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 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
Other comments

- Not clear why the paper uses an **adhoc 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