Beau, Clerc & Mojon: Macro-prudential Policy and the Conduct of Monetary Policy

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Basic issue

- The financial crisis has shown that an unstable financial system can have enormous costs
  - Fiscal costs
  - Policy uncertainty
  - Recession
- This has renewed interest in financial stability policies
- This paper is about the interaction between these policies and the conduct of monetary policy, with a particular focus on the inflation goals of the central bank
  - Is there important interaction between these policies and, if so, how should the interaction be managed?
How do policies interact?

- Macro-prudential policies, in a nutshell, are designed to lean against the wind of financial booms/busts.
- If the inflation cycle and financial cycle are positively correlated then standard monetary policy and macro-prudential policy are *complementary*.
- If the inflation cycle and financial cycle are negatively correlated then the two types of policy are *conflicting*.
- Assessing the extent of complementarity or conflict requires knowledge of the shocks driving the business cycle.
  - “Demand” shocks lead to complementarities.
  - “Supply” shocks lead to conflicts.
The paper’s DSGE framework

- Utility over consumption, housing and leisure
- Two types: patient and impatient
- Borrowers and entrepreneurs are subject to borrowing constraints linked to the value of housing
- Otherwise fairly standard DSGE model with the usual host of business cycle shocks
- Model is detailed in AMM (2010): essentially like Iaccoviello with the possibility of risk-shifting a la Allen and Gale (2000)
- Banks don’t internalize the effect of their overlending on the probability of household default
The policy regime is one of the following four:

1. A plain-vanilla Taylor rule
2. A Taylor rule that is augmented to lean against the wind of credit growth
3. The plain-vanilla Taylor rule, and a separate policy regarding the loan-to-value ratio that leans against the wind
4. An augmented Taylor rule and a policy regarding the loan-to-value ratio
Do policies conflict?

- The directional responses to most shocks seem invariant to the policy rule.
- Loan-to-value ratio rules seem to have no marginal contribution if the augmented Taylor rule is adopted.
- Most shock responses are dampened by the use of macro prudential policies.
- The extent of conflict appears to be minimal, although the paper does not currently have welfare analysis or variance decomposition needed.
  - Comment 1: finish the paper!
Chiu (2011) (shameless plug for a student) has a model a la Holmstrom and Tirole (1997), Christensen, Meh & Moran (2011)

- In the model, financial frictions deepen the responses of macroeconomic time series to the standard business cycle shocks

Financial sector shocks do not account for much real variation, but are a significant source of variation in inflation

- These are neither demand nor supply shocks in the traditional sense
- It would be useful to develop some intuition about the possibility of complementarities or conflicts here?
- Also, financial shocks are reduced form: is their variance invariant to the policy regime?
Is leaning against the wind optimal?

- Even if inflation was not a consideration, the optimal policy response might depend on where the wind is coming from.
- Burnside, Eichenbaum, Rebelo (2011): a model of housing prices driven by expectations
  - No financial sector
- In the current paper, a housing boom would lead to a credit expansion, and M-P policy would lean against this.
- In the BER paper, the housing boom can be driven by correct beliefs or false beliefs.
- Without knowledge of whose beliefs are correct, unclear what policy should do: strike a balance?
Gut check

- Why are we interested (now) in these questions?
  - It’s because of the financial crisis!
    - The deepest and longest lasting recession in the postwar period
  - Leads me to ask: is there a tradeoff?
    - The question of a tradeoff seems a little “Greenspan-era”
  - My gut tells me:
    - The costs of the financial crisis are first order
    - The costs associated with inflation variation are second order
  - A slight twist on the question: How does M-P policy affect day-to-day inflation-policy making?
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Risk-shifting

- Role of government guarantees against systemic failure

- If “no guarantees” is not a credible policy then regulation is required
  - More capital doesn’t help if there are off balance sheet tricks to get around this

- “The financial crisis has shown that neither market discipline nor regulation and supervision of the financial system’s main components can prevent systemic risk”
  - Is regulation futile or was it simply inadequate?
  - Were Canada and Australia just lucky?
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Conclusion

- An interesting paper about an important question
- The quantitative analysis is incomplete, so it’s too early to see exactly where the paper comes down on the issue
- Suggestions?
  - Re-frame the issue in terms of how M-P policy affects the day-to-day conduct of monetary policy
  - Develop intuition about financial shocks
  - Think about implications of expectations-driven cycles