally determined parameterization for the traditional inflation-aggressive rule

produces better results than that obtained under a rule that responds to the Tobin's q. This avenue needs to be explored before that results can be regarded as robust.

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