

Optimal Fiscal and Monetary Responses to Financial Shocks

Discussion by Luisa Lambertini

Banco de Espana Conference
Madrid, 26 February 2010

Plan of the discussion

- Goals of the paper
- Very selective review of the model
- Review of the important results
- Comments and questions about default, bank capital, securitization etc.

Goals of the Paper

Add a banking sector to a basic version of the NK model

Consider three financial shocks:

- Exogenous increase in the default rate on bank loans
- Exogenous increase in the bank's demand for excess reserves
- Exogenous increase in the cost of securitization

Show that optimal monetary policy of the basic NK model is also optimal here

Price stability is all that should matter for monetary policy, even when financial factors are present

Review of the Model

NK model with the following non-standard features:

- Cash- and deposit-in-advance constraints. A positive interest rate creates a distortion along the lines of the Friedman rule
- Exogenous and stochastic rate of default by firms on bank loans
- Banks:
 - ▶ Monopolistically competitive in the loan and deposit markets
 - ▶ Hold excess reserves in relation to deposits
 - ▶ Maximize p.d.v. of future profits
 - ▶ Can issue risk-free debt – in the paper this is called securitization
 - ▶ Dividend smoothing and securitization adjustment costs

Review of the Results

In response to an adverse financial shock output and consumption fall, inflation goes up and the central bank raises the nominal interest rate

Optimal monetary policy stabilizes prices in the intermediate good sector (with price rigidities)

A simple rule targeting intermediate good inflation is almost equivalent to Ramsey monetary policy

A simple rule targeting CPI does almost as well

(Dis)comforting news: all we learned about the basic NK framework holds true when some financial factors are incorporated.....

Ramsey fiscal and monetary policy: fiscal transfers can ease the balance sheet condition of banks and are non-distortionary. So, they should be used much more than standard monetary policy.

Comments and Questions

Do you really have a financial sector in your model?

Do you really have default, securitization, reserve demand?

Default

Default as an exogenous common output reduction $(1 - \delta_t)y_t$ accompanied by a proportional loan repayment reduction $(1 - \delta_t)l_t$

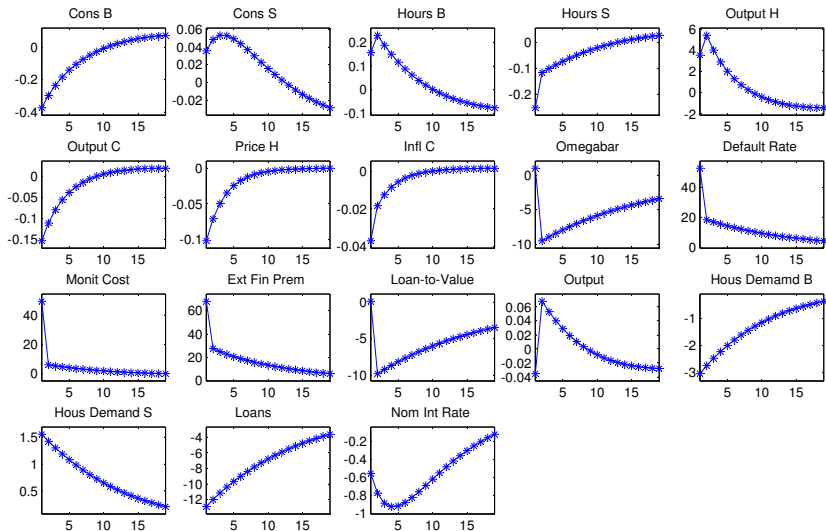
The external finance premium $R^L - R^A$ moves very little and it gives no amplification

It works like a negative technological shock. Inflation goes up and the nominal interest rate is raised both under the simple rule and under optimal monetary policy. No demand side effects.

During the recent financial crisis, inflation fell and interest rate were cut

Default rate is an endogenous variable that varies in response to shocks

Higher Riskiness of Mortgages



Securitization

In the paper: banks issue risk-free bonds paying the risk-free interest rate R^A . Loans increase.

In reality: move loans to off-balance sheet vehicles and then grant a credit line. Because of lower capital requirements for credit lines, banks could reduce the amount of capital held and issue more loans

These credit lines were *not* risk free. The toxic tranche typically kept at the issuing bank anyway

The model captures the increase in loans but it does not capture the increase in risk

It would be interesting to see the behavior of securitization in response to shocks

Technical Issues

The paper needs to be more clear about the equilibrium with securitization

With no dividend smoothing $\Phi_z = 0$ but securitization costs $\Phi_a > 0$, banks choose $a_t = a_t^*$

With no dividend smoothing $\Phi_z = 0$ and no securitization costs $\Phi_a = 0$, a_t is not determined

The choice of a_t^* must have welfare implications: as loans go up, economic activity goes up

Bank Equity

There is no bank equity in the model and banks do not have a meaningful choice between equity and debt. This would be an interesting extension.

With bank capital one can analyze bank regulation, capital adequacy constraints, Basel II, and reforms to bank regulation.

All this cannot be addressed here

Unconventional Monetary Policy

The recent financial crisis has witnessed many unconventional policy interventions

Consider alternative policy instruments: Gertler and Kiyotaki (2009) consider direct lending, discount window lending, and equity injections

Optimal Fiscal Policy

Your fiscal instrument is non-distortionary (lump-sum tax for households, lump-sum transfer to banks)

Ramsey analysis is not very meaningful

In the recent financial crisis, government interventions were equity injections. In your paper government interventions are transfers. You need to model bank capital for policy analysis.

Concluding Comments

Very topical paper; clear and neat

At the moment financial shocks are exogenous and some choices are not endogenous

A very good start and good luck with the extensions