Working Paper No. 531

Keep in mind

AUTHOR OR EDITOR

Juan David Prada

This paper analyses the role of a costly financial system in the transmission of monetary policy. The new-keynesian model for a small open economy is extended with a simple financial system based on Hamann and Oviedo (2006). The presence of the financial intermediation naturally allows the introduction of standard policy instruments: the repo interest rate and the compulsory reserve requirements. The model is calibrated to match key steady-state ratios of Colombia and is used to evaluate the alternative policy instruments. The financial system plays an important role in the transmission mechanism of the monetary policy, and determines the final effects of monetary policy on aggregate demand and inflation. Monetary policy conducted through the repo interest rate has the

standard effects predicted by the new-keynesian framework. But changes in the compulsory reserve requirement rate may generate, under different scenarios, totally different reactions on economic activity, and little quantitative effects on inflation rates and aggregate demand. Therefore this last policy instrument appears to be uneffective and unreliable.