Risk shocks and monetary policy in the new normal

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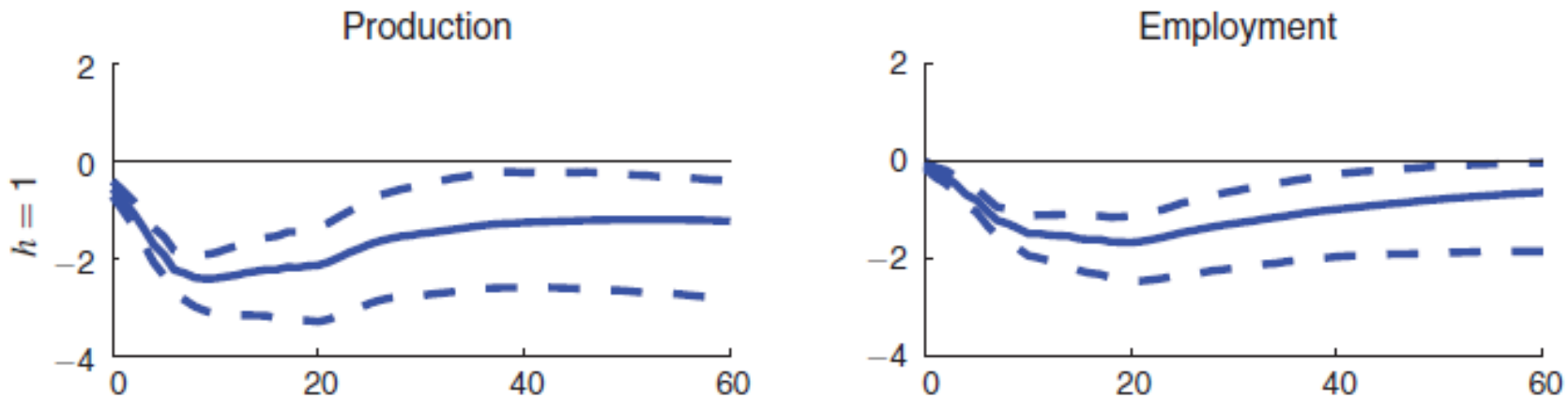
Plan of the Presentation

Why is it important?

- The paper checks how risk affects the economy in presence of the ZLB
- Important because:
  - Risk matters
  - So does the ZLB
- Strong empirical and theoretical support for both

Effects of risk

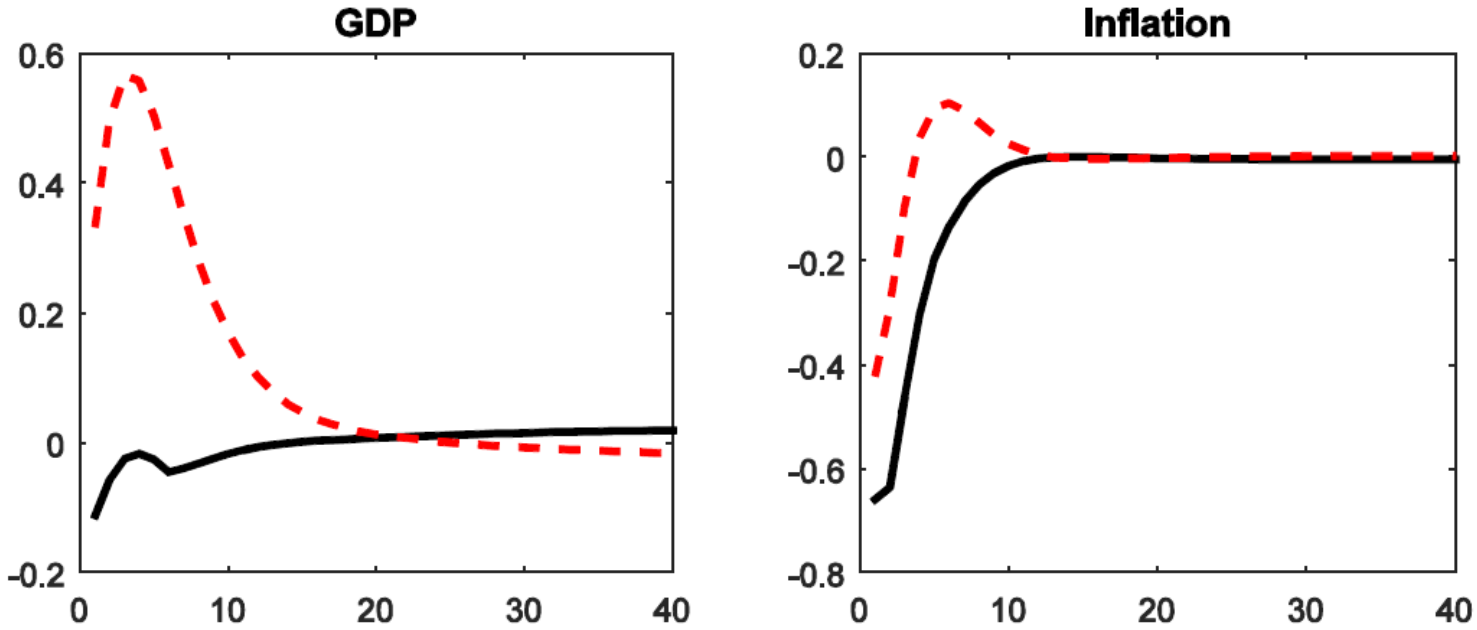
Impulse response of production and employment to risk shock from 11 variable VAR (1960:7-2011:12)



Source: Jurado, Ludwigson & NG (2015)

Effects of ZLB

Impulse responses to positive technology shock - normal times (dashed) and ZLB (solid)



Source: Brzoza-Brzezina, Kolasa & Szetela (2016)

This paper

- Standard 3-eq NK model with ZLB, solved globally
- Agents see the risk of hitting the ZLB
- They know that this implies deflation
- As a result they adjust their inflation expectations downwards
- Lower inflation follows - deflationary bias in stochastic steady state

Plan of the Presentation

Motivation and value added

- The motivation is clear and convincing
- But the paper should do more to distinguish itself from existing studies, e.g. Nakov (2007):
  - shows the impact of risk on dynamics at the ZLB under various monetary policy rules
  - shows that optimal discretionary policy involves a deflationary bias
- or Hills, Nakata & Schmidt (2016):
  - calculate risky ss in NK model with ZLB

Robustness

- Some examples in the literature where risky steady state can change dramatically with assumptions
- How robust are the results to choice of utility function?
- Here log utility - relatively low risk aversion. What about much higher risk aversion (e.g. in Epstein & Zin 1989)?
- Example: NFA position of a SOE in risky ss depends crucialy on amount of risk

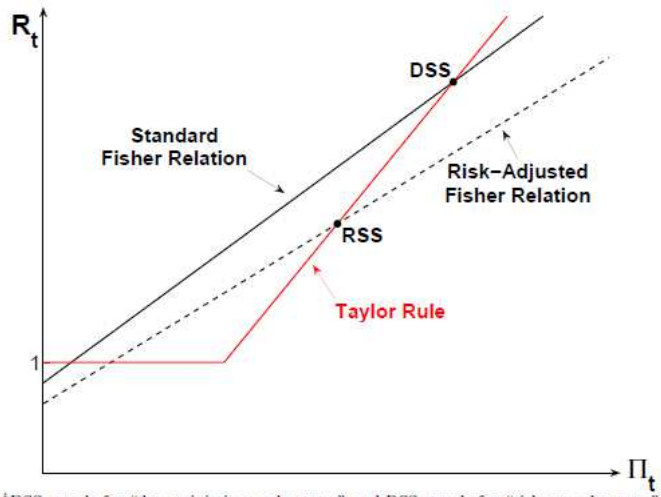
σ_y	$\overline{w}$
0.01	−0.161
0.025	0.0
0.05	0.607

Source: Coeurdacier, Rey & Winant (2011)

Implications for monetary policy

- So what are the policy conclusions?
- Policymakers should respond to changes in risk perception. But how?
- Should they raise inflation targets? This entails a cost (see Coibon, Gorodnichenko & Wieland 2012).
- Should the central bank adjust the slope or intercept in the TR?

Figure 4: The Risk-Adjusted Fisher Relation and the Taylor Rule



†DSS stands for "deterministic steady state," and RSS stands for "risky steady state."

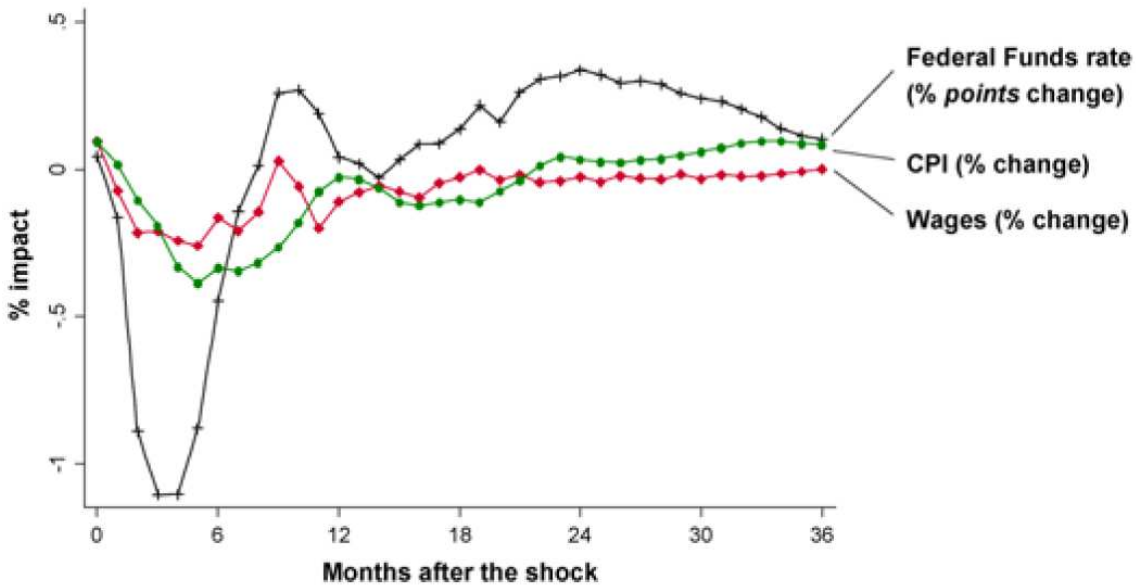
Source: Hills, Nakata & Schmidt (2016)

Plausibility (1)

- We are used to think of clever, rational agents as inhabitants of our models
- They solve linearized DSGE models to make rational forecasts
- We know people are less sophisticated
- But these guys are even more sophisticated: they react to the interaction between perception of higher risk and the ZLB
- Even less sophisticated results seem overblown - e.g. forward guidance in DSGE models
- Can you streghten the motivation by some empirical examples?

Plausibility (2)

- In the existing empirical literature risk shocks look rather like demand-type



Source: Bloom (2009)

- Would you be able to show they become supply-type close to the ZLB?

Summing up

- Nice paper and important topic
- Some work on robustness, policy conclusions and support of plausability would help (I guess)
- Thank you