Financial market frictions and monetary policy in general equilibrium

Abstract

In the rst essay, we develop a dynamic general equilibrium model with endogenously segmented asset markets and examine the dynamics between monetary policy and asset prices when an economy is faced with nancial sector shocks. Under endogenously segmented markets, monetary policy alters nancial risk sharing by impacting both the consumption of the asset market participants (intensive margin) and the number of active market participants (extensive margin). In such a milieu, we rst show that the optimal policy calls for a countercyclical response to a nancial shock, in contrast to an in ation targeting policy which is pro-cyclical. Further, we analytically derive the equity premium and show that it moves inversely with monetary policy. In particular, we show that optimal monetary policy, by being countercyclical, results in a higher equity premium than an in ation targeting policy. In the second essay, we study optimal exchange rate policies when there are shocks to the nancial sector in a small open economy with segmented asset markets. In such an environment, we show that the state-contingent optimal policy, by being countercyclical, facilitates greater risk sharing between nancial market participants and non-participants. We also show that exible exchange rate regime mimics optimal policy and welfare dominates xed exchange rate regime. On contrasting xed and exible exchange rate regimes we nd that the exible regime mimics optimal policy and welfare dominates the xed exchange rate regime.

In the third essay, we study equity premium when there are shocks to the nancial sector in a small open economy with segmented nancial markets. In such an environment, we contrast the equity premium under xed exchange rate and exible exchange rate regime. We show that the exible exchange rate regime, by facilitating greater risk sharing among the participants and the nonparticipants, incurs lesser volatility in asset prices. By consequence, equity premium is also quantitatively lesser in magnitude under exible regime in comparison to the xed exchange regime.