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In this paper we set up a small open economy model with financial frictions, following Curdia and

Woodford (2010)'s model. Unlike other results in the literature such as Curdia and Woodford (2010), McCulley and Ramin (2008) and Taylor (2008), we find that optimal monetary policy should not respond to changes in domestic interest rate spreads when the source of fluctuations are exogenous financial shocks. A novel result here is that the optimal size of policy responses to changes in the credit spread is large when the disturbance source are shocks to the foreign interest rate. Our results suggest that such a response is welfare enhancing.

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