Discussion of:

Financial Stability Considerations and Monetary Policy?

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KS: Three Main Points (with which I mostly agree)

1. Federal Reserve should have central role in maintaining financial stability.

2. Macropurdential policy provides best way to reduce likelihood of a crisis:
   - As opposed to monetary policy

3. Existing macroprudential toolkit may not be adequate
   - Some tools do not exist
   - Some are ambiguous or at least not "battle tested"

* Qualification: reg/sup advances post Dodd Frank → banking system much safer
Monetary Policy and Financial Stability: Big Picture.

- Policy objective: Output at full capacity with price stability.

- Maintaining financial stability an intermediate target.
  - Critical for achieving output and price stability goals.

- Not new idea: Lender of last resort function key motive for founding of Fed.

- What's different today? Evolution of financial markets:
  - Liquidity provision and systemic risks extend beyond commercial banking →
  - LOLR policies extend beyond commercial banking sector
  - Requires broader measures to protect financial system (e.g. macropru)
MP Framework Under Frictionless Financial Markets

\[ \hat{y}_t = f[(r_t^n - E_t \pi_{t+1}) - r_t^*, x_t]; \quad f_1 < 0 \]

\[ \pi_t = g(\hat{y}_t, z_t); \quad g_1 > 0 \]

\[ r_t^n = r_t^* + \pi + \phi_n(\pi_t - \bar{\pi}) + \phi_y \hat{y}_t \]

"Neutral" real rate \( r_t^* \) provides benchmark for policy but also constrains policy.

\( r_t^* \) is a moving target: depends on growth, saving, preference for safety, etc.
Real Rate and Neutral Rate

Source: Holston, Leubach and Williams (2017)

Output Gap and Inflation

Core Inflation y/y (right)

GDP Gap (left)
Adjustment for Financial Imbalances?

- Should Fed raise rates to offset "excess" credit or asset price growth?

- Issues
  - Trade-off: reduces output/inflation (also potential loss of credibility)
  - Difficulty identifying imbalances
    - Credit booms can be "good" as well as "bad"
    - True also for asset price booms
      - Not all asset price busts have disastrous effects (2001 Nasdaq correction)
  - Uncertain how rate increases will affect credit/asset prices
  - Not clear that raising rates reduces financial vulnerability
    - Rate increases reduce asset prices.
Figure 1. Actual and Counterfactual Outcome for the Policy Rate, Inflation, Unemployment, and the Household DTI Ratio

Integrating Financial Stability Considerations

\( r_k^t \equiv \text{required return on capital}; \ \chi_t \equiv \text{excess return} \)

Conditional on a financial crisis:

\[
 r_k^t = \chi_t + r_n^t - E_t \pi_{t+1}
\]

→

\[
 \tilde{y}_t = f[(\chi_t + r_n^t - E_t \pi_{t+1}) - r_t^*, x_t]
\]

Financial Crisis

\[
 \chi_t \uparrow \rightarrow \tilde{y}_t \downarrow
\]

Challenges for central bank

Ex post: offset the impact of \( \chi_t \) (via monetary and LOLR policies)

Ex ante: reduce likelihood of crisis (via macroprudential versus monetary policies)
Ex Post Interventions

- Ex post: Use monetary policy tools
  - Conventional interest rate adjustment (including forward guidance)
    * Offset impact of $\chi_t$ on cost capital →
    * Deviate from Taylor rule
      \[
      r_t^n = r_t^* + \pi + \phi_\pi (\pi_t - \pi) + \phi_y \hat{y}_t - \phi_\chi \chi_t
      \]
  - Unconventional
    * Directly reduce $\chi_t$
    * Examples
      - Libor spread → Term Auction Facility and related liquidity policies
      - Commercial paper spread → CP funding facility
      - Mortgage Spreads and Term Premia → LSAPs (i.e. QE)
Larger Scale Asset Purchases as "Ex Post" Interventions

• LSAPs reflect central bank intermediation.
  - Fed funds long term assets with short term debt (interest bearing reserves).
    * Government bond LSAPs reduce "excess" term premia
    * AMBS purchases reduce "excess" mortgage spreads and term premia

• LSAPs most effective when private intermediaries are under stress
  - Useful crisis tool:
  - Limited effect in normal times:
    * Term premia may vary for reasons other than LSAPs
    * i.e., Currently compressed term premia likely reflect forces beyond the Fed!
MacroPrudential as "Ex Ante" Policy

- Three (interdependent) spheres of potential financial vulnerability:

1. Commercial banking
2. Nonbanks just outside the regulatory perimeter (e.g. shadow banks)
3. Non-financial borrowers

- General consensus: macropru has reduced risks in commercial banking (1)
  - Higher capital/liquidity requirements; stress tests; FSR, CCyB

- KS: Less progress with (2) and (3)
  - FSOC has limited authority: Main tools: "Comply or Explain"
  - Though norm amongst financial stability committees (Edge/Liang, 2017)
Macroprudential Policy in the Interim

- First objective of macropru: avoid disasters
  - Protect core banking system
  - Banking collapse accounted for $\geq$ half the output decline during GR
    - Gertler/Gilchrist, Aikman et. al., Bernanke
- Strong capitalization of banking system a good first step.
  - Well capitalized banks can’t perfectly offset limits to macropru toolkit
  - But can help avoid disasters
- Also critical to have leverage over systemically relevant financial institutions on regulatory perimeter (think Lehman, AIG, etc)
- While threats may currently not exist, history suggests regulatory migration
  - Next crisis will likely involve new generation of shadow banks.