Discussion of Optimal Macro-Prudential and Monetary Policy

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CIMS conference
September 15 2012
Introduction

Some thoughts on macro with financial frictions and the crisis

1. The conventional view of the crisis
   - over-borrowing, too much lending
   - financial institutions allocate funds in bad projects (housing)
   - frictions located with highly leveraged intermediaries
   - policy implication: curb lending by intermediaries
   - countercyclical tools desired
Some thoughts on macro with financial frictions and the crisis

1. The conventional view of the crisis
   ▶ over-borrowing, too much lending
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2. Most macro models with financial frictions
   ▶ frictions act like a tax on factor inputs (typically capital)
   ▶ so factors are under accumulated
   ▶ holds in models with or without banks
   ▶ typically too little lending
   ▶ policy implication: subsidize lending !
What models align macro theory with policy discussion?

The debate in the UK

- raise the capital requirement on average
- for given bank capital, this requires reduction in loans
- how costly is bank equity issuance, how flexible is it?
- how easily can firms obtain non-bank finance
- make capital requirement cyclical
What models align macro theory with policy discussion?

The debate in the UK

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The models

- typically no equity-debt choice for banks
- typically no choice between different sources of firm finance
Summary of paper

The model

- habit, capital, investment adjustment costs, sticky prices
- banking sector friction as in Gertler and Karadi
- policy tools: interest rate and tax/subsidy on banks

The exercise

- Optimal monetary policy: discretion, commitment, simple implementable rules
- Add macroprudential tool: optimal steady state value and cyclical behavior
- concern for lower bound in practical way: limit on VAR(R)
Findings: Monetary policy only

- Discretion is worse than commitment
- This true even more so with financial frictions
- Optimized simple rules not much worse than commitment
- Lower bound sometimes a little bit of a concern
- Small (no?) benefit from responding to Tobin’s Q
- ‘Imposing ’ZLB increases welfare losses a little bit
My questions here

1. How do frictions affect loss function?
   - Edge has loss function in model with capital: complicated
   - CFP JMCB (2010): simple model with credit friction
   - welfare based loss function with credit spreads
   - but standard loss function is still pretty good

2. Is discretionary equilibrium unique?
   - Blake Kirsanova (2011): multiple equilibria in discretionary LQ
   - need endogenous states and strategic complementarities

3. The role of money and central banking
   - standard model, money demand does not matter
   - non-trivial interaction between commercial and central bank
   - for instance, CB lends reserves against collateral with haircut, study role of haircuts?
Steady state of the discretionary equilibrium

A lot of people do discretion like this
Steady state of the discretionary equilibrium

A lot of people do discretion like this
- linearize the model about a convenient steady state
- derive quadratic approximation to welfare
- solve an LQ problem under discretion
- think of it as a game between successive policy makers
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But the nature of discretion affects the steady state of the problem

- average inflation higher under discretion
- New Keynesian Phillips curve different with trend inflation
- Niemann, Pichler, Sorger look at this kind of problem
- I do not know what is done in this paper ...
Banking Frictions and macro-pru tools

The underlying banking friction
▶ bank may run away with part of assets (start of period)
▶ run: divert and never be allowed in business again
▶ no run: enjoy stream of future profits (franchise value)
▶ IC: gain from running < franchise value
▶ households adjust deposits so that IC holds at all times

The macro-prudential policy tool
▶ tax on bank loans finances subsidies to bank net worth
▶ and the scheme is revenue neutral!
▶ why does such a policy increase lending in steady state?
How does this scheme increase lending?

Paper stresses *incentive* effects of scheme, I think its about *feasibility*

- in itself, tax on loans reduces franchise value
- in itself, rebate via net worth subsidy increases franchise value
- balanced budget: two effects cancel in steady state
- why does this increase lending in steady state?
- my answer: its like restricting dividend payout ...
Comparative advantage in transferring wealth across time

How do banks accumulate net worth over time?
- bankers die with prob $(1 - \sigma)$
- in case of death, return from loans is transferred to households
- common device to prevent self-financing in long run
- I interpret this as dividend payment to shareholders in practice

How does policy tool affect banks net worth accumulation?
- government tax on loans are fully rebated back
- no leakage due to ‘dividend payment’ to shareholders
- I expect this raises steady state bank net worth
- this is equivalent to restricting dividend payout

Shortcut with similar outcome: make $\sigma$ a policy choice variable
Cost of the scheme and interpretation

- costly to run the scheme: 0.2% of steady state GDP (large)
- quote from the paper to achieve a steady-state of the Ramsey problem we found that $\phi \geq 0.75$ (equivalent to cost of 0.2%)
- why is there no solution for costs smaller 0.2% ?
- without cost, could achieve self-financing via tax and rebate ?
- could get rid of friction all together!

Close connection with crisis

- counterfactual: restrict dividend payments prior to 2008
- no need to bail out the big banks in UK
Discussing the findings

- benefits of macropru: steady state benefit big, cyclical small
- Lucas’macroeconomic priorities: mean matters!
- two instruments only better than one with commitment
- with discretion, one instrument can be better than two
- intuition: discretion is an existing distortions (second best)
- removing one of many distortions need not improve welfare
- question: does this depend on the shock
- squares well with my own work
Some digression

Compare to my work with Bianca de Paoli

- simple credit friction model
- A dynamic game between two policy institutions
- monetary authority and macroprudential authority
- compare co-ordination with Nash-equilibrium in the game
- under discretion: co-operation can give lower welfare
- intuition: co-operation exacerbates discretionary bias
- in our model easy to explain (conservative central banker idea)
- stems from narrow mandates in game
Summary

- very nice paper, pleasure to read
- can interpret their tool as restrictions on dividend payouts
- would like a model with over-borrowing
- would like a model where ‘standard’ central bank operations can have prudential effects,
  1. haircuts on risky assets can be prudential policy tool
  2. BoE Funding for Lending Scheme is like money financed subsidy to banks