

Discussion of “Optimal Monetary Policy Under Financial Sector Risk” by S. Davis and K. Huang

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Disclaimer: Views are those of the author and not those of the Bank of Canada

Outline

1. Brief summary of the paper
2. Comments
 - a. Three main suggestions
 - b. Other comments
3. Conclusion

Brief Summary



Context and objective of the paper

Context

- The recent global financial crisis clearly demonstrated that price stability and financial stability are inextricably linked, and pursuing the first without due regard for the second risks achieving neither

Goal

- Examine how monetary policy should react to periods of financial stress in a an open economy
 - Should central banks (CB) incorporate domestic or foreign interbank lending spreads into a Taylor type rule?

Overview of model

- Construct a standard two-country DSGE model with many frictions and rigidities ; build on Davis (2010)
- Financial accelerators a la BGG
 - But, net worth of **both** banks and entrepreneurs matter ; Not just that of entrepreneurs
 - Banks and entrepreneurs face endogenous default risks
- “Risk shocks” a la CMR, but now in banking sector
 - Key shock in this model and it is the financial shock
- Two type of shocks (productivity shocks and financial shock) at home and abroad
- CB can follow simple Taylor rule augmented with lending spreads and nominal exchange rate

Highlights of results

Key result

- CB should adjust the policy rate directly in response to **exogenous** changes in the domestic and foreign interbank lending spreads; But not to any **endogenous** variations in the spreads
 - endogenous variations in spreads contain no new info that is not already contained in output gap and inflation

Related result

- Targeting the nominal exchange rate affects the nature of policy responses to changes in lending spreads
- Trade-off between exchange rate stabilization and financial stability following **domestic financial shocks**
 - Exchange rate stabilization: **contractionary** monetary policy following domestic financial shocks
 - Financial stability: **expansionary** monetary following domestic financial shocks
- No Trade-off between exchange rate stabilization and financial stability following **foreign financial shocks**
 - Both exchange rate stabilization and financial stability : **expansionary** monetary policy

Comments



Comment 1: Policy-relevant question and important role of banking-sector “risk shock”

- Enjoy reading the paper. Very nice paper!
- Paper is addressing an important policy-relevant question and it is very topical especially in the wake in the financial crisis
- CMR showed that the “risk shock” is essential to explain the observed behaviour of credit spreads and economic activity
- The paper introduces the risk shock in the banking sector . **More interesting since it will affect directly the supply of credit**
- But, it may be useful to examine the **interaction between the two risk shocks** as both demand and supply of credit will be affected simultaneously:
 - see whether they complement each other or substitute for each other
 - to which extent the results are affected

Comment 2: Macroprudential tools first line of defence against financial stress and monetary policy plays supporting for role financial stability

- Extent to which monetary policy may be used to deal with financial stability will depend in part on the availability of macroprudential tools
- **First line of defence** is regulatory tools such as countercyclical capital buffers recently introduced in Basel III
 - Increase capital requirement in upturn; decrease capital requirement in downturn
- **Monetary policy can play a supporting role** especially when the financial stress is due to the conduct of monetary policy
- A complete analysis of the nexus between monetary policy and financial stability requires to take into account the interaction between monetary and macroprudential policies
 - This can be studied in the current model

Comment 3: Price stability does not guarantee financial stability

- CB reacts only to exogenous fluctuations in spreads; CB does not react to endogenous fluctuations in spreads since reacting to inflation and output also generates financial stability
- Although result is intuitive in the model, it should be interpreted with caution in practice. For example, can one **distinguish** between exogenous and endogenous variations in spreads?
- Lessons from the recent crisis
 - Recent crisis shows that pursuing price stability does not guarantee financial stability
 - In fact, the seeds of the next crisis is created in tranquil periods (e.g. Low interest rate and “Great Moderation”)
- **Excessive risk-taking by banks** (excessive leverage) is being introduced in standard macroeconomic model
 - See Woodford (2011), “Monetary Policy and Financial Stability”

Other comments

- Not clear why the paper uses an **ad hoc loss function** since welfare is well-defined metric in this model
 - In fact, a second order approximation of welfare in a model with financial frictions gives a loss function that depends on usual variables but also on “credit spreads”
- Since the results are compared to the solution of the Ramsey problem, suggest that the **Ramsey problem** be set and clearly shown in the paper
- Since risk shock (financial shock) plays important role for the results in the paper, needs to **estimate** the model to see how much this shock can explain the data
- When entrepreneurs can borrow from foreign banks, their share of debt coming from foreign banks is **exogenously set at 50%**. Why? Maybe for technical constraints. But, this share is likely to be endogenous and affected by policy

Conclusion

- Very nice paper, topical question, nice model
- I look forward to read future research using this model

Thank you

